



MARCH 17, 2017 BY **TRANSFER PRICING ASIA**

## Five Transfer Pricing Methods With Examples

Are you looking into the five transfer pricing methods, and wish to see examples of each?

Below, we explain the common methods which you can use to determine transfer prices. We also explain for every method when, and how you should use it.

After reading this article you'll have a better understanding of the different methods and how they can be applied to your firm's transactions.

*As of June 2023, this article has been read 250.000 times!*

*Before we continue, it is important to understand that the main purpose of transfer pricing methods is to examine the "arm's-length" nature of "controlled transactions." If these terms do not ring a bell, we advise you to first read our article [What is transfer pricing?](#)*

### What Transfer Pricing Methods Are There?

The good thing about transfer pricing is that the principles and practices are quite similar all around the world. The OECD Transfer Pricing Guidelines ([OECD Guidelines](#)) provide 5 common transfer pricing methods that are accepted by nearly all tax authorities.

The five transfer pricing methods are divided in "traditional transaction methods" and "transactional profit methods."

### Traditional Transaction Methods

Traditional transaction methods measure terms and conditions of actual transactions between independent enterprises and compares these with those of a controlled transaction.

This comparison can be made on the basis of direct measures such as the price of a transaction but also on the basis of indirect measures such as gross margins realized on a particular transactions.

## **Transactional Profit Methods**

The transactional profit methods don't measure the terms and conditions of actual transactions. In fact, these methods measure the net operating profits realized from controlled transactions and compare that profit level to the profit level realized by independent enterprises that are engaged in comparable transactions.

The transactional profit methods are less precise than the traditional transaction methods, but much more often applied. The reason is that application of the traditional transaction methods, which is preferred, requires detailed information and in practice this information is not easy to find.

In short:

- Traditional transaction methods rely on actual transactions.
- Traditional profits method rely on profit levels.

## **The Five Transfer Pricing Methods**

As mentioned, the OECD Guidelines discuss five transfer pricing methods that may be used to examine the arm's-length nature of controlled transactions. Three of these methods are traditional transaction methods, while the remaining two are transactional profit methods.

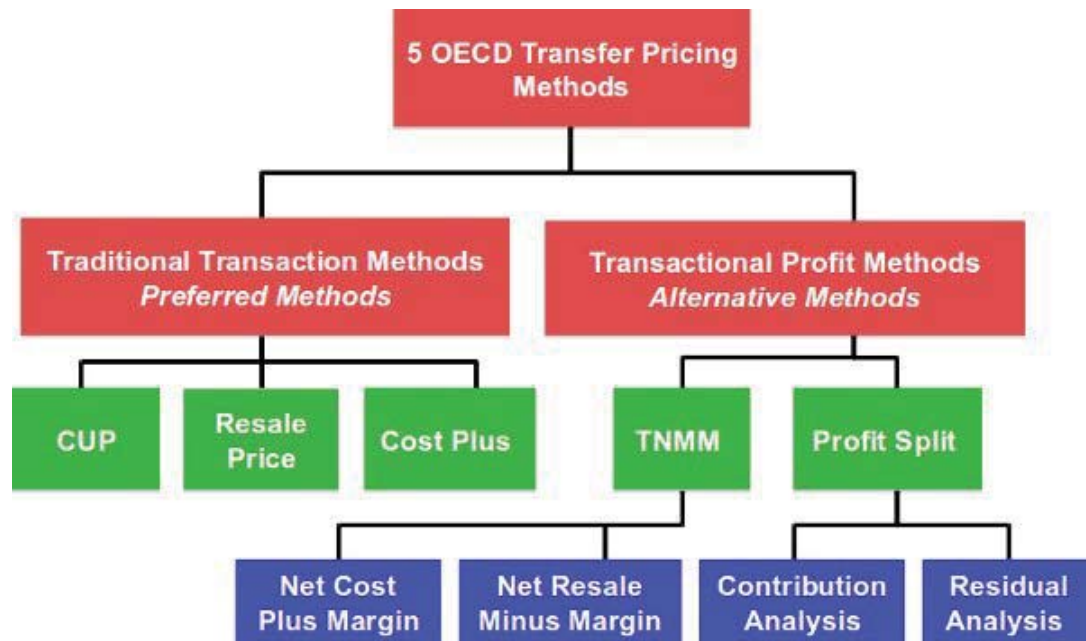
We list the methods here, and provide a handy graph we created:

### **Traditional transaction methods:**

1. CUP method
2. Resale price method
3. Cost plus method

### **Transactional profit methods:**

4. Transactional net margin method (TNMM)
5. Transactional profit split method.



The OECD Guidelines provide that you as a taxpayer should select the most appropriate transfer pricing method. However, if a traditional transaction method and a transactional profit method are equally reliable, the traditional transaction method is preferred.

In addition, if the CUP method and any other transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred.

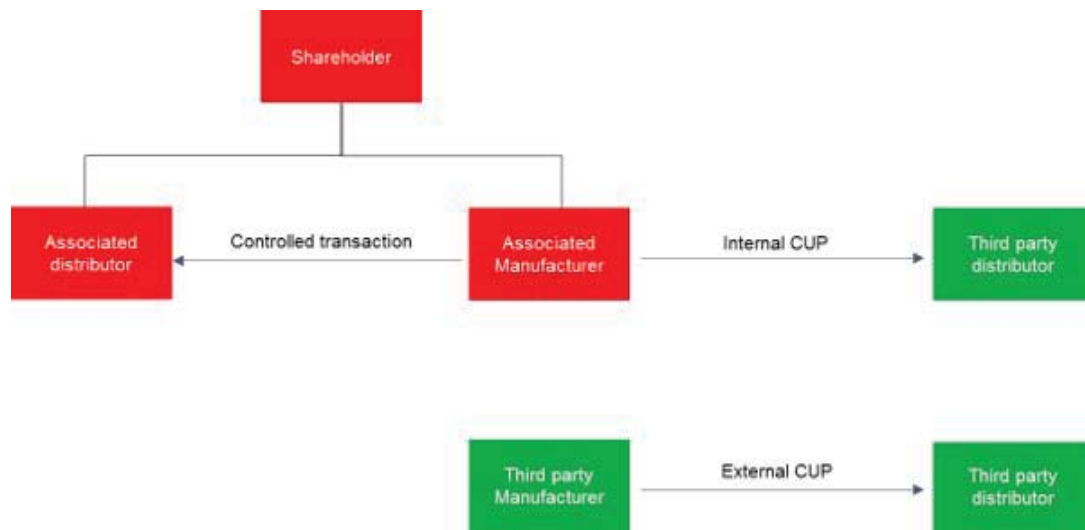
We'll explain each of these methods in more detail now.

## Transfer Pricing Method 1: The Cup Method

The CUP Method compares the terms and conditions (including the price) of a controlled transaction to those of a third party transaction. There are two kinds of third party transactions.

- Firstly, a transaction between the taxpayer and an independent enterprise (Internal Cup).
- Secondly, a transaction between two independent enterprises (External Cup).

The below example shows *the difference* between the two types of CUP Methods:



In the article [the CUP method with example](#) we look at the details of this transfer pricing method, provide a calculation example and indicate when this method should be used.

## Transfer Pricing Method 2: The Resale Price Method

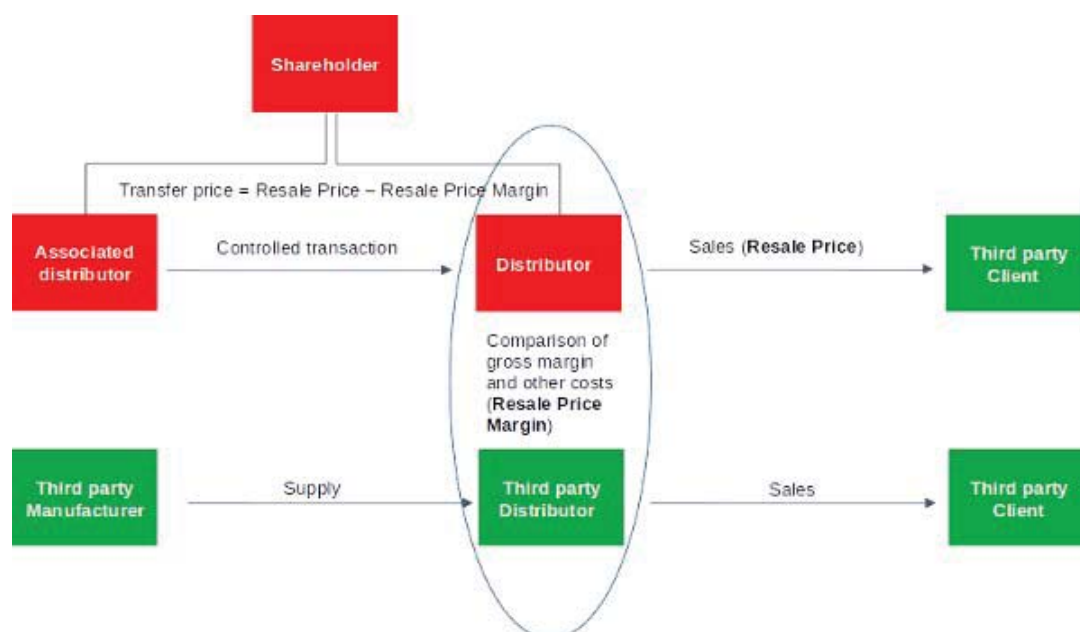
The Resale Price Method is also known as the “Resale Minus Method.”

As a starting position, it takes the price at which an associated enterprise sells a product to a third party. This price is called a “resale price.”

Then, the resale price is reduced with a gross margin (the “resale price margin”), determined by comparing gross margins in comparable uncontrolled transactions. After this, the costs associated with the purchase of the product, like custom duties, are deducted.

What is left, can be regarded as an arm’s length price for the controlled transaction between associated enterprises.

The below image is an example of the Resale Price Method:



In the article [the Resale Price Method with example](#) we look at the details of this transfer pricing method, provide a calculation example and indicate when this method should be used.

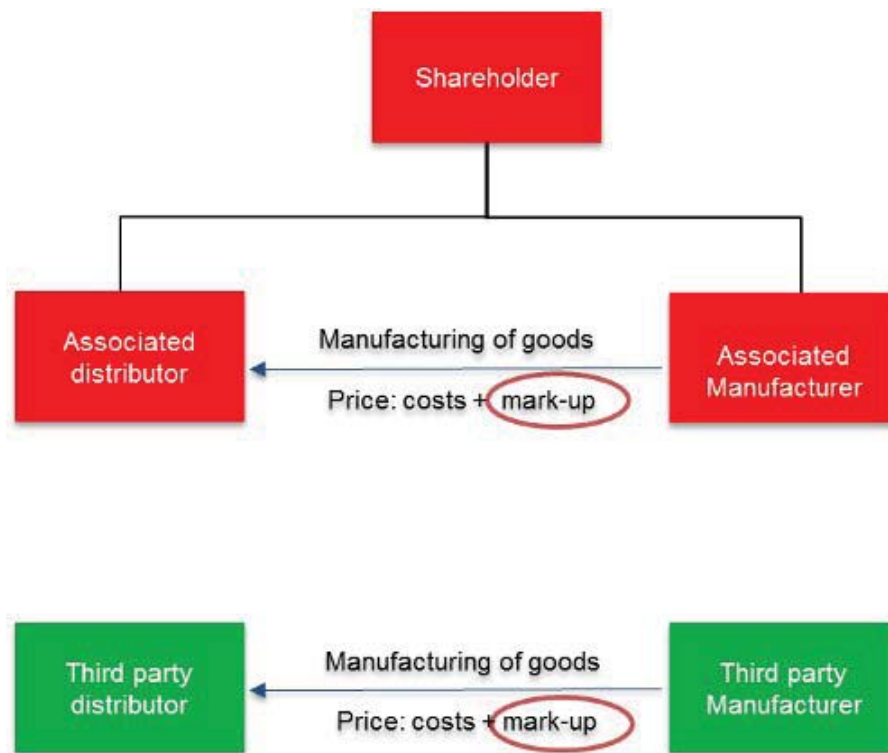
## Transfer Pricing Method 3: The Cost Plus Method

***[Edit September 2018: Re-written to explain this method better]***

The Cost Plus Method compares gross profits to the cost of sales. The first step is to determine the costs incurred by the supplier in a controlled transaction for products transferred to an associated purchaser. Secondly, an appropriate mark-up has to be added to this cost, to make an appropriate profit in light of the functions performed. After adding this (market-based) mark-up to these costs, a price can be considered at arm's length.

The application of the Cost Plus Method requires the identification of a mark-up on costs applied for comparable transactions between independent enterprises. An arm's length mark-up can be determined based on the mark-up applied on comparable transactions among independent enterprises.

The following image explains this in more detail, using a simple sale of manufactured goods to a distributor:



In the article the [Cost plus Method with example](#) we look at the details of this transfer pricing method, provide a calculation example and indicate when this method should be used.

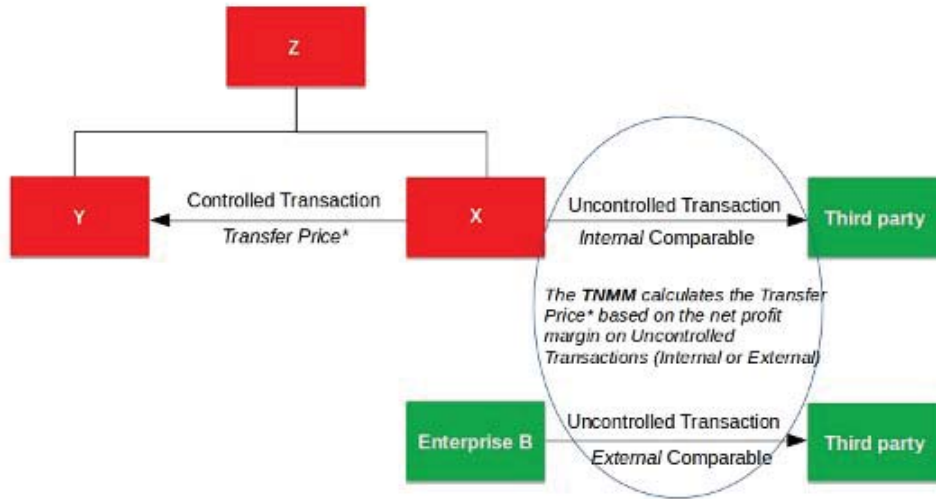
## Transfer Pricing Method 4: The Transactional Net Margin Method

With the Transactional Net Margin Method (TNMM), you need to determine the net profit of a controlled transaction of an associated enterprise (tested party). This net profit is then compared to the net profit realized by comparable uncontrolled transactions of independent enterprises.

As opposed to other transfer pricing methods, the TNMM requires transactions to be "broadly similar" to qualify as comparable. "Broadly similar" in this context means that the compared transactions don't have to be exactly like the controlled transaction. This increases the amount of situations where the TNMM can be used.

A comparable uncontrolled transaction can be between an associated enterprise and an independent enterprise (internal comparables) and between two independent enterprises (external comparables).

Let's see how this looks in this example:



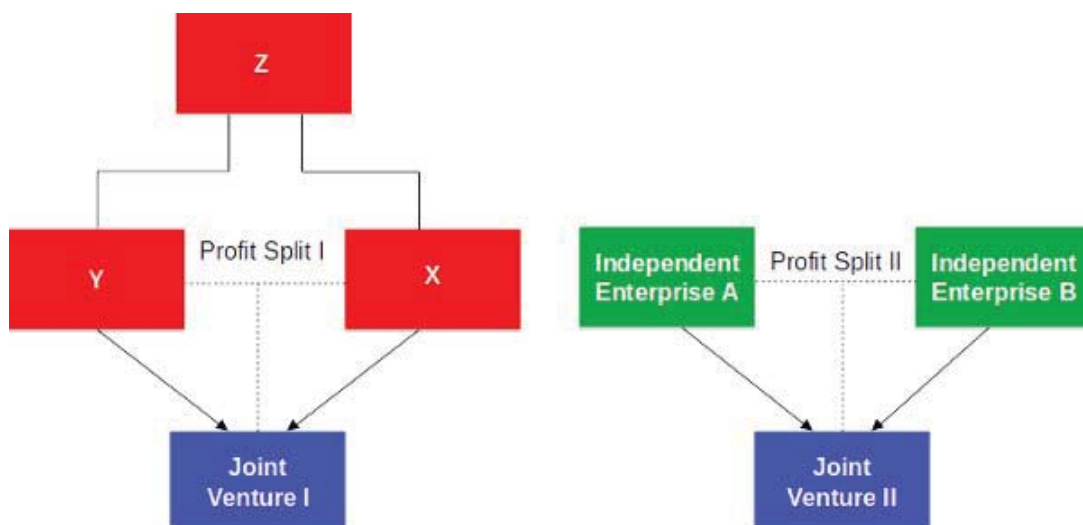
In the article the [Transactional Net Margin Method with example](#) we look at the details of this transfer pricing method, provide a calculation example and indicate when this method should be used.

## Transfer Pricing Method 5: The Profit Split Method

Associated enterprises sometimes engage in transactions that are very interrelated. Therefore, they cannot be examined on a separate basis. For these types of transactions, associated enterprises normally agree to split the profits.

The Profit Split Method examines the terms and conditions of these types of controlled transactions by determining the division of profits that independent enterprises would have realized from engaging in those transactions.

An example of this method is shown in this image:



*In the above example, we see two comparable joint ventures. Joint Venture I is owned by associated enterprises Y and X. Opposite to that, Joint Venture II is owned by independent*

*enterprises A and B.*

*Let's say that we need to determine the transfer prices to be charged for the transactions related to Joint Venture I. For that, we can compare the terms and conditions of the controlled transactions by determining the division of profits of comparable uncontrolled transactions. In this example, this means that we can compare Profit Split I with Profit Split II.*

In the article the [The Profit Split Method Example](#) we look at the details of this transfer pricing method, provide a calculation example and indicate when this method should be used.

## **The Five Transfer Pricing Methods With Examples – Conclusion**

Transfer pricing methods are quite similar all around the world. The OECD Guidelines provide five transfer pricing methods that are accepted by nearly all tax authorities. These include 3 traditional transaction methods and 2 transactional profit methods.

A taxpayer should select the most appropriate method. In general, the traditional transaction methods is preferred over the transactional profit methods and the CUP method over any other method.

In practice, the TNMM is the most used of all five transfer pricing methods, followed by the CUP method and Profit Split method. Cost Plus Method and Resale Margin Method are barely used.

We hope you enjoyed reading this article.

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