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CUP Method: Could It Be a Reliable "Sanity Check" When the Arm's Length Principle Is Verified Using a Transactional Profit Method?

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Automatic year's end adjustments deriving from the application of the transactional net margin method could trigger under specific circumstances to inconsistencies with the underlying transactions. The application of the transactional net margin method cannot disregard the price of the goods when the significant economic terms and conditions are substantially comparable and, notwithstanding comparable uncontrolled price method does not satisfy all the conditions to be applied as most preferable transfer pricing method, it could improve the level of reliability of the transfer pricing analysis

1. Introduction

In the old version[1] of OECD Transfer Pricing Guidelines (hereinafter OECD Guidelines), traditional methods were considered the most preferable, and the use of transactional profit methods was limited to exceptional circumstances with no available data or where its availability was insufficient to rely, solely or entirely, on traditional methods. Such transactional methods represented a sort of "subsidiary approach" applicable where traditional methods prove unreliable if used alone or in exceptional circumstances in which they cannot be applied in the first place. More specifically, among traditional transaction methods (i.e. those at the top of the OECD methodology hierarchy), the comparable uncontrolled price method (CUP) was regarded as preferable to the cost plus (Cost+) and resale price methods (RPM).

Differently from the past, for the selection of the applicable transfer pricing method the current version of OECD Guidelines[2] suggests using the "most appropriate method", based on the specific facts and circumstances. Such method should be identified ad hoc, considering the strengths and weaknesses of each available method,[3] their appropriateness in consideration of the economically relevant characteristics and the availability of reliable information. The OECD Guidelines also establish that the application of more than one method is not "strictly" required, although it might be useful in some cases.

The following paragraphs analyse the unusual cases in which the outcome of the application of a transactional profit method could be usefully tested using a traditional method; particularly through the CUP, which can be reliably applied as a "sanity check" to verify the rationality of prior results obtained with the transactional method.

2. Application of the CUP as a "Sanity Check" to Test the Reasonability of the Outcome of a Transactional Method

The OECD Guidelines do not require the compulsory use of more than one method (as already mentioned above) and in general suggest applying the method that provides the most reliable estimation of the arm's length principle (hereinafter also ALP). Nevertheless, in difficult cases[4] or when inconsistent or unreasonable results are obtained using a single method (traditional or transactional) the OECD Guidelines recognize that a flexible approach, based on the combined use of various methods could help increase the reliability of transfer pricing analyses.

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1. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 2.5 (OECD 1995), Primary Sources IBFD.
2. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2022), Primary Sources IBFD [hereinafter *OECD Guidelines*].
3. The *OECD Guidelines* also allow the application of methods other than those described in detail (*see* para. 2.9).
4. In particular, para. 2.12 *OECD Guidelines* specifies that:
   > In such cases, an attempt should be made to reach a conclusion consistent with the arm's length principle that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration. See paragraphs 3.58- 3.59 for a discussion of cases where a range of figures results from the use of more than one method.

Under the described scenario, the hands-on experience shows that transactional methods are used more frequently than traditional ones. Moreover, it is well known that, from a practical point of view, the analysis of net margins (often used as a "Profit Level Indicator" – PLI – for the application of transactional methods) in place of gross margins may improve the reliability of transfer pricing studies, also under a Generally Accepted Accounting Principles (GAAP) perspective. GAAP mismatches among countries are more impactful on gross margins than on net ones. Consequently, the computation of gross margin (as a PLI) may provide less reliable results than calculating net margins, especially in benchmarking analyses based on comparable data across various countries (such as pan-European studies).

There are various cases of accounting discrepancies, especially between the GAAP and the International Financial Reporting Standards (IFRS), such as those related to the evaluation of inventory or stock, due to the differences in the methods adopted for inventory reversals and write-downs. For example, Italian GAAP allows for choosing between the adoption of the weighted-average cost method, the First-In, First-Out (FIFO) method and the Last-In, First-Out (LIFO) method. IFRS do not allow for the application of the LIFO method. As a consequence, since accounting principles could be varied materially in each country and again the classification of cost of goods sold[5] could be not so comparable among various jurisdictions, different GAAP could affect the reliability of pan-European studies based on the calculation of gross margin.

Moreover, the wide application of the transactional methods has also likely increased thanks to past support and clarifications provided by the Joint Transfer Pricing Forum which concluded, after a statistical study on transactional methods, that "Europe is one market for TNMM [transactional net margin method] transfer pricing purposes, and that an arm's length range of results based on a pan-European set of comparable companies provides a reliable measure of arm's length results".[6] From another perspective, it is also worth remembering that gross margin data are rarely available in public databases: a condition that makes it challenging, for taxpayers to arrange transfer pricing studies based on the application of traditional methods different from CUP.

Up to this point, however, we have only analyzed the "success" factors that have played a part in making the transactional methods and, in particular, the TNMM essentially the 'default' method for taxpayers and tax administration in recent years; at the same time, the OECD Guidelines highlight the fact that there are also several weaknesses in respect to the application of TNMM. For example, the net margins can be influenced by some factors that would either have no effect or a smaller substantial or direct effect on the price or gross margins between independent parties.[7] Unlike traditional methods focused on single transactions, where the basis for comparison is the price (e.g. CUP) or gross margins (RPM and Cost+), the TNMM is focused on the functional profile and therefore its application could lead, in certain circumstances, to unreasonable results in term of market prices or in light of the economic dynamics of the controlled transaction(s).

Furthermore, the application of TNMM can potentially introduce a greater element of volatility into the criteria applied in order to establish *ex-ante* the pricing of intercompany transactions. Net margins can be influenced by factors that have no effect (or have a less material impact) on gross margins and prices, generally for the variation of operating expenses across enterprises (especially during the pandemic of COVID-19). Moreover, net margins can be affected by some factors, such as competitive position: for example, the level of the threat posed by new competitors could be determined by such elements as product differentiation, capital requirements and government subsidies and regulations.

Under the described scenario and specific situations, a traditional method (e.g. CUP) could be applied to validate the rationality of the outcome of a transactional method that is used as the primary method, for example when the results of using a transactional method are unsatisfactory.

As mentioned in the OECD Guidelines,[8] among traditional methods, the CUP one remains preferable in a majority of cases; when CUP and another method can be both expected to lead to a reliable result, the CUP should be applied.[9]. Part of its attractiveness comes from its easy application, should the relevant conditions be met: the use of CUP just needs a comparison between the controlled transaction and a comparable uncontrolled transaction under the same circumstances. In particular, when applying CUP it is important to carry out a comparability analysis between the related and unrelated transactions, according to the comparability factors addressed in OECD Guidelines.[10] In assessing the level of comparability between

5. Please note that the International Financial Reporting Standards consider cost of sales as a functional item that may combine the following items by nature: raw material costs, labour and other employee benefit costs, depreciation or amortization. These expenses all arise from the entity's production activities
6. *See* EU Joint Transfer Pricing Forum, *Draft Report on the Use of Comparables in the EU, Meeting of 23 June 2016,* available at https://taxation-customs.ec.europa.eu/system/files/2016-09/jtpf0072016_en.pdf.
7. Para 2.70 *OECD Guidelines*.
8. Para 2.12-2.20 *OECD Guidelines*.
9. Para 2.3 *OECD Guidelines*. In this respect, *see also* art. 4 of the Italian Ministerial Decree on transfer pricing of 14 May 2018.
10. In particular, the authors refer to the contractual terms of the transaction; the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the multinational enterprise group to which the parties belong, the circumstances surrounding the transaction, and industry practices; the characteristics of the property transferred or services provided; the economic circumstances of the parties and of the market in which the parties operate; and the business strategies pursued by the parties.

controlled transactions, it is important to perform a detailed functional analysis, examining the functions performed, the risks assumed and the assets used in the transactions being compared. However, sometimes the potential use of CUP is rejected because it is hard (or impossible) to match one or more of the comparability criteria, such as similar markets, volumes and positions in the supply chain. In a lot of sectors, even small differences between material facts and circumstances involved in two similar transactions could influence prices and impact the analysis.

The above arguments show that ALP estimation could lead to different outcomes depending on the transfer pricing method used and its strengths and weaknesses: for instance, the CUP could ensure greater reliability on the intercompany price, while TNMM, with its focus on the functional profile, could be more appropriate to avoid misalignment between the tested party's remuneration and the one achieved by third parties when assuming the same risks, performing the same functions and employing the same assets. Thus, for the sake of reliability, it could be useful to verify the ALP of related transactions by combining the application of two methods, as illustrated in the following example, in which the application of the TNMM, the primary method, will be adjusted using the internal CUP.

3. Example of Issues in Business Practices on Transfer Pricing Adjustments

The case concerns the parent company ALFA S.p.A., part of the “ALFA” group (hereinafter the Group), which is a leader in the design, production and distribution of luxury clothing, accessories, and footwear for women and men. Under the business model of the Group, ALFA S.p.A. manufactures and sells its products under the “A” brand also through its foreign subsidiaries, involved in the wholesale and retail distribution activities. In particular, ALFA S.p.A. sells to third parties’ customers and to its subsidiaries, i.e. Beta FR, Beta UK and Beta GE, acting as limited risk distributors (LRD), “A” products that will be resold by each of such entities in their reference market through the retail channel, consisting also of flagship stores located in the so-called “fashion” streets.

As part of the marketing processes and in addition to the functions generally performed by third-party distributors, the group LRDs carry out also the following “additional” activities:

- marketing and communication, mainly consisting of the implementation of the communication strategy designed by Alfa S.p.A., and activities, such as the choice of location where to open a store, which represent the core of the entire strategy, internal visual merchandising and visual display;
- supporting production functions, to ensure that the Group better plans production processes, especially the timing of the launch of purchases of raw materials and the first production stages;
- supporting commercial functions, as reference “player” in the different markets for A products (i.e. customer service activities such as the management of the relationship with Alfa S.p.A. customers, the initial skimming of complaints from clients, as well as the logistic management of the A product);
- sizing of purchases, since LRDs are requested by Alfa S.p.A. to keep high levels of A product stock and assortment throughout the entire selling season; and
- sizing of sales areas – according to which LRDs are requested by Alfa S.p.A. to keep locations of luxury standards (so called “flagship stores”), ensuring the maximum visibility of A products. For this reason, LRDs incur heavy burden of rental costs, plant structuring, real estate maintenance and ordinary daily use (lighting, cleaning, staging, etc.), with negative side effects in terms of net margin returns, arising also from the important dilution of the sales index per square meter.

For LRDs, such “additional” functions trigger materially different structure costs in respect to a third-party retailer, making the application of CUP as a primary method hardly reliable.

For such reasons the transfer pricing policy adopted by the Group is structured in two steps: in the first instance TNMM is applied to verify that the related parties’ profitability (expressed in terms of Operating Margin or Return on Sales) is consistent with their functional and risk profile (i.e. LRD) and falls within the interquartile range of the specific benchmarking analysis prepared by the Group. In order to check that the transactions are in line also with ALP from a price perspective, a corroborative analysis (sanity check) could be performed using internal CUP, ensuring that the application of the TNMM and related year’s end transfer pricing adjustments, if the case may be, would not lead to inconsistent results in terms of prices.

For illustrative purposes, it is assumed that:

- Beta FR (operating as an LRD under the above description), having as sole supplier Alfa S.p.A., realize a Return on Sales (Ros) equal to 22% in fiscal year X, further to favorable market conditions;

- Ros margin of the relevant benchmark in fiscal year X shows the range below;[11] and

Minimum	Lower quartile	Median	Upper quartile	Maximum
1%	3%	5%	7%	9%

- further to “mechanical” application of the TNMM, Beta FR should be subject to an year’s end adjustment of 15%, to be consisted with the benchmark study for the fiscal year X.

Table 1 summarizes the main economic results obtained by Beta FR in fiscal year X.[12]

Table 1 – Beta FR results adjusted through TNMM

	EUR	**Ros %**
Sales	4.500	
Cost of Goods Sold (COGS)	**2.163**	
Overhead expenses	1.350	
Tot. Costs	3.513	
EBIT	988	22%
Ros to be adjusted		(15%)
TP Adjustment	**(673)**	
Adjusted EBIT	**315**	**7%**

According to the aforementioned transfer pricing policy, a corroborative analysis (sanity check) is performed through the application of the CUP method. For this purpose, Table 2 provides a comparison of the purchase price(s) for A products applied to third parties and to Beta FR.

Table 2 – ALFA S.p.A’s price and units for A Products in fiscal year X and relative level Beta FR COGS

	Third parties (EUR)		**Beta FR**				
	Min	**Max**	**Intercompany price(EUR)**	**Δ Price(EUR)**	**Units**	**COGS (EUR)**	**A product % of COGS**
Products A1	9	10	8.5	-1.50	100	850	57%
Products A2	18	20	17.5	-2.50	75	1,313	43%
Tot. COGS					**175**	**2,163**	

As shown in Table 2 and before TNMM adjustment, Beta FR's purchase prices are not in line (lower of EUR 1.5/2.5) with those ones applied to unrelated customers of ALFA S.p.A., since in the price setting procedure of Alfa S.p.A. the described “addition” functions are taken into account. Notwithstanding that, it should be noted that the transfer pricing adjustment would trigger the inconsistent effect that the intercompany pricing applied to Beta FR is higher than market levels, represented by the maximum price charged to third parties (second column of Table 2) as shown in Table 3.

Table 3 – Beta FR unit price and related COGS for A product after TNMM adjustment (value in EUR)

	Transfer pricing adj split on % of COG	**COGS adjusted**	**Price per units - adjusted**	**Δ Price**
Products A1	(384)	1,234	12.34	(2.34)
Products A2	(288)	1,601	21.34	(1.34)
Tot.	**(673)**	**2,835**		

11. Criteria for identification of the benchmark are out of scope of the present work.
12. In the following example, it is assumed that the adjustment is to the upper quartile, taking into account some limitation in the comparability between the final set of the benchmark and the tested party.

As shown, splitting proportionally the transfer pricing adjustment[13]' equal to EUR 673 according to the A products breakdown (%) of cost of goods sold, i.e. respectively EUR 384 for A1 products and EUR 288 for A2 products, and calculating the relative gap with the corresponding COGS amount (please refer to second column of Table 3), i.e. respectively EUR 1,234 for A1 products and EUR 1,601 for A2 products, it is possible to note that the adjusted unit prices, equal to EUR 12.34 for A1 products and EUR 21.34 for A2 products, are respectively higher of EUR 2.34 and EUR 1.34 in comparison with the relative maximum unit price charged by ALFA S.p.A. to third parties for same products (please refer to third column of the Table 3).

In particular, such analysis reveals that the application of TNMM adjustment would lead to inconsistent results from a price (setting) perspective, since it triggers that ALFA S.p.A. would have had to sell A products to Beta FR at prices higher than those charged to third parties, notwithstanding the additional functions carried on by the related LRDs.

Thus, to keep the Beta FR intercompany prices within ALP values, the amount of the TNMM adjustment should be reduced by applying (also) the internal CUP and in particular by referring to the maximum price charged by ALFA S.p.A. to third parties for A products, as a maximum threshold of market values. As result, the COGS amount of Beta FR, initially adjusted thorough the TNMM method to a value of EUR 2,835, is reduced, applying the internal CUP, to an amount equal to EUR 2,500 as detailed in Table 4.

Table 4 – Beta FR COGS reduction after CUP adjustment (value in EUR)

	Units	Δ Price	COGS post TNMM adjustment	COGS reduction	COGS post CUP adjustment
Products A1	100		1,234	(234)	1,000
Products A2	75		1,601	(101)	1,500
Tot.	**175**		**2,835**	**(335)**	**2,500**

As a consequence, and through the "floored" effect obtained after the CUP "sanity check", the adjusted results of Beta FR in fiscal year X can be summarized as illustrated Table 5.

Table 5 – Beta FR results adjusted after CUP "sanity check"

	EUR	Ros %
Sales	4,500	
Cost of Goods Sold (COGS)	**2,500**	
Overhead expenses	1,350	
Tot. Costs	3,513	
EBIT	**650**	**14%**

The case examined above shows how the corroborative analysis, performed using the CUP method, improved the level of reliability of the transfer pricing analysis by ensuring that the intercompany transaction was in line with ALP values from a functional profile point of view (in terms of functions performed, assets used and risks assumed by the tested party) as well as from a price perspective, to avoid inconsistencies upstream between the controlled purchase prices of the goods (LRD's COGS) and the market values resulting from the CUP analysis.

Under the proposed combined application perspective, it could be argued that a reasonable and rational approach of TNMM cannot disregard the price of the goods when the significant economic terms and conditions (especially price) are substantially comparable with ones in place among third parties.

13. 57% of products A1 and 43% of products A2.