

Annex II to Chapter II

Example to Illustrate the Application of the Residual Profit Split Method

See Chapter II, Part III, Section C of these Guidelines for general guidance on the application of the profit split method.

The adjustments and assumptions about arm's length arrangements in the examples that follow are intended for illustrative purposes only and should not be taken as prescribing adjustments and arm's length arrangements in actual cases or particular industries. While they seek to demonstrate the principles of the Sections of the Guidelines to which they refer, those principles must be applied in each case according to the specific facts and circumstances of that case.

1. The success of an electronics product is linked to the innovative technological design both of its electronic processes and of its major component. That component is designed and manufactured by associated company A, is transferred to associated company B which designs and manufactures the rest of the product, and is distributed by associated company C. Information exists to verify by means of a resale price method that the distribution functions and risks of Company C are being appropriately rewarded by the transfer price of the finished product from B to C.

2. The most appropriate method to price the component transferred from A to B may be a CUP, if a sufficiently similar comparable could be found. See paragraph 2.14 of the Guidelines. However, since the component transferred from A to B reflects the innovative technological advance enjoyed by company A in this market, in this example it proves impossible (after the appropriate functional and comparability analyses have been carried out) to find a reliable CUP to estimate the correct price that A could command at arm's length for its product. Calculating a return on A's manufacturing costs could however provide an estimate of the profit element

which would reward A's manufacturing functions, ignoring the profit element attributable to the intangible used therein. A similar calculation could be performed on company B's manufacturing costs, to give an estimate of B's profit derived from its manufacturing functions, ignoring the profit element attributable to its intangible. Since B's selling price to C is known and is accepted as an arm's length price, the amount of the residual profit accrued by A and B together from the exploitation of their respective intangible property can be determined. See paragraphs 2.108 and 2.121 of the Guidelines. At this stage the proportion of this residual profit properly attributable to each enterprise remains undetermined.

3. The residual profit may be split based on an analysis of the facts and circumstances that might indicate how the additional reward would have been allocated at arm's length. Paragraph 2.121 of the Guidelines. The R&D activity of each company is directed towards technological design relating to the same class of item, and it is established for the purposes of this example that the relative amounts of R&D expenditure reliably measure the relative value of the companies' contributions. See paragraph 2.120 of the Guidelines. This means that each company's contribution to the product's technological innovation may reliably be measured by their relative expenditure on research and development, so that, if A's R&D expenditure is 15 and B's 10, the residual could be split 3/5 for A and 2/5 for B.

4. Some figures may assist in following the example:

a) **Profit & Loss of A and B**

	A	B
Sales	50	100
Less:		
Purchases	(10)	(50)
Manufacturing costs	(15)	<u>(20)</u>
Gross profits	25	30
Less:		
R&D	15	10
Operating expenses	10 (25)	10 (20)
Net profit	<u>0</u>	<u>10</u>

b) Determine routine profit on manufacturing by A and B, and calculate total residual profit

5. It is established, for both jurisdictions, that third-party comparable manufacturers without innovative intangible property earn a return on manufacturing costs (excluding purchases) of 10% (ratio of net profit to the direct and indirect costs of manufacturing).¹ See paragraph 2.121 of the Guidelines. A's manufacturing costs are 15, and so the return on costs would attribute to A a manufacturing profit of 1.5. B's equivalent costs are 20, and so the return on costs would attribute to B a manufacturing profit of 2.0. The residual profit is therefore 6.5, arrived at by deducting from the combined net profit of 10 the combined manufacturing profit of 3.5.

c) Allocate residual profit

6. The initial allocation of profit (1.5 to A and 2.0 to B) rewards the manufacturing functions of A and B, but does not recognise the value of their respective R&D that has resulted in a technologically advanced product. That residual can, therefore, be split between A and B based on their share of total R&D costs, since, for the purposes of this example², it can reliably be assumed that the companies' relative expenditure on R&D accurately reflects their relative contributions to the value of the product's technological innovation. A's R&D expenditure is 15 and B's 10, giving combined R&D expenditure of 25. The residual is 6.5 which may be allocated 15/25 to A and 10/25 to B, resulting in a share of 3.9 and 2.6 respectively, as below:

A's share $6.5 \times 15/25 = 3.9$

B's share $6.5 \times 10/25 = 2.6$.

¹ This 10% return does not technically correspond to a cost plus mark-up in its strictest sense because it yields net profit rather than gross profit. But neither does the 10% return correspond to a TNMM margin in its strictest sense, since the cost base does not include operating expenses. The net return on manufacturing costs is being used as a convenient and practical first stage of the profit split method, because it simplifies the determination of the amount of residual net profit attributable to intangible property.

² But see paragraph 6.27 of the Guidelines.

d) Recalculate Profits

7. A's net profits would thus become $1.5 + 3.9 = 5.4$.

B's net profits would thus become $2.0 + 2.6 = 4.6$.

The revised P & L for tax purposes would appear as:

	A	B
Sales	55.4	100
Less:		
Purchases	(10)	(55.4)
Manufacturing costs	(15)	(20)
Gross profit	30.4	24.6
Less:		
R&D	15	10
Operating expenses	10 (25)	10 (20)
Net profit	5.4	4.6

Note

8. The example is intended to exemplify in a simple manner the mechanisms of a residual profit split and should not be interpreted as providing general guidance as to how the arm's length principle should apply in identifying arm's length comparables and determining an appropriate split. It is important that the principles that it seeks to illustrate are applied in each case taking into account the specific facts and circumstances of the case. In particular, it should be noted that the allocation of the residual split may need considerable refinement in practice in order to identify and quantify the appropriate basis for the allocation. Where R&D expenditure is used, differences in the types of R&D conducted may need to be taken into account, *e.g.* because different types of R&D may have different levels of risk associated with them, which would lead to different levels of expected returns at arm's length. Relative levels of current R&D expenditure also may not adequately reflect the contribution to the earning of current profits that is attributable to intangible property developed or acquired in the past.



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