



Tax explanations

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Transfer pricing tax explanatory note 4 - Transactional net margin method



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Abbreviations used

CIT Act	Act of 15 February 1992 on corporate income tax (Journal of Laws 2021, item 1800, as amended).
PIT Act	Act of 26 July 1991 on personal income tax (Journal of Laws 2021, item 1128, as amended).
Amending Act	Act of 23 October 2018 amending the the Personal Income Tax Act, the Corporate Income Tax Act, the Tax Ordinance Act and certain other acts (Journal of Laws item 2193)
TP Regulation 2019	Ordinance of the Minister of Finance of 21 December 2018 on transfer pricing for corporate income tax (Official Gazette 2021, item 1444)
TPR Regulation	Ordinance of the Minister of Finance of 21 December 2018 on corporate income tax transfer pricing information (Journal of Laws item 2487, as amended).
OECD Guidelines	<i>OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations</i> , Paris, July 2017
UN Handbook	<i>UN Practical Manual on Transfer Pricing for Developing Countries</i> , 2017.
TNMM	Transactional net margin method
MPCN	Comparable uncontrolled price method
IAS	Profit and loss account
Intangible assets	Intangible assets

Introduction

1. These tax explanations apply to controlled transactions carried out after 31 December 2018, in accordance with the transitional provisions of the Amending Act.
2. These tax explanations refer to the provisions of the CIT Act regarding the application of the Transactional net margin method, effective as of 1 January 2019. (in particular Article 11d(1) of the CIT Act and § 3(1), § 5(1-2), § 14(1-5) of Regulation TP 2019).
3. These tax explanations are to be applied mutatis mutandis to the provisions of the PIT Act regarding the application of the Transactional net margin method, effective as of 1 January 2019. (Article 23p(1) of the PIT Act, § 3(1), § 5(1)-(2), § 14(1)-(5) of the Ordinance of 21 December 2018 on transfer pricing for personal income tax (Journal of Laws 2021, item 870).
4. With a view to clarifying the practical aspects related to the application of the Transactional net margin method and in an effort to increase taxpayers' tax security, this clarification is provided.

Extract from regulations

CIT Act

Article 11d. (1) Transfer prices shall be verified using the method most appropriate in the circumstances, selected from the following methods:

- 1) comparable uncontrolled price;*
- 2) resale prices;*
- 3) cost-plus;*
- 4) net transaction margin;*
- 5) profit sharing.*

2. Where it is not possible to apply the methods referred to in paragraph 1, another method, including valuation techniques, most appropriate under the circumstances shall be used.

3. In selecting the most appropriate method under the circumstances, particular account shall be taken of the conditions that have been agreed or imposed between the related parties, the availability of the information necessary for the correct application of the method and the specific criteria for its application.

TP Regulation 2019

§ 14. 1. The Transactional net margin method consists in determining a financial ratio reflecting the relation of the net profit margin that a related party obtains in a controlled transaction to the relevant base.

2. The net profit margin referred to in paragraph 1 shall be determined by deducting from the revenue generated by the controlled transaction the costs associated with the execution of that transaction. Where, for the purposes of the calculation of the net profit margin, it is reasonable to take into account costs which cannot be directly attributed to the transaction concerned, the attribution of such costs shall be performed by applying an attribution key which reasonably reflects the value creation in the controlled transaction.

3. The base referred to in paragraph 1 may consist in particular of revenues, costs, assets or elements of revenues, costs or assets.

4. The selection of the appropriate financial indicator referred to in paragraph 1 shall be made taking into account the specific characteristics of the industry and the relevant circumstances of the transaction.

5. The market value of the financial indicator referred to in paragraph 1 shall be determined by reference to the level of the financial indicator:

- 1) which obtains from entity w comparable transactions z unrelated parties in respect of the same underlying, or*

- 2) obtained in comparable transactions by unrelated parties on a comparable basis, or
- 3) obtained by entities engaged in activities comparable to the scope of the transaction under review on a comparable basis.

Annex to the TPR - Explanation of the preparation of transfer pricing information - Table 23

Financial indicators based on accounting regulations			
Code	Indicator name	Formula Comparative variant of the P&L	Formula the P&L activity statement variant
WF01	Gross margin on sales	n.d.	$\frac{\text{Zysk (□□□□□) brutto na sprzedaży} * 100\%}{\text{Net sales revenue}}$
WF02	Gross margin from resale	$\frac{\text{Przychody netto ze sprzedaży towarów i materiałów (A.□□) - Wartość sprzedanych towarów i materiałów (B.□□□□) * 100\%}}{\text{Przychody netto ze sprzedaży towarów i materiałów (A.□□)}}$	$\frac{\text{Przychody netto ze sprzedaży towarów i materiałów (A.□□) - Wartość sprzedanych towarów i materiałów (B.□□) * 100\%}}{\text{Przychody netto ze sprzedaży towarów i materiałów (A.□□)}}$
WF03	Gross charge from sales	n.d.	$\frac{\text{Zysk (□□□□□) brutto na sprzedaży} * 100\%}{\text{Koszty sprzedanych □□□□□□□□, towarów i materiałów}}$
WF04	Net margin on sales	$\frac{\text{Profit (loss) from sales} * 100\%}{\text{Przychody netto ze sprzedaży i zwrócone z nimi - Zmiana stanu produktów- Koszt wytworzenia świadczeń na potrzeby własne}}$	$\frac{\text{Zysk (□□□□□) ze sprzedaży} * 100\%}{\text{Przychody netto ze sprzedaży □□□□□□□□, towarów i materiałów}}$
WF05	Net charge on sales	$\frac{\text{Zysk (□□□□□) ze sprzedaży} * 100\%}{\text{Koszty działalności operacyjnej. Zmiana stanu produktów- Koszt wytworzenia świadczeń na potrzeby własne}}$	$\frac{\text{Zysk (□□□□□) ze sprzedaży} * 100\%}{\text{Koszty sprzedanych □□□□□□□□, towarów i materiałów + Koszty sprzedaży + Koszty ogólnego zarządu}}$
WF06	Operating margin	$\frac{\text{Zysk (□□□□□) z działalności operacyjnej} * 100\%}{\text{Przychody netto ze sprzedaży i zwrócone z nimi - Zmiana stanu produktów- Koszt wytworzenia świadczeń na potrzeby własne + Pozostałe przychody operacyjne}}$	$\frac{\text{Zysk (□□□□□) z działalności operacyjnej} * 100\%}{\text{Przychody netto ze sprzedaży □□□□□□□□, towarów i materiałów + Pozostałe przychody operacyjne}}$
WF07	Operating charge	$\frac{\text{Zysk (□□□□□) z działalności operacyjnej} * 100\%}{\text{Koszty działalności operacyjnej. Zmiana stanu produktów- Koszt wytworzenia świadczeń na potrzeby własne + Pozostałe koszty operacyjne}}$	$\frac{\text{Zysk (□□□□□) z działalności operacyjnej} * 100\%}{\text{Koszty sprzedanych □□□□□□□□, towarów i materiałów + Koszty sprzedaży + Koszty ogólnego zarządu + Pozostałe koszty operacyjne}}$

Financial indicators based on accounting regulations			
Code	Indicator name	Formula Comparative variant of the P&L	Formula the P&L activity statement variant
WF08	Gross profit margin	$\frac{\text{Zysk (strata) brutto} * 100\%}{\text{Przychody netto ze sprzedaży i zrównane z nimi - Zmiana stanu produktów - Koszt wytworzenia świadczeń na potrzeby własne + Pozostałe przychody operacyjne + Przychody finansowe}}$	$\frac{\text{Zysk (strata) brutto} * 100\%}{\text{Przychody netto ze sprzedaży} + \text{Koszty sprzedanych towarów i materiałów} + \text{Pozostałe przychody operacyjne} + \text{Przychody finansowe}}$
WF09	Gross profit surcharge	$\frac{\text{Zysk (strata) brutto} * 100\%}{\text{Koszty działalności operacyjnej. Zmiana stanu produktów - Koszt wytworzenia świadczeń na potrzeby własne + Pozostałe koszty operacyjne + Koszty finansowe}}$	$\frac{\text{Zysk (strata) brutto} * 100\%}{\text{Koszty sprzedanych towarów i materiałów} + \text{Koszty sprzedaży} + \text{Koszty ogólnego zarządu} + \text{Pozostałe koszty operacyjne} + \text{Koszty finansowe}}$
WF10	Profitability assets	$\frac{\text{Zysk (netto)} * 100\%}{\text{Aktywa razem}}$	$\frac{\text{Zysk (netto)} * 100\%}{\text{Aktywa razem}}$
WF11	Return on capital own	$\frac{\text{Zysk (netto)} * 100\%}{\text{Kapitał własny}}$	$\frac{\text{Zysk (netto)} * 100\%}{\text{Kapitał własny}}$
WF12	Berry index	n.d.	$\frac{\text{Zysk (brutto ze sprzedaży)} * 100\%}{\text{Koszt sprzedaży} + \text{Koszty ogólnego zarządu}}$
WF13	Another indicator based on Polish data	n.d.	

Financial indicators based on international standards			
Code	Indicator name	Formula (PL)	Formula (ANG)
WF14	EBIT charge	$\frac{\text{EBIT} * 100\%}{\text{Całkowite przychody operacyjne - EBIT}}$	$\frac{\text{EBIT} * 100\%}{\text{Operating revenue - EBIT}}$
WF15	EBIT margin	$\frac{\text{EBIT} * 100\%}{\text{Całkowite przychody operacyjne}}$	$\frac{\text{EBIT} * 100\%}{\text{Operating revenue}}$
WF16	Return on equity	$\frac{\text{Zysk netto} * 100\%}{\text{Kapitał własny.}}$	$\frac{\text{Net Income} * 100\%}{\text{Shareholders funds}}$
WF17	Another indicator based on data	n.a.	

Financial indicators based on international standards			
Code	Indicator name	Formula (PL)	Formula (ANG)
	international		

A. Principles of use TNMM

A.1. Scope of application method

1. The Transactional net margin method is one of the transfer pricing verification methods. Pursuant to Section 14(1) of the TP Regulation 2019, the Transactional net margin method consists of determining a financial ratio reflecting the relationship of the net profit margin that the audited entity obtains in a controlled transaction to the relevant base.
2. As a general rule, the financial ratio makes it possible to assess the dynamics of economic phenomena. In the Transactional net margin method, the financial ratio expresses profitability at the level of the controlled transaction¹, calculated on the basis of data contained in the financial statements or derived from other sources of information.
3. The net profit margin is calculated on the basis of the revenue generated in a controlled transaction less the costs associated with the execution of that transaction. The net profit margin in a given transaction is then related to an appropriate base, which may be, in particular, revenues, costs, assets or elements of revenues, costs, assets. It is important to be able to compare the chosen basis reliably and consistently at the level of comparable transactions.
4. The term 'net profit margin' should be understood as the various profit categories (including the mark-up). This profit, as of 1 January 2019, may include or exclude general and administrative expenses. The main profit categories are indicated in the descriptions of the financial indicators listed on pages 6-7.
5. The application of the Transactional net margin method makes it possible to verify that the level of the 'net profit margin' achieved by an entity in a controlled transaction has been set at a market level. As a general rule, profitability should be compared at the level of the controlled transaction. In the TNMM, it is permissible to test profitability ratios calculated on the entity's entire business, in particular when:
 - a) carries out homogeneous activities - e.g. a manufacturing entity with simple functions, assets and risks, producing on outsourced material;
 - b) carries out several activities, but one of them is the leading activity, while the others (together and separately) are complementary (supportive) to the main transaction and are not significant in terms of value - e.g. a manufacturing entity with simple functions, assets and risks, providing transport of its products to the customer;

By contrast, the use of a comparison on the entire business is not appropriate where a related party engages in a variety of controlled transactions that, even after aggregation, do not allow for a valid comparison with the activities of an unrelated party - e.g. for entities that carry out both manufacturing and distribution and service activities exclusively for related parties.

6. In the Transactional net margin method, the comparison can be made with all or part of the business of an unrelated party that can be recognised, based on the criteria of the

¹ Paragraphs 3.17-3.18 of the OECD Guidelines.

comparability as defined in Section 3 of Regulation TP 2019, to be comparable to the audited controlled transaction.

7. The term "controlled transaction" as used in § 14 of the TP Ordinance 2019 is to be understood in accordance with the definition in Article 11a(6) of the CIT Act, and "basis" is to be understood in particular as revenue, costs, assets or elements of revenue, costs, assets in accordance with § 14(3), in conjunction with § 14(1) of the TP Ordinance 2019.
8. The application of TNMM involves the following stages:
 - a) the selection of the tested (tested) entity (party to the controlled transaction),
 - b) determination of the net profit margin,
 - c) base definition,
 - d) choice of profitability indicator,
 - e) profitability comparison.

These stages are explained in paragraphs 11 to 24.

9. TNMM is used in particular in transactions involving production or the provision of services, commonly occurring in the market. Indeed, a fundamental condition for the application of TNMM is the availability of data on comparable transactions concluded by independent parties.
10. TNMM is not advisable for verifying the marketability of a controlled transaction if both parties to the transaction involve unique intangible assets or make unique contributions.²

A.2. Choice of tested party

11. The application of the TNMM is preceded by the selection of a tested party based on a functional analysis, including the elements indicated in § 3 of the TP Ordinance 2019, aiming to establish the functional profiles of the parties to the controlled transaction.
12. Functional profile means the succinctly described role of an entity in a controlled transaction resulting from the functional analysis indicated in § 3(1)(2) of the TP Regulation 2019 (e.g. full risk manufacturer, distributor, contract manufacturer). The level of complexity of the functional profile is a key factor in the selection of the entity to which the TNMM will be applied. As a general rule of thumb, the tested party in the TNMM should be the entity with the simpler profile.³

A.3. Determination of net profit margins

13. Pursuant to Section 14(2) of Regulation TP 2019, the net profit margin is determined by deducting from the revenue generated by a controlled transaction the costs associated with the implementation of that transaction. It is important to correctly allocate the costs to the controlled transaction:

² Paragraph 2.65 of the OECD Guidelines.

³ Paragraphs 2.65, 3.18 of the OECD Guidelines.

direct costs (e.g. material costs, staff salary costs) and a reasonable proportion of the indirect costs associated with the transaction.

14. We first allocate direct costs that can be directly attributed to a controlled transaction. A different allocation is applied for indirect costs that cannot be directly attributed to the controlled transaction. Pursuant to Section 14(2) of the TP Regulation 2019, if a cost relates to a transaction and direct allocation is not possible, it is allocated using an allocation key (indirect allocation).
15. An allocation key can be defined as a quantitative measure indicating the extent to which a cost should be allocated to a controlled transaction. The allocation key should reasonably reflect the value-added process of the controlled transaction. Indirect allocation should use allocation keys to ensure that indirect costs are reliably allocated to the controlled transaction. The allocation key should be reasonable and consistent. A properly selected key should clearly and verifiably reflect the commitment of resources and their impact on value creation in the controlled transaction, ensuring reliable allocation of indirect costs (see example 1).

Example 1

For the allocation of some costs, keys based on revenue are appropriate, and for others on parameters such as number of equipment, employees, working time, etc. For the allocation of costs for the provision of HR and payroll services, an allocation key related to the number of employees covered by these services, rather than a key related to revenue, will be appropriate. For the costs of marketing support services, for example, the allocation key may be sales volume.

Examples of cost allocation keys that can be used in indirect allocation:

- *the share of revenue from a controlled transaction in total revenue (e.g. in distribution);*
- *the share of direct costs in the total of these costs (e.g. production);*
- *the number of employees involved in a particular controlled transaction;*
- *the time commitment of employees to a particular controlled transaction;*
- *number of programme users / computers / desks etc..;*
- *area of premises/buildings;*
- *number of orders;*
- *balance sheet total;*
- *the number of documents processed (e.g. in accounting services).*

A.4. Definition of base

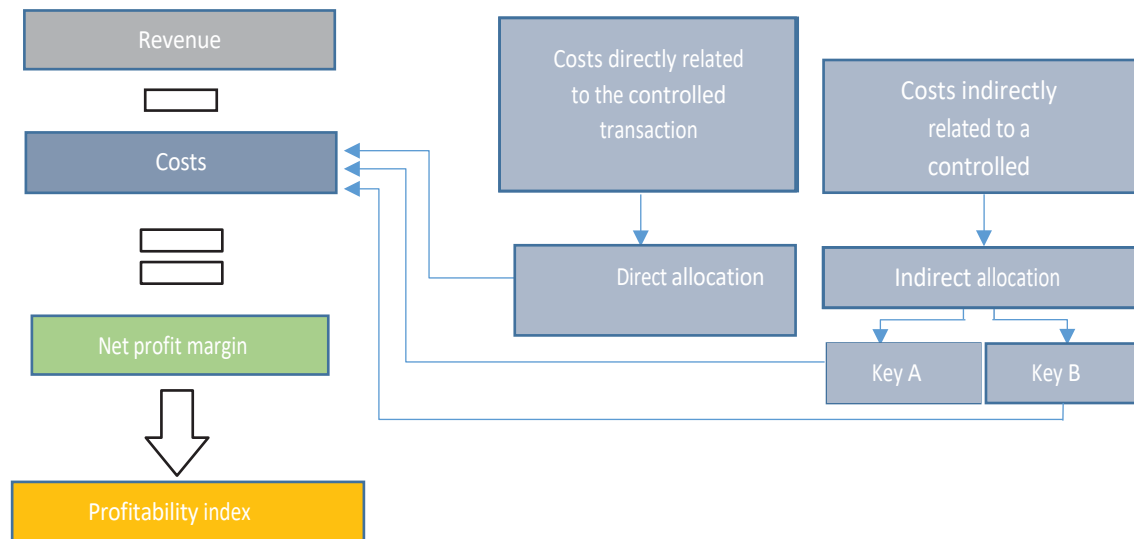
16. The correctness of the determination of the appropriate basis requires consideration of the results of the functional analysis and the specifics of the controlled transaction.

17. A base, according to Section 14(3) of Regulation TP 2019, is in particular revenues, costs, assets or elements of revenues, costs or assets. The determination of the relevant base depends on the type and circumstances of the controlled transaction; for distribution activities, the base may be revenue or cost of sales, for production activities it may be the total costs of the operations and, for capital-intensive activities (e.g. investments), the assets involved.
18. In addition to revenue, costs and assets, the OECD Guidelines provide examples of other bases such as retail outlet area, weight of products transported, number of employees, distance, etc. Such bases may, depending on the circumstances, reasonably demonstrate the added value created in a controlled transaction, but their use can only be considered when comparable and reliable information is available to enable application.⁴
19. The determination of the transfer price can be based on budgeted costs, based on historical data from financial statements or a forecast. What is important, however, is that the actual financial results of the controlled transaction (including costs) are finally included in the transfer price, determined using TNMM.

A.5. Choice of profitability indicator

20. In order to apply the TNMM, an appropriate profitability indicator must be selected, i.e. a financial indicator reflecting the relationship of the "net profit margin" to a specific base, appropriate to the nature and conditions of the controlled transaction being carried out, in particular taking into account the comparability criteria indicated in § 3 of the TP Regulation 2019.
21. The choice of base (denominator) should result from an analysis of the controlled transaction, reflecting the functions performed, the assets involved and the risks borne by the related parties. Pursuant to Section 14(4) of Regulation TP 2019, the selection of an appropriate financial ratio shall be made taking into account the object of the business (industry specific) and the relevant circumstances of the transaction. In addition, the strengths and weaknesses of the various profitability ratios must be taken into account, as well as the possibility of calculating the ratio for the entity's overall business or a segment of the entity's business.
Figure 1 shows how to determine the net profit margin, which, when referred to an appropriate base, allows the selection of a profitability indicator.

⁴ Paragraph 2.105 of the OECD

Figure 1: Diagram for determining the net profit margin in a controlled transaction

22. The Annex to the TPR Regulation - Explanatory Notes on the Preparation of Transfer Pricing Information indicates examples of profitability ratios based on accounting regulations for the purpose of transfer price verification. For TNMM, as a rule, the ratios listed under symbols WF04 to WF13 are used. In the current state of the law, it is also permissible to use indicators based on gross margin (or mark-up), i.e. WF01 to WF03. For profitability indicators based on data presented according to international standards, the indicators listed under symbols WF14 to WF17 are also used. Depending on the facts and circumstances, the typical use of ratios based on sales value or cost of sales is in distribution activities, on operating costs in services or production, and on assets in capital-intensive activities.⁵

Example 2

Examples of indicators and their common use:

- *Operating mark-up (WF07) - an indicator based on a cost-related basis, used for services, e.g. manufacturing, transport, IT, administration;*
- *Return on assets (WF10) or return on equity (WF11) - indicators based on asset- or equity-related bases, used for capital-intensive activities (e.g. manufacturing in heavy industry).*

For a distribution transaction, the following indicators can be used, among others:

- *net margin on sales (WF04);*
- *net mark-up on sales (WF05);*
- *operating margin (WF06);*
- *gross profit margin (WF08);*
- *Berry index (WF12);*
- *other indicators.*

⁵ Paragraph 2.93 of the OECD

In the case of distribution activities using TNMM, the Berry ratio can be applied, which relates gross profit on sales to operating expenses, understood as selling and general and administrative expenses, but not to the cost of products, goods. The Berry ratio can be used as a financial indicator to estimate the remuneration of distributors who do not bear significant risks and perform limited functions. The advantage of this indicator is that it can be used when the entity's activities consist of purchasing goods from related parties and then selling them to related parties.

23. In the state of law in force until 31 December 2018, the net transaction margin was calculated by deducting from the revenue generated by the transaction the costs incurred to obtain that revenue, including general and administrative expenses. As of 1 January 2019, the legal status introduced the principle of calculating indirect costs related to a controlled transaction based on an allocation key, without explicitly referring to general and administrative expenses. The absence of such a provision now makes it possible to apply more financial ratios under the TNMM than before 1 January 2019. As the Explanatory Memorandum to the TP Regulation 2019 shows,⁶ financial ratios based on the examination of the result at different levels may be used under the Transactional net margin method. By way of example, it is permissible to use a Berry indicator based on gross profit on sales, which was not previously possible due to the need to exclude general and administrative expenses.

A.6. Profitability comparison

24. In order to verify the marketability of an TNMM-controlled transaction, in accordance with Section 14(5) of Regulation TP 2019, the financial ratio that an entity achieves in a related party transaction must be compared with:
- a) an indicator realised by the same entity in a comparable transaction with an unrelated party ("internal comparison") - applicable when the entity in question enters into comparable transactions with both a related and an unrelated party. The internal comparison is the most accurate, but often cannot be applied by the lack of comparable transactions entered into by an entity with unrelated parties (see *Transfer Pricing Tax Notes 31.03.2021-No. 3: Comparable uncontrolled price method*);
 - b) indicator realised by unrelated parties in the market in comparable transactions ("external comparison of transactions"). This option is applicable when relevant comparative data can be obtained. According to Section 6 of the TP Regulation 2019, this must be publicly available data;
 - c) an indicator obtained by entities engaged in activities comparable to the scope of the controlled transaction under review ("external comparison of activities").

The key is to compare the same financial indicator against a comparable base (cf. A.4. Defining the base). Example 3 shows how the TNMM can be applied in an internal comparison variant.

⁶ <https://legislacja.rcl.gov.pl/docs//502/12318101/12549995/12549996/dokument368038.pdf>

Example 3

Company 'Alfa', which is a manufacturer of forklift trucks, sells products to both unrelated parties (PRODUCT A) and related parties (PRODUCT B). Due to the technological differences between PRODUCT A and PRODUCT B, resulting in different manufacturing costs, the application of MPCN was not possible. To determine the transaction price, it was decided to apply TNMM in the internal variant. Company "Alfa", in its operations, achieved the following results for comparable uncontrolled and controlled transactions respectively:

Category	Comparable uncontrolled transaction PRODUCT A	Controlled transaction EXTRACT B
Number of pieces of the product	250	150
Costs direct costs (materials, labour)	220	100
Indirect costs:		
departmental costs	80	40
marketing costs	30	15
General and administrative expenses	22	8
Cost base	352	163
Profit (revenue - cost base)	48	?
Net charge on sales (profit/cost base)	13,64%	?
Sales revenue	400	?
Unit price	1,60	?

The net mark-up on sales (WF05) was used as the profitability indicator. The 'Comparable uncontrolled transaction' column contains the production volume and financial data related to the uncontrolled transaction. The 'controlled transaction' column contains the costs incurred in relation to the controlled transaction.

We relate the profitability ratio (WF05), calculated for the uncontrolled transaction at 13.64%, to the cost of the controlled transaction with the related party. On this basis, the transfer price (on actual costs) was determined, corresponding to market conditions.

Category	Comparable uncontrolled transaction PRODUCT A	Controlled transaction EXTRACT B
Product quantity	250	150
Labour direct (materials, costs)	220	100
Indirect costs:		
departmental costs	80	40
marketing costs	30	15
General and administrative expenses	22	8
Cost base	352	163
Profit (revenue - cost base)	48	22,23
Net charge on sales (WF05)	13,64%	13,64%
Sales revenue	400	185,23*
Unit price	1,60	1,23*

* rounded

The following illustrates how the transfer price (CT) is determined using TNMM, based on the results Alpha realised on PRODUCT A.

CT = (direct costs + indirect costs + overheads) x (1 + mark-up)

Net charge on sales (WF05) = 13.64% CT =

PLN 163 × 1.1364

CT = PLN 185.23

Unit price of product B (£185.23/150 units) = £1.23/unit.

B. Criteria for comparability of transactions and entities

25. The comparability study (analysis) takes into account, in particular, comparability criteria such as:

- characteristics of goods (services),
- the course of the controlled transaction, including the functions performed by the entities, the assets involved and the risks incurred,
- the terms of the controlled transaction set out in the agreement,
- economic conditions prevailing in the market at the time,
- economic strategy.

The comparability criteria should be taken into account to the extent that they have (or may have) an impact on the terms of the transaction.

26. In TNMM, comparability of the products or services that are the subject of the controlled transaction under review is of lesser importance. The TNMM assesses whether the comparability criteria in question significantly affect the development of the net profit margin.

Example 4

Entity A, an apple juice producer, has its own orchard and production machinery. The analysis of comparable entities identified, among others, entity B, selling apple juice but from apples purchased from producers and processed into juice by external subcontractors, and entity C, engaged in the production and sale of Chips, using its own potato crop and its own production machinery. In this situation, despite the identical product supplied by entity A and entity B, it is entity C that shows greater functional comparability, because entity A and entity C have similar functional profiles (both entities are producers, processing their own products themselves). Entity B, on the other hand, is involved in limited coordination of the production and distribution of the product.

27. Where comparable non-controlled transactions are carried out by unrelated parties (external comparison), particular attention should be paid to whether a high degree of functional similarity is maintained in relation to the functional profile of the related and unrelated party.

28. As with the application of other methods, a comparability analysis is necessary to determine whether transactions are comparable. It should also show whether adjustments should be made to ensure comparability - and whether it is possible to make such adjustments.

29. Factors should be identified that can significantly affect the development of the net profit margin in the audited transaction under review. In addition to the characteristics of goods and services and functional profiles, there are other factors that may affect comparability (as in example 5). The catalogue presented below is illustrative and the inclusion of individual factors in the TNMM analysis depends on whether the factor materially affects the development of the net profit margin in the audited controlled transaction and is relevant to the comparability analysis.

Example 5

Examples of factors to be considered in the benchmarking analysis for the application of TNMM:

- *industry and type of activity (production, distribution, services),*
- *the volume of revenue generated,*
- *employment size,*
- *size and structure of assets,*
- *intangible assets held,*
- *net working capital employed,*
- *stock levels,*
- *the type of consumer goods offered (luxury/popular goods),*
- *the specific situation of the company (market entry, bankruptcy).*

30. Financial ratios can be further influenced by market factors such as:

- the risk of the emergence of competing players,
- the risk of the emergence of fungible goods,
- competitive position,
- efficiency of business management,
- individual strategies,
- cost structure,
- differences in the cost of capital (self-financing versus, for example, lending),
- level of business experience (development phase of the company).⁷

The presence of the above factors can be mitigated to some extent by the use of statistical ranges. However, when factors specific to the taxpayer under examination are present, the range of market comparable results may not reflect their impact.⁸

Example 6

For industries with a low entry cost, competition from other participants is an important factor affecting comparability, while in industries with a high entry cost, the degree of experience in the business is more important. Significant influence should be examined on a case-by-case basis, taking into account the specifics of the industry and transaction in question. If the two entities being compared are in the same industry, their profitability may differ significantly depending on their competitive position, market share, etc., which may affect the reliability of the results obtained.

⁷ Paragraph 2.77 of the OECD Guidelines.

⁸ Paragraph 2.79 of the OECD

C. Difficulties in applying TNMM

31. The application of TNMM, including the selection and calculation of financial ratios, may involve difficulties, e.g. the lack of appropriate comparative data. By way of example, in the case of the data from the P&L available only in the comparative variant, the determination of some indicators is not possible, e.g. WF01, WF03 (cf. Annex to the TPR Regulation). The following characteristics and considerations should be taken into account when applying TNMM:
- a) one-sidedness - examining only one side of a controlled transaction;
 - b) the use of multi-year data to indicate product life cycles, business fluctuations that affect the entire sector;
 - c) where possible, the audited entity's performance on a particular controlled transaction should be analysed, rather than the performance on the total business (cf. paragraphs 4 and 5);
 - d) differences in accounting standards and presentation of financial results.
32. If each party to a controlled transaction makes unique and valuable contributions (e.g. representing intangible assets that are difficult to value, such as patents, know-how or trademarks, or that do not constitute classic Tangible Assets, e.g. unique employee skills, business contacts), the application of TNMM will be unreliable - in such a situation the profit-sharing method is more appropriate.⁹

⁹ Paragraph 2.65 of the OECD

D. Comparison with other methods verification

33. For TNMM, as well as under the resale price method or the cost-plus method, the financial ratio, the level of margin (or mark-up) on a comparable transaction is compared. In the case of the comparable uncontrolled price method, the price of a comparable object of transaction (goods, services, other benefits) in comparable transactions is compared. The margin (or mark-up) represents the remuneration for the functions performed, assets employed and risks incurred. The assumptions of TNMM imply that differences in the characteristics of goods or services have less impact on the margin and thus there is greater tolerance for product differences. When applying TNMM, there should be a greater focus on the comparability of entities in a functional sense.
34. The TNMM is more versatile in practice as it can be applied to a wide range of transactions, whereas the resale price method is most appropriate when goods or services purchased from a related party are resold to an unrelated party. The TNMM verifies the amount of the financial ratio, selected depending on the nature of the transaction. The resale price method, on the other hand, verifies the amount of the resale price margin and whether this margin ensures that the direct and indirect costs of the transaction are covered and an appropriate profit is achieved.
35. TNMM involves verifying the level of the 'net profit margin', while the cost-plus method involves verifying the level of the profit mark-up. In both the cost-plus method and TNMM (where a cost-weighted financial indicator is chosen), reference can be made to the cost base. As a general rule, the cost-plus method uses gross mark-up ratios.
36. The TNMM verifies the financial ratio realised on the controlled transaction by the entity (one-sided method), whereas the profit-sharing method involves determining the total profit associated with the controlled transaction and verifying the rules for its distribution. TNMM can be used as part of the analysis performed by the profit sharing method.
37. Selected advantages of the Transactional net margin method over other methods:
 - a) differences in transaction terms (e.g. payment terms, transport terms - cf. paragraph 16) have less impact on the net profit margin than on the price, which is the subject of comparison in MPCN, among others;
 - b) access to reliable comparative data is facilitated by using data from publicly available financial statements;
 - c) analyses using TNMM often use statistical intervals, which can minimise the risk of incomplete data comparability.¹⁰

¹⁰ Paragraph 3.57 of the OECD

E. Practical application of TNMM

38. Below, the methodology for applying TNMM in the external comparison variant to verify the transfer price is presented in a simplified manner as an example.

Factual situation

Entity A (Manufacturer) is a manufacturer of electrical appliances. It sells all of its manufactured products to a related Entity B (Distributor). The production includes one type of equipment. The Manufacturer has no other significant activities.

The functional analysis showed that the Manufacturer performs functions typical of a manufacturer with a limited range of functions, assets and risks being a contract manufacturer.

Assumptions:

It is not possible to apply the MPCN in the internal and external variants due to the lack of access to reliable and comparable data. As the Producer does not provide production services to unrelated parties, there are no comparable transactions with unrelated parties (internal variant). The Producer does not have price information on comparable transactions between unrelated parties.

It is not possible to apply the cost-plus method in the internal and external variants. The Producer does not provide production services to unrelated parties and the Distributor does not receive comparable services from unrelated parties. The Manufacturer also does not have information on the mark-up on costs in comparable uncontrolled transactions, hence it is not possible to apply the cost-plus method in the external variant.

In view of the assumptions made, the Transactional net margin method was used to verify the terms of the controlled transaction in question. The Manufacturer, which performs routine functions, was adopted as the tested (tested) party. For the purposes of the financial analysis, the operating cost mark-up ratio (WF07) was used, adopted on the basis of available financial data and the company's functional profile.

As production is homogeneous and the Manufacturer has no significant other activities, an operating mark-up was calculated on the basis of all the entity's activities:

Item (according to the calculation option)	Value
A. Cost of products, goods and materials sold	PLN 73,246,325
B. Cost of sales	PLN 12,110,000
C. General and administrative expenses	PLN 4 825 000
D. Other operating expenses	PLN 2 243 565
E. Operating profit	PLN 4,621,245
Operating charge: $\frac{E}{A+B+C+D} * 100\%$.	5%

Comparability analysis

A comparability analysis was then carried out on the basis of the criteria indicated in Section 3 of the TP Ordinance 2019.

Characteristics of goods, services or other performances

The analysis focused on entities carrying out activities as comparable as possible to those carried out by the Manufacturer. For this reason, entities engaged in the production of electrical equipment, which, due to the routine nature of the manufacturer, did not provide distribution or support in terms of, inter alia, installation or post-warranty service, were considered comparable.

The above criterion was taken into account in the analysis of external comparative data available in the financial statements database. In this database, comparable entities were searched using business activity codes (PKD) identical to the Producer's activities.

Transaction flow, including functional analysis

As the entities selected on the basis of business activity codes may in fact perform a different range of functions, involve different assets and incur different risks than the Producer, it is necessary to further analyse the comparability of the entities in the sample (e.g. by qualitative analysis of the data on the basis of information from the companies' websites). Further analysis excluded from the sample of preselected entities those that do not meet the comparability criterion for the Producer's business profile.

Key factors influencing the comparability of the Manufacturer were then identified. In particular, companies that were active in the manufacture of electrical equipment were considered comparable.

Companies that were considered to be incomparable were:

- were involved in the distribution of equipment,
- offered support related to the installation of the equipment,
- offer post-warranty support.

Conditions specified in the contract, agreement or other evidence documenting those conditions

Based on the available data, it was not possible to assess the specific terms and conditions set out in the transactions of the comparators.

Economic conditions prevailing at the time and place of the transaction

The analysis was carried out with reference to entities operating on the Polish market. This made it possible to identify companies operating in comparable market conditions to the Producer, e.g. with regard to labour costs or local legal conditions. The analysis was not extended to other countries, as the application of the criterion of the geographical range of operations made it possible to identify a sufficient number of comparable entities on the local market.

Economic strategy

The information on the applied business strategy provided in the transfer pricing documentation indicated the general objectives of the company, such as providing products of the highest quality by controlling the production processes, ensuring timely deliveries, etc. No impact of the applied strategy on the profitability of the Manufacturer was found.

Selection of operators

Stage I - Entity search

Entities engaged in comparable activities were searched in external databases. The search was conducted on the basis of the producer's PKD codes. The entities thus selected were subjected to further verification.

Stage II - verification of the availability and quality of financial data of the selected entities

In Phase II, only entities were accepted that had the relevant financial data necessary for the financial analysis, i.e. to calculate the mark-up on operating costs.

Stage III - Verification of comparability

Stage III consists of a detailed qualitative analysis and final selection of entities, based, among other things, on the information provided in the database and on the websites of individual companies.

In Stage III, companies were rejected:

- for which there was insufficient information to determine the object of the activity,
- which may have been involved in related party transactions,
- engaged in incomparable activities or activities of a similar nature, which, however, could not be considered comparable due to the overly broad scope of the offer.

If a subject is rejected from the sample, the reason for the rejection is noted in a way that can be verified later.

Ultimately, 16 comparable entities were selected. Financial and statistical analysis

Based on the data obtained, statistical calculations were made of the interquartile ranges for the selected entities.

With regard to the selected sample of entities, it is difficult to identify observations that are more or less comparable to the controlled transaction under study. Due to the heterogeneity of the financial results of the companies analysed, it was considered that there may be differentiating factors, which in practice, however, are difficult to identify based on publicly available data.

In order to increase the reliability of the results and to take into account the possible risk of incomplete comparability of the data and the rejection of extreme observations, a market interval, understood as an interquartile range, was applied, as shown below.

Operating charge	
Position	Value
Number of observations	16
Minimum	0,5%
Lower quartile	4,3%
Median	5,5%
Upper quartile	6,4%
Maximum	15,5%

The level of the manufacturer's operating mark-up (5%) was related to the operating mark-ups identified in the study. The inter-quartile range (defined by the lower and upper quartile) of the operating mark-ups realised by entities similar to the manufacturer is between 4.3% and 6.4%. The manufacturer's operating mark-up is 5% and is therefore within the inter-quartile range, which makes it possible to assume that the operating mark-up applied by the manufacturer is a market mark-up under the given circumstances.