A Practical Analysis of Transfer Pricing Methodologies for Bilateral Advance Pricing Arrangements

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Abstract

I was previously Director of Mutual Agreement Procedures, National Tax Agency (‘NTA’), in Japan. This paper was written during my stay at Columbia University as senior visiting research scholar. I hope that this paper will lead to further discussion of practical aspects of Transfer Pricing Methodologies for Bilateral Advance Pricing Arrangements. The opinions expressed herein are my personal views and do not necessarily reflect organizational or state positions.

It is desirable for multinational enterprises to minimize the risk of economic double taxation arising as a result of transfer pricing adjustments. Such economic double taxation should be, if at all possible, addressed under the condition of rational income allocation between countries. For this purpose we need practicable transfer pricing methodologies. Furthermore, it is better if we have an efficient bilateral framework in which to settle transfer pricing disputes. There is some possibility that Bilateral Advance Pricing Arrangements (‘BAPA’), where Transfer Pricing Methodologies (‘TPMs’) are mainly based on profit methods, can be a reliable way of resolving these disputes. Looking to the past, actual results of BAPA between Japan and the United States may be viewed as a successful model whereby tax authorities have reached agreement in a considerable number of cases of various types related to both inbound and outbound transactions.

In this paper, which is intended to be highly supportive of the BAPA, I enumerate the practical points at issue, after taking note of world currents in transfer pricing taxation. I also express some important items for development of the BAPA.
I. Currents in Transfer Pricing Taxation

The present international standard of transfer pricing taxation is the 1995 Transfer Pricing Guidelines (‘Guidelines’) published by the Organisation for Economic Co-operation and Development as a sort of “soft law.” The world current of transfer pricing taxation since 1995 has three aspects: the proliferation of countries taking serious interest in such taxation, the trend toward profit methods, and the increase in use of BAPA.

First, as related-party transactions have spread quantitatively and geographically, European countries have seemed to strengthen their policies regarding transfer pricing since the late 1990’s. And many Asian and Latin America countries have introduced transfer pricing legislation and adopted policies toward transfer pricing. Most of these countries, reflecting both the OECD’s outreach activities and tax practitioners’ guidance, have developed transfer pricing regimes that include profit methods as TPMs and the framework of BAPA as an administrative approach for resolving transfer pricing disputes.

Second, with regard to the hierarchy of TPMs in each country’s regime, most countries prioritize the three traditional transactional methods over profit methods. In the United States, however, there is no fixed hierarchy among TPMs and regulations require use of the best method. There seems to be some tendency toward profit methods gradually becoming mainstream in practice because, in many cases, there has been difficulty in identifying comparable transactions allowing use of the traditional methods. Furthermore, considerable experience with practical applications of profit methods has developed, mainly in the United States, including discussions of intangibles, income from services, and cost sharing arrangements.
Third, there has been an increase of usage of BAPA as a transparent and user-friendly framework to resolve transfer pricing disputes. A fairly large number of countries seem to be accumulating relevant experiences. BAPA can be used as a framework by which economic double taxation can be avoided in advance under certain understandings and in full recognition of some flaws, including the practical difficulty of the Arm’s Length Principle and some of the weaknesses of profit methods.

In addition to these world currents in transfer pricing, the rich harvest from discussions relevant to transfer pricing taxation in the OECD has been important, including ‘attribution of profits to permanent establishments’ and ‘tax issues relating to business restructurings’ as extensions of the Guidelines; ‘comparability’ and ‘profits methods’ with a view to monitoring application of the Guidelines; and ‘improving international tax dispute settlement procedures’ and ‘reaching out to non-OECD economies.’

At present, transfer pricing legislation throughout the world mostly includes the framework of BAPA and the TPMs of BAPA are mostly based on profit methods. Therefore, the first and second trends mentioned above have much to do with the development of BAPA. In this article I focus on the practical points of issue regarding TPMs for use in the BAPA.

II. Points of Issue in Practice

Currently in Japan, BAPA cases occupy more than 70 percent of all mutual agreement procedures. Thus, BAPA plays a significant role in resolving transfer pricing disputes. The Advance Pricing Arrangement was introduced in Japan together with the transfer
pricing regime in 1986. In 1991 the United States introduced a system that assumes a bilateral framework through the mutual agreement procedure and the use of profit methods. The NTA has taken a positive stance towards the BAPA since the early 1990’s, accepting that the BAPA framework can effectively assist taxpayers by eliminating uncertainty with respect to the tax treatment of international transactions. In this way the NTA provides a tax environment that is favorable for investment. Around the mid-1990s a considerable number of Japanese corporations that had economic double taxation risks on related-party transactions between Japan and the United States entered the BAPA and proceeded to solve problems of past business years by rolling back the TPM of BAPA. Many of these corporations have since renewed the BAPA several times. Starting in the early 1990s, transfer pricing examinations were routinely carried out in Japan and economic double taxation risks in Japan have gradually increased as they had previously in the United States. Until now the BAPA has functioned well in various types of transactions in both investment directions. The United States is basically a pioneer of the most appropriate TPMs. And in the BAPA process these TPMs have been arranged, applied, and developed on a case-by-case basis.

Until now the NTA has succeeded in almost all the BAPA cases and the time from application to final agreement of BAPA cases is two years on average. There are some cases involving complex related-party transactions in which three or four years have been needed to reach agreement, but the kinds of BAPA cases that had been stalled for a very long time in negotiations are today non-existent. As of June 2006, the NTA has BAPA cases in inventory with 16 countries in all. Japan is one of the most practically experienced countries in the world, mainly because of its history with the United States.
A. Features of the BAPA

Coverage by the BAPA is ordinarily five years on average. In practice, most BAPA agreements are concluded after two or three coverage years either have or almost have elapsed. The BAPA literally means an ‘advance’ arrangement, but corporations often have difficulties predicting their operating profit five years in advance. Equally, tax authorities have difficulties reaching agreements based upon distant future profit prospects. The BAPA, with many critical assumptions, may not substantially enhance predictability. The appropriate time to reach a BAPA agreement is when the corporation can, to a certain extent, foresee business conditions for coverage years to come. That is one of the keys to success for operating the BAPA.

With regard to the practical advantages of the BAPA, a cooperative spirit and atmosphere can advance the information flow among all parties involved and the mutual agreement procedures may often lead to a sharing of a certain sense of direction toward a final agreement. Furthermore, once a BAPA is agreed, accumulation of relevant information may require fewer resources for renewals. BAPA is therefore an efficient framework for a long term. On the other hand, corporations, especially small businesses, hope to find less costly and time-consuming procedures for using the BAPA. And some people may be concerned about such features of the BAPA as its somewhat flexible approach.

There are certain limited types of transactions in which the BAPA can not work well. For example, when the content of a contractual arrangement between related parties is significantly different from the actual risk profile of the respective parties, the choice of a TPM may be difficult. And in the case when legal and/or economic ownership of
significant intangible property is transferred to a foreign subsidiary, recognition of the transfer in the context of transfer pricing taxation may itself be a disputed point. Moreover, although the issues are rather different than with the above examples, if a corporation intentionally manipulates the transfer price in order to realize higher operating profit in a lower tax rate country or to produce net operating losses, tax authorities may be more cautious in the procedure for renewal. That means negotiation for a renewal may be quite contentious.

B. Survey of TPMs of the BAPA

The TPMs generally used in the BAPA are profit methods that are consistent with the Transactional Net Margin Method (‘TNMM’) or the Profit Split Method (‘PSM’) as described in the Guidelines. A hybrid of TNMM and PSM might be the most appropriate method in some cases. In general, the important aspects of determining a TPM for a BAPA are first to make a choice between TNMM and PSM and, second, in using the TNMM, to make a choice of the most appropriate Profit Level Indicator (‘PLI’). The TNMM is sometimes considered to be the default TPM of BAPA because there is a high possibility of finding comparables with a certain extent of rationality in many types of industries. Cherry picking of comparables is undesirable and selecting comparables with a transparent procedure is important.

Among the types of PSM, at present the Residual Profit Split Method (‘RPSM’) seems to be a key method, because (1) it is logically clear in that consolidated profit is divided between a basic return generated by function and a residual profit generated by non-routine intangibles; (2) the basic return is determined by reference to market returns
and (3) RPSM assumes that all residual profit should be attributable only to the contribution of non-routine valuable intangibles and so it can lead the final conclusion by a determination of the relative proportion of the value of non-routine valuable intangibles without requiring a determination of the absolute economic value of such intangibles. It is also generally understood that the PSM approach, including contribution analysis, is often applied as a backstop test of the reasonableness of other methods. Some practitioners consider the consolidated profit rate as the starting point of analysis.

A discussion of transfer pricing requires economic analysis, but such analysis is generally based upon facts represented in financial statements as well as in other tax-related matters. Intangibles developed internally, a products portfolio, an organization description, the long-term relationship with customers, and the actual value of subsidiaries are not listed on a corporation’s balance sheet and the book value of tangible property is only a proxy of fair value. In the economic analysis we should appropriately use the financial statements with sufficient understanding of such features and limits.

An advance consultation with tax authorities before entering a formal BAPA will help the taxpayer and authorities efficiently move through the BABA. In the advance consultations it is important for both countries’ tax authorities to understand the transactions in question, in order to determine the framework of the TPM and to recognize potential alternative TPMs.
C. TNMM

1. Selection of the PLI

With regard to the choice of the most appropriate PLI, some points may be observed. We sometimes face the argument that ‘the tested party is the commission agent under the contractual arrangement between related parties, so such a party should be characterized as a mere service provider, and the TPM should be cost plus a low margin.’ However in certain cases this mechanical logic might be inappropriate. For example, when the tested party’s various types of day-to-day service to large customers with sophisticated products significantly contributes to maintaining long-term business relationships, the tested party may not be a mere service provider, even though there is no doubt that the most essential economic value is the quality of the product and the tested party performs little in the way of marketing functions.

The economic value of services has increased in the world economy. That should be properly appreciated in the context of transfer pricing taxation. Services vary from commission business to innovative pioneering of new business. With regard to the latter cases, in the starting stage when a business framework is initially structured profitability is low, but in later stages it becomes higher because the business basis and practical knowledge obtained by the investment can be used to advantage. In some cases the parent corporation prepares and forms the business framework by its ideas and expenditures and in the stage when the business reaches profitability the parent has the local subsidiary engage in the operating business and itself performs only managerial functions. In this stage something of the contractual value might be viewed as having been transferred from the parent corporation to the subsidiary and some transfer pricing issues akin to a
transfer of contractual value may occur in practice after the business sets up and begins to return a profit. Considering the TPM for the service industry, as the case may be, we may assume a license of intangibles. The most appropriate TPM in the service industry is, on a case-by-case basis, (1) Cost Plus Method (‘CP method’) as consideration for intra-group services, or CP method with a higher mark-up as consideration for something of greater value, (2) Resale Price Method (‘RP method’) based upon net sales, (3) Comparable Uncontrolled Price Method (‘CUP method’) for a management fee, (4) Contribution Analysis of PSM under the joint venture model and (5) RPSM under the condition that both related corporations hold non-routine valuable intangibles.

In applying Return on Costs (‘ROC’) for a case where the tested party is an assembler in a developing country but local comparables are full-fledged manufacturers, some recognition of the difference is important. An assembler’s ratio of processing expense to total costs is relatively low and the external manufacturer of material brings about relatively high value added. On the other hand, a full-fledged manufacturer’s ratio is relatively high and it brings about relatively high value added. These are the differences in value added structure and cost structure between an assembler and a full-fledged manufacturer. Thinking of value added of an assembler as a tested party only processing expense is important because the assembler purchases most significant material from the parent corporation without assuming any risk; for an independent full-fledged manufacturer total costs may reflect its value added because both processing expense and purchasing expense of material reflect its function and risk. In applying TNMM using ROC as a PLI, costs of the tested party times operating margin/costs of comparables should be calculated. A problem emerges regarding the
appropriateness of costs of the tested party and of costs of the comparables as a denominator. In general, process expense may be better for the tested party but that may have some weakness for comparables because the risks of purchasing materials from a third party are neglected. However especially in a case where a tested party’s ratio of processing expense to total costs is extremely low and so purchasing expenses heavily occupy total costs reflecting the value added brought about by the parent corporation, processing expense should be better for the tested party and a better denominator for comparables, because an inappropriateness of using total costs in the tested party is assumed to exceed an inappropriateness of using processing expense in comparables.

In applying Return on Assets (‘ROA’) for the case where fixed assets for the use of assembly activity of the tested party is for some reason booked by a foreign parent corporation, operating assets thus provided for substantial use by the tested party may be the best denominator for a consensus between respective tax authorities. Otherwise, the ROA is inapplicable.

With regard to the PLI for manufacturers or assemblers, ROA is not usually reliable when the interrelation between profitability and the level of operating assets is small for the tested party and/or a substantial difference in asset-intensity and asset structure between the tested party and comparables exists. On the other hand, ROC is not reliable when the ratio of the related transactions to total costs is not small because the denominator is affected by related transactions. Thus, the issue of appropriateness and reliability as between ROC or ROA involves a variety of factors that are very difficult to
evaluate as a general matter. Therefore, the choice between these PLIs is made according to the facts presented. Further development of this comparison may be expected.

Return on Capital Employed (‘ROCE’) is preferred as a method for measuring return on resources or investments and as a test for the presence of barriers to entry. Return on Equity (‘ROE’), which is net income divided by the book value of the equity on the balance sheet, measures returns to the owners of the business. A company earning money can elevate its ROE by raising debt and reducing the portion of assets funded by equity without in any way improving its operations. More debt generally means more risk, but ROE by itself provides no information on debt levels. ROCE solves that problem by treating both debt and equity as invested capital. Also, in transfer pricing analysis ROCE is a theoretical PLI, but in some cases it might seem very complex.

2. Selection of Comparables

In selecting qualified comparables from publicly available financial data, a detective approach is desirable in light of the goals of transparency and objectiveness. When more than one database is available, one database should be primary and others may be used for confirmation. A database ordinarily provides raw data disclosed by the corporation and processed data through footnotes and the like based upon the database company’s policies. How we should deal with processed data, such as the treatment of expenses of restructuring, downsizing, price protection expense, division of costs of goods sold, and sales and general administrative cost, may be points of argument.

When examining the difference in goods or products, sensitivity to the business cycle and business environmental change is important. On this point the semiconductor
and related industries are unique. In excluding crucially different corporations in the sales scale by setting a certain threshold, when products or goods are not necessarily similar between the tested party and comparables and the level of sales comparables is lower than that of the tested party, whether such threshold would enhance comparability should be examined. When the profit level of the whole business segmentation is extremely depressed, as the case may be, there may be some possibility that independent corporations experiencing losses are included in a comparables set, except for bankrupt corporations and corporations lacking financial data.

In general, renewal cases in the BAPA can be handled efficiently because the comparables set that was agreed on previously can be referred to. However, it is important to take note of any change in business conditions, any change of function and risk profile of the tested party, and the like. To mechanically pour data of the tested party into the mold formed in the past may lead to an outcome that is remote from one based upon the Arm’s Length Principle.

3. Adjustment of Differences

With regard to working capital adjustments, in BAPA in Japan, accounts receivable, accounts payable, and inventory are generally adjusted for an income statement-based PLI on the ground that capital used for the business in such items yields additional profit. Whether inventory should be adjusted is a particular point of issue because there is a viewpoint that the optimum level of inventory is ordinarily determined by the supply and demand prospect in the business environment, not by financing or working capital.
However a flexible way might be taken on this point because no one predetermined view is absolutely right.

On the other hand, accounts payable are only adjusted under a balance sheet-based PLI because accounts receivable and inventory are included in the denominator. In general, the level of comparables is adjusted to that of the tested party. One point of issue is which interest rate should used in making a working capital adjustment. Sometimes practitioners’ opinions about this subject differ and the matter may delay the BAPA. To enhance consistency and accelerate negotiation in the BAPA, some reasonable numerical proxy in each market might be recommended. If inventory is adjusted, there are two ways of doing so. One is that the interest rate for use in the inventory adjustment is the same as that for use in adjusting the other two items; the other is that the interest rate for the inventory adjustment should be higher than for accounts receivable and accounts payable because inventory may be financed not only with short-term debt but also with long-term debt and be related to not only credit risk but also economic risk. In Japan’s practice of the BAPA the former approach is the usual one. Furthermore, there is a viewpoint that not only accounts payable but also Non Interest Bearing Liabilities (NIBLEs) on the whole should be adjusted, for example in the case of a large amount of NIBLEs. However, on this matter there is no generally accepted theory and the discussion is not mature.

With regard to Property, Plant & Equipment (PPE), the viewpoints of economists for the reliability of an adjustment vary. Some practitioners think an adjustment is reliable and important. In Japan’s practice of the BAPA, PP&E adjustments are not
common. In my personal opinion whether this adjustment enhances comparability is uncertain because valuing PP&E is very difficult as a practical matter.

Start-up adjustments may be most influential in cases where the tested party needs a large scale of plant and equipment investment, but the comparables do not. The actual conditions of such investment vary. The impact of such investment on profitability depends on the scale of the investment and the business conditions when the investment occurs. Adjustment should be considered when plant and equipment are significantly expanded and such added investments significantly influence profitability.

In examining the operating margin of the tested party, special expenses in the start-up, but not found at the same point in time in the comparables, should be excluded from the actual result of operating margin. In case ROA is used as a PLI, the tested party’s operating assets that actually contribute to profitability should be used exclusively, so constructive tentative accounts and assets that do not yet operate should be excluded. Whether depreciation occurring in the start-up of the tested party should be adjusted may vary on a case-by-case basis because such depreciation represents a means of profit deferral.

There is ordinarily some difference in the rate of operation between the tested party and the comparables. However an adjustment for the relative rate of operation might be better if done only when start-up adjustments are done, because we can not know the correct rate of operation of comparables and can not deny the possibility that a very high rate of operation means expense surplus and bad profitability.

In regard to the adjustment for foreign exchange risk, there is one way of thinking that is commonly used in setting critical assumptions. First, the band of expected foreign
exchange fluctuation is determined. As long as the actual rate of exchange falls within the band, the foreign parent corporation would completely assume the risk and the operating margin target range of the tested party would not move. Such a band can be called a no-adjustment band. However, if the actual rate of exchange lies outside the no-adjustment band due to a large fluctuation, the difference between the actual exchange rate and the edge of the no-adjustment band would be considered the maximum adjustment spread for foreign exchange and the tested party would partly assume the foreign exchange risk for a portion of such maximum adjustment spread. Here the maximum adjustment spread means the maximum one over which a parent and its subsidiary should share the foreign exchange risk. The operating margin target range of the tested party would be shifted downward or upward so as to assume foreign exchange risk outside the no-adjustment band. Since each party’s share of the necessary adjustment is not clear, it may sometimes be fifty-fifty, but occasionally the ratio of the tested party’s operating assets to consolidated operating assets is considered.

Even when the foreign exchange rate fluctuates in a disadvantageous direction for a corporate group, the subsidiary could sometimes prevent loss by raising the sales price of products in the market. In this situation the maximum adjustment spread may be often smaller under the consideration of a pass through in which the influence of foreign exchange fluctuation can be shifted onto a third party, because such a pass through negates the loss brought about by realization of foreign exchange risk for the corporate group.

Generally, it is assumed that an independent distributor takes on only a limited portion of business risk including foreign exchange risk and so the no-adjustment band is
set to reflect this. However in a case where a tested party truly assumes a large portion of business risk, it is generally thought that the tested party assumes larger foreign exchange risk as a part of other business risks and so the narrower no-adjustment band is justified.

An adjustment for the difference of markets where the tested party and comparables operate is not easy. The distinguishing features of markets are diverse. For example, in regard to conditions of manufacturing of multinational enterprises in Southeast Asia, there are three macroscopic trends: First, manufacturing functions have shifted to the lower wage level countries within the same regions (for example from Malaysia to China). Second, some full-fledged manufacturers have changed to risk-limited manufacturers in a trend towards the centralized management of multinational enterprises. And finally, the manufacturing function of the electric industry tends to be placed in Malaysia, while the same function of the car industry tends to be placed in Thailand. Various developments occur in the same market at the same time. So it is not easy even to characterize the features of a market. In practice, we sometimes consider whether the similarity of market conditions or the similarity of products manufactured and functions performed would be more important. Although the capital cost adjustment exists as a means of adjusting for the difference of markets, the extent of reliability of this adjustment can be uncertain.

4. Carving out / Business Segmentation / Range

It is in principle necessary to isolate the operating margin of a tested corporation with respect to target related transactions, except for cases in which such isolation is not rational where buy-sell transactions and license transactions for manufacturing
intangibles are integrated, or where the tested party manufactures the product by purchasing one part from a foreign parent party and another part from a non-related party. And in applying the PSM, it is necessary to carve out the operating margin of the parent corporation to isolate the range of business considered to be united with the business of the tested party.

In a case where there is a related manufacturing corporation in a third country involved in the target transaction of the BAPA, if the ratio of purchases from the related corporation in the third country to total costs of the tested party is not high, some arrangement can be considered in which the range of the operating margin of the related corporation in the third country would be determined as a critical assumption.

When transactions of a BAPA include tangible, service, and intangible transactions with the same related party, segmentation for transfer pricing analysis is a point at issue. The matter should be solved within the context of the evaluation of separate and combined transactions in the Guidelines. In a case where the manufacturing function and the distribution function are performed by more than one tested party in a single country, segmentation for transfer pricing analysis would be based upon the actual functions performed by the tested parties. If segmentation such as manufacturing and distributing is adopted, it is necessary for analysis of the manufacturing piece to select comparables with little distribution function. Of course, if the comparables selected are less clearly comparable in business conditions or profitability, this would be a misplacing of priorities.

When there is more than one segment for transfer pricing analysis, whether we should test the actual operating margin of tested parties separately by more than one
range or by a single integrated range is another question. The key element here is the
degree of managerial and business integration among plural segments. And the
integration ratio between manufacturing function and distribution function should reflect
the relative values of each function. The discussion of integration ratio in which
thresholds are sales or operating assets should be open to development.

In general, the interquartile range is used as the range for testing operating margin
in the BAPA. In forming the range by the use of pooling data, errors may be encountered
if in the business years of pooling one sees that business conditions are notably different
between tested party and comparables. In practice in the BAPA, the integrated target
range covering a series of years is sometimes set separately from a single-year target
range, in a case where the business cycle of the industry is subject to volatility. If in the
current year test the actual operating margin of the tested party lies outside the single-
year range, which is ordinarily wider than the multi-year integrated target range,
adjustment is done by calculating the difference between the actual point and the edge of
the single-year target range. Finally, the multi-year weighted average operating margin is
reviewed after the adjustment under the current year test has been made, and tested
against the multi-year integrated target range. The current year test has the effect of
preventing a huge amount of compensating adjustment in the final year.

5. Some Important Considerations in Using TNMM

TPMs generally used in the BAPA are profit methods that are consistent with the TNMM
or PSM as described in the Guidelines. And as mentioned previously, TNMM is
sometimes considered the default TPM of BAPA because there is high possibility of finding comparables with a certain extent of rationality in almost any type of industry. In using TNMM one strives to remove influences to profitability from factors other than transfer pricing. Actually, this consideration is founded in the Guidelines and has been consistently and soundly adopted as profit methods have gradually become mainstream in practice.

Paragraph 3.36 and subsequent paragraphs of the Guidelines are particularly important in mentioning forces directly affecting net margins. Paragraph 3.38 states:

It might be argued that the potential inaccuracies resulting from the above factors can be reflected in the size of the arm’s length range. The use of a range may to some extent mitigate the level of inaccuracy, but may not account for situations where a taxpayer’s profits are reduced by a factor unique to that taxpayer. In such a case, the range may not include points representing the profits of independent enterprises that are affected in a similar manner by a unique factor.

We sometimes face a concern about failing to remove factors apart from transfer pricing that may significantly influence profitability. For example, a loss brought almost by a factor unique to the tested party should be removed from the result of operating margin analysis, because it is difficult as a practical matter to shift down the target range indicated by the comparables set and hard to gauge the accuracy of such an adjustment. When a business factor unique to the tested party seems to influence profitability, we confirm the justification for removing the loss brought about by that factor by verifying that the tested party assumed the business risk compatible with the Arm’s Length Principle and that the loss occurred as a consequence of such risk. It is not appropriate, in evaluating factors unique to the tested party, to depend mechanically on whether a matter was found worthy of special mention in disclosed financial statements. And when the tested party exports products to the related party in a third country and books the loss
brought about by foreign exchange fluctuation, such loss should also be removed from the result of the operating margin analysis of the tested party because it has little to do with the transfer pricing issue pertaining to the transactions with which the BAPA is concerned.

Paragraph 3.31 of the Guidelines is also important. Parties who are concerned with transfer pricing taxation recognize the need to take into account overall profitability of the group. To know the consolidated profit, the actual profit on the target business of the parent corporation should be calculated. But in practice, it is not clear what should be used for the calculation. In general, if the parent corporation holds objective managerial accounting data for each transaction with the specified related party, calculation should be based upon that data. There is occasionally some difficulty when the weight of the transactions with the tested party compared to other transactions of the parent corporation is low, so profits from the transactions at issue may easily change depending on the method of allocation of indirect costs. Income creation is an important issue and the difficulty must be addressed.

D. PSM
As mentioned, among various types of PSM at present RPSM seems to be the leading method. In the second stage of RPSM, actual costs for contributing to create intangibles are generally used as a threshold measure of allocation because relative market values of intangibles are difficult to determine. In cases where residual profit remaining after the first-stage division represents a large component of the entire combined profits in a highly profitable business, the TPM would be similar to a contribution analysis. Some
people point out that a costs concept is not appropriate as an index for allocation in the second stage, where the correlation between costs, such as research and development costs, advertising costs, and the like, and the contribution to residual profits is not confirmed. Others have the view that the risks assumed in the research and development activity should be actively evaluated. However, these alternative ways seem not to be in general use.

Analysis of how we should understand the origin of residual profits is crucially important but seems difficult. Residual profits may be derived not only from non-routine valuable intangibles but also from external factors such as specific market features (consumers’ preference, distribution structure, and the like). However it seems that in the theory of RPSM, such external factors should be considered as issues of comparability in calculating the routine return in the first stage and only intangibles are relevant to the residual profit.

In some cases it is difficult in the first stage to find comparables that are influenced by the same external factors as the tested party and so we determine allocation factors in the second stage with the recognition that external factors are also relevant to residual profit. In this stage in some cases, the residual profit governed by external factors may be significant. Occasionally, they may be attributed to the party that assumes the entrepreneurial risk by starting the business with an initial idea, knowledge, and funding. Other times it may be the party that performs the operating activity with significant customers and, in some cases, natural resources. Although it cannot be completely denied that this issue might give rise to an endless theological argument, the issue should be solved through the mutual agreement procedure. It is expected that the competent
authorities will have common understanding about the extent to which the external factors are relevant to residual profit and they finally may reach agreement rationally in a give and take spirit on this issue.

E. Critical Assumptions

Although it is basic that a BAPA is invalid if it turns out that actual business conditions do not meet critical assumptions, more flexible approaches can be adopted such as confirmation by tax authorities of actual conditions and the specific causes of any changes and trying to identify the TPM that is compatible with changed business conditions. Invalidity immediately upon failure of a critical assumption is not desirable in light of the intent of the BAPA.

F. Actual Conditions of the Business

To grasp the actual business conditions in transfer pricing analysis, it is important to understand the diversity of the business environment, business practices, distribution structures, and the peculiarity of the market affecting the tested party. Occasionally, it may be difficult for tax authorities who have jurisdiction over the foreign parent corporation to obtain such understanding. Our practical experience and the text books of business schools in the United States have taught a diversity of business, competitive environments, and markets.

Some markets, for example, are very competitive, with low entry barriers without governmental control or oligopoly, and other markets are less competitive. In some competitive markets the market share leader quickly tends to react to the behavior of
competitive corporations and new entrants, and in other markets it does not. Competitive conditions for even the same products are very different from each other depending on the market and the stage of penetration in the market. Governmental control over even products of the same industry segment may be very different depending on the individual product and country. There may be a remarkably immediate change from oligopoly to competition as soon as governmental control is abolished, and in this case transfer pricing analysis by use of multiple year data may be essential.

In some markets customers are very sensitive to model change, including minor change, and prices of old model products necessarily decrease. In other markets inexpensive products with a certain function are continuously saleable for a relatively long time. There may be a large retail store or car dealer that has strong bargaining power as a buyer or a distributor. Vendors to such stores generally manage to continue in business by accepting the demand of price protection and practicing sales incentives and the like. There are somewhat unique products that have economic value by reason of superior technique and a need for elaborate technical support. Medical devices would be an example. Switching costs for such a product may be high, so there may be a tendency for users to arrange with specific corporations to provide superior products and service. High switching costs would be reduced as information of products comes to be common among users, but the closeness of the market might prevent switching costs from being reduced very rapidly. A corporation in such a closed market that captures the user establishes high entry barriers as a result. In this situation, there is a possibility that high profitability continues once a corporation establishes a footing. Some independent businesses may judge performance by return on equity or share price while other
businesses may judge according to market share. Independent businesses sometimes fail in management or business.

Global Trading generally adopts a two-point strategy; it incurs little in the way of unhedged risks and earns most income from the dealer “spread” between bid and ask prices, and it allows traders to take unhedged “proprietary” positions to generate significant trading gains. In global trading conducted under the dealer strategy, which NTA has encountered in BAPAs, the function of marketers is of relatively greater importance and capital is of relatively lesser importance as compared to global trading under the proprietary trading strategy. Occasionally, both business strategies can be seen in the same trading book, so it is important to understand actual transactions as well as the business strategy of the group overall. Managerial accounting data, which is often used to evaluate the business unit’s accomplishments and the bonus of traders and marketers, is sometimes used for the purpose of transfer pricing analysis. When there is no alternative to managerial accounting data, such data should be valued for transfer pricing analysis.

The United States seems to have great practical experience in the area of buy-ins as external contributions to cost sharing agreements. In the proposed regulations of the United States regarding cost sharing agreements, publicly released in August of 2006, the buy-ins is the external contribution in the Preliminary or Contemporaneous Transaction. How to evaluate the external contribution is explained in supplementary guidance. This proposed regulation might be a bit extreme, because it seems that research and development activity relevant to the cost sharing agreements is never viewed as
generating non-routine valuable intangibles. On this point there might be room for the taxpayers to contest the regulation.

In the proposed regulations, if the buy-ins contributes to the cost sharing agreement activity as the platform of technology, residual profits in the future will be attributed to the owner of that platform. According to my understanding, alternatively, if the buy-ins generates economic value only with manufacturing and sales rights, the owner of the external contribution will enjoy only a declining royalty, not residual profits. The question whether the platform of technology is recognized may considerably influence future profits. Therefore detailed analysis and documentation will be important on this point.

III. Some Important Items for Development of the BAPA

1. The theoretical background of TNMM and the first stage of RPSM is economics. Operating margins will converge in a free and competitive market and capital markets do not admit the existence of firms whose profits are below par. That thinking is true as a theoretical model under a certain supposition but sometimes not absolutely true in the real competitive market. An actual market is rich in diversity. Although in general independent distributors may not assume high business risks, the extent of the risks they assume will vary. It may not be appropriate to cite the economic teachings that “profitability converges in the long term,” “a distributor does not assume business risk,” and “a commission agent under contractual agreement is a pure service provider,” at least not in a mechanical fashion. The diversity of actual business conditions in the competitive market should be understood for the analysis of profit methods.
Furthermore, it is necessary to recognize the inaccuracy of comparability in the factors that influence profitability. As mentioned above, some considerations in using TNMM are important to remove influences to profitability attributable to factors other than transfer pricing.

If the sense of value of the above mentioned observations is held in common among parties concerned with a BAPA, the BAPA can be an effective framework without the serious concern that pertains to other dispute resolution programs for transfer pricing taxation.

2. Needless to say, for small businesses as well as large multinational enterprises, it is desirable to minimize the managerial risk of double taxation caused by transfer pricing taxation. Actual economic double taxation issues should by all means be solved under the condition of rational income allocation between the countries in question. It is important for all persons concerned with the BAPA to balance the detailed discussion aiming towards elaborate TPMs with a measure of resistance to complexity of the TPM from the standpoint of tax administration.

3. In general, an APA involving three or more countries presents considerable complexity and practical difficulty. Many countries may be inexperienced, with the exception of some global trading cases. Nevertheless the number of such cases seems to be increasing, so each country should enhance its ability to handle and manage the APA with the gradual accumulation of practical experience. At the present stage of the mutual agreement procedure, tax authorities in the country where the core base of the related
transactions is located may be expected to play a central role.

4. The substantial effect of the mutual agreement procedure on transfer pricing cases including the BAPA is that both countries make necessary adjustments according to the agreement. In that way economic double taxation can be eliminated. Recently, the number of countries that make transfer pricing adjustments under their own legislation is increasing, but some do not have provisions that enable them to make corresponding adjustments. That issue is significant.

5. With a view to securing a reliable and sufficient quantity of comparables data, it is desirable that many public corporations that perform business activities fulfill the requirements of public disclosure with a view to a global standard. This means the development of profit methods partly depends on comprehensive development of the capital markets in each country. However, in some countries listed corporations are not so numerous because of the control of core industries by family groups and the preponderance of foreign direct investment. The number of listed corporations might be small in a core industry. In addition, listed corporations occasionally include state owned corporations that have the dual purpose of gaining profit and adhering to governmental policy, and corporations that are rated as having weak corporate governance. In a comparability analysis it is important to at least roughly understand the actual condition of the capital market that provides publicly available financial data in the country concerned, as well as the homogeneity of markets such as in European or Latin American regions.
IV. Conclusion

As I have enumerated in the practical points of issue in TPMs for BAPA, there are essential issues such as how we should understand the origin of residual profits and what the most appropriate TPM is for various types of service transactions. Both issues involve intangibles. In addition, there are more than a few practical issues, including very technical ones. Many among them will be further developed and rationally solved through accumulation of practice and theoretical research.

We have two important points in operating BAPA. One is the importance of understanding the diversity of business, competition, and markets. The other is the importance of considering the influence of factors other than transfer pricing. As long as the sense of these two points is held in common among the parties concerned with the BAPA, the BAPA can be the best dispute resolution program for transfer pricing taxation in the world.