## Profit Split Method

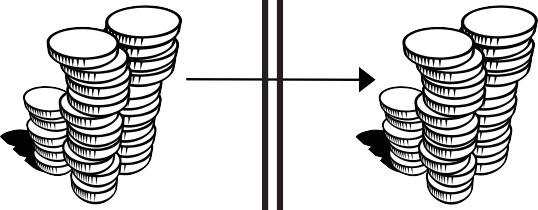
* + - * 1. The Profit Split Method is typically applied when both sides of the controlled transaction contribute significant intangi- ble property. The profit is to be divided such as is expected in a joint venture relationship.
        2. The Profit Split Method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transac- tion (or in controlled transactions that it is appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions. Figure B.3.5 illustrates this.

Figure B.3.5:

### Profit Split Method

Associated Enterprise 1

Associated Enterprise 2



* + - * 1. The Profit Split Method starts by identifying the profits to be divided between the associated enterprises from the controlled trans- actions. Subsequently, these profits are divided between the associated enterprises based on the relative value of each enterprise’s contribu- tion, which should reflect the functions performed, risks incurred and assets used by each enterprise in the controlled transactions. External market data (e.g. profit split percentages among independent enterprises performing comparable functions) should be used to value each enter- prise’s contribution, if possible, so that the division of combined profits between the associated enterprises is in accordance with that between independent enterprises performing functions comparable to the func- tions performed by the associated enterprises. The Profit Split Method is applicable to transfer pricing issues involving tangible property, intan- gible property, trading activities or financial services.

## Methods to Allocate or Split the Profits

* + - * 1. There are generally considered to be two specific methods to allocate the profits between the associated enterprises: contribution analysis and residual analysis.
        2. Under the contribution analysis the combined profits from the controlled transactions are allocated between the associated enterprises on the basis of the relative value of functions performed by those associated enterprises engaged in the controlled transactions. External market data that reflect how independent enterprises allocate the profits in similar circumstances should complement the analysis to the extent possible.
        3. If the relative value of the contributions can be calcu- lated directly, then determining the actual value of the contribution of each enterprise may not be required. The combined profits from the controlled transactions should normally be determined on the basis of operating profits. However, in some cases it might be proper to divide gross profits first and subsequently subtract the expenses attributable to each enterprise.
        4. Under the residual analysis the combined profits from the controlled transactions are allocated between the associated enter- prises based on a two-step approach:

*Step 1*: allocation of sufficient profit to each enterprise to pro- vide basic arm’s length compensation for routine contributions. This basic compensation does not include a return for possible valuable intangible assets owned by the associated enterprises. The basic compensation is determined based on the returns earned by comparable independent enterprises for comparable transactions or, more frequently, functions. In practice TNMM is used to determine the appropriate return in Step 1 of the residual analysis; and

*Step 2:* allocation of residual profit (i.e. profit remaining after Step 1) between the associated enterprises based on the facts and circumstances. If the residual profit is attributable to intan- gible property then the allocation of this profit should be based on the relative value of each enterprise’s contributions of intan- gible property.

* + - * 1. The residual analysis is typically applied to cases where both sides of the controlled transaction contribute valuable intangi- ble property to the transaction. For example, Company X manufac- tures components using valuable intangible property and sells these components to a related Company Y which uses the components and

also uses valuable intangible property to manufacture final products and sells them to customers. The first step of a residual analysis would allocate a basic (arm’s length) return to Company X for its manufac- turing function and a basic (arm’s length) return to Company Y for its manufacturing and distribution functions. The residual profit remain- ing after this step is attributable to the intangible properties owned by the two companies. The allocation of the residual profit is based on the relative value of each company’s contributions of intangible prop- erty. The OECD Guidelines do not refer to specific allocation keys to be used in this respect. Step 2 may not, and typically does not, depend on the use of comparables.

* + - * 1. The following approaches have been specified in some jurisdictions to determine the relative value of each company’s contri- butions of intangible property:

External market benchmarks reflecting the fair market value of the intangible property;

The capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible;**51** and

The amount of actual intangible development expenditures in recent years if these expenditures have been constant over time and the useful life of the intangible property of all parties involved is broadly similar.

* + - * 1. The Residual Profit Split Method is used more in practice than the contribution approach for two reasons. Firstly, the residual approach breaks up a complicated transfer pricing problem into two manageable steps. The first step determines a basic return for routine functions based on comparables. The second step analyzes returns to (often unique) intangible assets based not on comparables but on rela- tive value which is, in many cases, a practical solution. Secondly, poten- tial conflict with the tax authorities is reduced by using the two-step residual approach since it reduces the amount of profit that is to be split in the potentially more controversial second step.

51 A disadvantage of this approach is that cost may not reflect the market value of the intangible property.

## Comparable Profit Split Method

* + - * 1. A different version of the Profit Split Method is used in some countries. In this version the profit is split by comparing the allo- cation of operating profits between the associated enterprises to the allocation of operating profits between independent enterprises partic- ipating in similar activities under similar circumstances (Comparable Profit Split Method). The major difference with the contribution anal- ysis is that the Comparable Profit Split Method depends on the availa- bility of external market data to measure directly the relative value of contributions, while the contribution analysis can still be applied even if such a direct measurement is not possible.
        2. The contribution analysis and the Comparable Profit Split Method are difficult to apply in practice and therefore not often used. This is especially the case because the reliable external market data necessary to split the combined profits between the associated enter- prises are often not available.

## Strengths and Weaknesses

* + - * 1. The strengths of the Profit Split Method include:

It is suitable for highly integrated operations for which a one-sided method may not be appropriate;

It is suitable in cases where the traditional methods prove inap- propriate due to a lack of comparable transactions;

The method avoids an extreme result for one of the associated enterprises involved due to its two-sided approach (i.e. all par- ties to the controlled transaction are being analyzed); and

This method is able (uniquely among commonly used transfer pricing methods) to deal with returns to synergies between intangible assets or profits arising from economies of scale.

* + - * 1. The weaknesses of the Profit Split Method include:

The relative theoretical weakness of the second step. In par- ticular, the theoretical basis for the assumption that synergy value is divided pro rata to the relative value of inputs is unclear (although this approach is arguably consistent with the way interests are divided between participants in a joint venture);

Its dependence on access to data from foreign affiliates. Associated enterprises and tax administrations may have dif- ficulty obtaining information from foreign affiliates; and

Certain measurement problems exist in applying the Profit Split Method. It may be difficult to calculate combined revenue and costs for all the associated enterprises taking part in the con- trolled transactions due to, for example, differences in account- ing practices. It may also be hard to allocate costs and operating expenses between the controlled transactions and other activi- ties of the associated enterprises.

## When to Use the Profit Split Methods

* + - * 1. The Profit Split Method might be used in cases involving highly interrelated transactions that cannot be analyzed on a sepa- rate basis. This means that the Profit Split Method can be applied in cases where the associated enterprises engage in several transactions that are so interdependent that they cannot be evaluated on a sepa- rate basis using a traditional transaction method. In other words, the transactions are so interrelated that it is impossible to identify compa- rable transactions. In this respect, the Profit Split Method is applica- ble in complex industries such as, for example, the global financial services business.
        2. The (Residual) Profit Split Method is typically used in complex cases where both sides to the controlled transaction own valu- able intangible property (e.g. patents, trademarks and trade names). If only one of the associated enterprises owns valuable intangible prop- erty, the other associated enterprise will be the tested party in an analy- sis using the cost plus, resale price or transactional net margin methods. However, if both sides own valuable intangible properties for which it is impossible to find comparables, then the Profit Split Method might be the most reliable method. A practical example would be where Company A designs and manufactures electronic components and transfers the components to a related Company B which uses them to manufacture an electronic product. Both Company A and Company B use innovative technological design to manufacture the components and electronic product, respectively. Company C, a related Company, distributes the electronic products. Assuming that the transfer price between Company B and Company C is at arm’s length based on the

Resale Price Method, the Residual Profit Split Method is applied to determine the arm’s length transfer price between Company A and Company B because both companies own valuable intangible property.

* + - * 1. In step 1 of the residual analysis, a basic return for the manufacturing function is determined for Company A and Company

1. Specifically a benchmarking analysis is performed to search for comparable independent manufacturers which do not own valuable intangible property. The residual profit, which is the combined profits of Company A and Company B after deducting the basic (arm’s length) return for the manufacturing function, is then divided between Company A and Company B. This allocation is based on relative R&D expenses which are assumed to be a reliable key to measure the rela- tive value of each company’s intangible property. Subsequently, the net profits of Company A and Company B are calculated in order to work back to a transfer price.
   * + - 1. The Profit Split Method involves the determination of the factors that bring about the combined profit, setting a relative weight to each factor and calculating the allocation of profits between the associated enterprises. The contribution analysis is difficult to apply, because external market data that reflect how independent enterprises would allocate the profits in similar circumstances is usually not avail- able. The first step of the residual analysis often involves the use of the TNMM to calculate a return and is not, in itself, more complicated than the typical application of TNMM. The second step is, however, an additional step and often raises difficult additional issues relating to the valuation of intangibles.

## Examples: Application of Residual Profit Split

1. XYZ is a corporation that develops, manufactures and markets a line of products for use by the police in Country A. XYZ’s research unit developed a bulletproof material for use in protective cloth- ing and headgear (Stelon). XYZ obtains patent protection for the chemical formula for Stelon. Since its introduction, Stelon has cap- tured a substantial share of the market for bulletproof material.
2. XYZ licensed its Asian subsidiary, XYZ-Asia, to manufacture and market Stelon in Asia. XYZ-Asia is a well-established company that

manufactures and markets XYZ products in Asia. XYZ-Asia has a research unit that adapts XYZ products for the defence market, as well as a well-developed marketing network that employs brand names that it has developed.

* 1. XYZ-Asia’s research unit alters Stelon to adapt it to military specifi- cations and develops a high-intensity marketing campaign directed at the defence industry in several Asian countries. Beginning with the 2009 taxable year, XYZ-Asia manufactures and sells Stelon in Asia through its marketing network under one of its brand names.
  2. For the 2009 tax year XYZ has no direct expenses associated with the license of Stelon to XYZ-Asia and incurs no expenses related to the marketing of Stelon in Asia. For the 2009 tax year XYZ-Asia’s Stelon sales and pre-royalty expenses are $500 Million and $300 Million, respectively, resulting in net pre-royalty profit of $200 Million related to the Stelon business. The operating assets employed in XYZ-Asia’s Stelon business are $200 Million. Given the facts and circumstances, Country A’s taxing authority determines that a residual profit split will provide the most reli- able measure of an arm’s length result. Based on an examination of a sample of Asian companies performing functions similar to those of XYZ-Asia the district director determines that an aver- age market return on XYZ-Asia’s operating assets in the Stelon business is 10%, resulting in a market return of $20 Million (10% x

$200 Million) for XYZ-Asia’s Stelon business, and a residual profit of $180 Million.

* 1. Since the first stage of the residual profit split allocated profits to XYZ-Asia’s contributions other than those attributable to highly valuable intangible property, it is assumed that the residual profit of $180 Million is attributable to the valuable intangibles related to Stelon, i.e. the Asian brand name for Stelon and the Stelon for- mula (including XYZ-Asia’s modifications). To estimate the relative values of these intangibles the taxing authority compares the ratios of the capitalized value of expenditures as of 2009 on Stelon-related research and development and marketing over the 2009 sales related to such expenditures.
  2. As XYZ’s protective product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide busi- ness activities to which they relate. The taxing authority determines that it is reasonable to allocate the value of these expenses based

on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, the taxing authority capitalizes and amortizes XYZ’s protective product research and development expenses. This analysis indicates that the capitalized research and development expenditures have a value of $0.20 per dollar of global protective product sales in the 2009 tax year.

1. XYZ-Asia’s expenditures on Stelon research and development and marketing support only its sales in Asia. Using information on the average useful life of XYZ-Asia’s investments in marketing and research and development the taxing authority capitalizes and amortizes XYZ-Asia’s expenditures and determines that they have a value in 2009 of $0.40 per dollar of XYZ-Asia’s Stelon sales.
2. Thus, XYZ and XYZ-Asia together contributed $0.60 in capitalized intangible development expenses for each dollar of XYZ-Asia’s protective product sales for 2009, of which XYZ contributed a third (or $0.20 per dollar of sales). Accordingly, the taxing authority determines that an arm’s length royalty for the Stelon license for the 2009 taxable year is $60 Million, i.e. one-third of XYZ-Asia’s

$180 Million in residual Stelon profit.

## B .3 .4 . The “Sixth Method” or “Commodity Rule”

* + - 1. **Introduction**
         1. Transfer pricing rules require associated enterprises to price their intercompany transactions in accordance with the arm’s length principle. The five methods set forth in Chapters B.3.2 and B.3.3 (Transfer Pricing Methods) of this Practical Manual are used to calcu- late or test the arm’s length nature of intercompany prices or prof- its earned from intercompany transactions. As set forth in Chapter B.3.1.2.1, the starting point in selecting a transfer pricing method is an understanding of the controlled transaction (inbound or outbound) based on the comparability (including the functional) analysis. This is necessary regardless of which transfer pricing method is selected. The CUP method is a suitable method when prices from comparable trans- actions of the same or similar products are available. For instance, the quoted prices of the commodities market may be comparable uncon- trolled prices for transactions with commodities performed by related parties under comparable circumstances.
         2. Tax authorities may find themselves unable to successfully determine whether a controlled transaction between associated enter- prises is comparable with uncontrolled transactions observed in the market if the taxpayer does not provide sufficient supporting docu- mentation to its controlled transactions. For developing countries this concern may be even more pressing than for developed countries, as the former countries may not have data on companies doing business in their countries to perform a comparability analysis in addition to potentially having limited know-how and resources to conduct trans- fer pricing studies.
         3. In view of this difficulty, several countries have a rule in place that is generally referred to as the so-called “sixth method” or “commodity rule” although the name of the rule or the method applied may differ from country to country. Historically this approach has been used for commodities by several countries. The common feature of these rules is that they rely on the quoted prices of the commodi- ties market to price commodity transactions between associated enter- prises. For practical purposes, in this Section the approach will be referenced as the “sixth method”.**52**
         4. Because of its widespread application, this Section discusses the rationale for and country experiences with the “sixth method”. Its inclusion in this Section, however, does not seek to address the rela- tionship between the sixth method as implemented in any particular domestic legislation and the arm’s length principle as defined under Article 9 of UN Model Convention. The workings of the sixth method may resemble the Comparable Uncontrolled Price (CUP) method. In addition, it generally considers certain characteristics and substance requirements, as defined in relevant domestic practices, for the sixth method to be applicable to a particular transaction. Absent reliable and timely confirmation from the taxpayer about the relevant charac- teristics of the controlled transaction, some countries apply a default rule which includes the application of a transfer price based on publicly available pricing information and typically an assumption of the time the relevant tested transaction took place (which corresponds to the

52 As the rule is referenced as the “sixth method” in Argentina where it seems to have originated, for all practical purposes this title and wording will be used in this Section.

commodity price listing used). Despite its more general title, consider- ing its operation, the sixth method— depending on how it is applied— could be considered as an anti-abuse rule, an abuse-deeming rule or even presumed a form of safe harbour. Some countries consider the sixth method an (imperfect) application of the CUP method.**53** This Section will refer to the practice as “the sixth method” without address- ing whether the term method, anti-abuse rule or abuse-deeming rule or safe harbour is more appropriate or legally more correct.

* + - * 1. The sixth method-approach has benefits and disadvantages. A benefit of the sixth method is its relative certainty and relative ease of application for the tax authorities and its tax collection efficiency. Some disadvantages of the sixth method are that it is not one of the traditional transactions methods or traditional profit methods described in this Chapter and thus may not be recognized by the country of the associ- ated enterprise at the other end of the transaction; its inaccuracy consid- ering the general standard application of the arm’s length principle; that the method does not consider the economic circumstances of the actual transaction that is tested; and that the method may result in overcom- pensation of one associated enterprise at the detriment of another asso- ciated enterprise and therefore potential double taxation. Benefits and disadvantages are discussed further in paragraph B.3.4.3.3.1 infra.

This chapter describes the so-called sixth method as it is observed in practice in several countries. It also discusses OECD guid- ance and an Inter-American Center of Tax Administrations (CIAT) study relevant to this method or approach that generally is used to tackle abusive transfer pricing practices. The chapter aims to provide a description of the application of the so-called sixth method in case of commodity transactions and describes what steps can be taken to mitigate some identified disadvantages of using the sixth method