Annex III to Chapter II

Illustration of Different Measures of Profits When Applying a Transactional Profit Split Method

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

The assumptions about arm's length arrangements in the following examples are intended for illustrative purposes only and should not be taken as prescribing adjustments and arm's length arrangements in actual cases of 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.

Furthermore, the comments below relate to the application of a transactional profit split method in the situations where, given the facts and circumstances of the case and in particular the comparability (including functional) analysis of the transaction and the review of the information available on uncontrolled comparables, such a method is found to be the most appropriate method to be used.

1. Below are some illustrations of the effect of choosing a measure of profits to determine the combined profits to be split when applying a transactional profit split method.

2. Assume A and B are two associated enterprises situated in two different tax jurisdictions. Both manufacture the same widgets and incur expenditure that results in the creation of an intangible asset which they can mutually use. For the purpose of this example, it is assumed that the nature of this particular asset is such that the value of the asset contribution attributable to each of A and B in the year in question is proportional to A and B's relative expenditure on the asset in that year. (It should be noted that this assumption will not always be true in practice. This is because there may be cases where the relative values of asset contributions attributable to each party would be based on accumulated expenditure from the prior, as well as current years.) Assume A and B exclusively sell products to third

parties. Assume that it is determined that the most appropriate method to be used is a residual profit split method, that the manufacturing activities of A and B are simple, non-unique transactions that should be allocated an initial return of 10% of the Cost of Goods Sold and that the residual profit should be split in proportion to A's and B's intangible asset expenditure. The following figures are for illustration only:

	A	B	Combined A + B
Sales	100	300	400
Cost Of Goods Sold	60	170	230
Gross Profit	40	130	170
Overhead expenses	3	6	9
Other operating expenses	2	4	6
Intangible asset expenditure	30	40	70
Operating Profit	5	80	85

3. **Step one:** determining the initial return for the non-unique manufacturing transactions (Cost of Goods Sold + 10% in this example)

A	60 + (60 * 10 %) = 66	→ Initial return for the manufacturing transactions of A =	6
B	170 + (170 * 10 %) = 187	→ Initial return for the manufacturing transactions of B =	17
		Total profit allocated through initial returns (6+17) =	23

4. **Step two:** determining the residual profit to be split

a) In case it is determined as the operating profit:

Combined Operating Profit	85
Profit already allocated (initial returns for manufacturing transactions)	23
Residual profit to be split in proportion to A's and B's intangible asset expenditure	62

Residual profit allocated to A:	62 * 30/70	26.57
Residual profit allocated to B:	62 * 40/70	35.43
Total profits allocated to A:	6 (initial return) + 26.57 (residual)	32.57
Total profits allocated to B:	17 (initial return) + 35.43 (residual)	52.43
Total		85

b) *In case it is determined as the operating profit before overhead expenses (assuming it is determined that the overhead expenses of A and B do not relate to the transaction examined and should be excluded from the determination of the combined profits to be split):*

	A	B	Combined A + B
Sales	100	300	400
Cost Of Goods Sold	60	170	230
Gross Profit	40	130	170
Other operating expenses	2	4	6
Intangible asset expenditure	30	40	70
Operating Profit before overhead expenses	8	86	94
Overhead expenses	3	6	9
Operating Profit	5	80	85

Combined Operating Profit before overhead expenses	94
Profit already allocated (initial returns for manufacturing transactions)	23
Residual profit before overhead expenses to be split in proportion to A's and B's intangible asset expenditure	71

Residual profit allocated to A:	71 * 30/70	30.43
Residual profit allocated to B:	71 * 40/70	40.57
Total profits allocated to A:	6 (initial return) + 30.43 (residual) – 3 (overhead expenses)	33.43
Total profits allocated to B:	17 (initial return) + 40.57 (residual) – 6 (overhead expenses)	51.57
Total		85

5. As shown in the above example, excluding some specific items from the determination of the combined profits to be split implies that each party remains responsible for its own expenses in relation to it. As a consequence, the decision whether or not to exclude some specific items must be consistent with the comparability (including functional) analysis of the transaction.

6. As another example, in some cases it may be appropriate to back out a category of expenses to the extent that the allocation key used in the residual profit split analysis relies on those expenses. For example, in cases

where relative expenditure contributing to the development of an intangible asset is determined to be the most appropriate profit split factor, residual profits can be based on operating profits *before* that expenditure. After determining the split of residual profits, each associated enterprise then subtracts its own expenditure. This can be illustrated as follows. Assume the facts are the same as in the example at paragraph 2 above and assume the overhead expenses are not excluded from the determination of the residual profit to be split.

7. **Step one:** determining the basic return for the manufacturing activities (Cost of Goods Sold + 10% in this example)

Same as at paragraph 3.

8. **Step two:** determining the residual profit to be split

a) *In case it is determined as the operating profit after intangible asset expenditure:*

Same as at paragraph 4, case a)

b) *In case it is determined as the operating profit before* intangible asset expenditure*:*

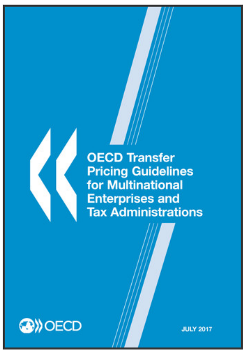
	A	B	Combined A + B
Sales	100	300	400
Cost Of Goods Sold	60	170	230
Gross Profit	40	130	170
Overhead expenses	3	6	9
Other operating expenses	2	4	6
Operating profit intangible asset expenditure	35	120	155
Intangible asset expenditure	30	40	70
Operating Profit	5	80	85

Combined Operating Profit before intangible asset expenditure		155
Profit already allocated (initial returns for manufacturing transactions)		23
Residual profit before intangible asset expenditure to be split in proportion to A's and B's intangible asset expenditure		132
Residual profit allocated to A:	132 * 30/70	56.57

Residual profit allocated to B:	132 * 40/70	75.43
Total profits allocated to A:	6 (initial return) + 56.57 (residual) – 30 (intangible asset expenditure)	32.57
Total profits allocated to B:	17 (initial return) + 75.43 (residual) – 40 (intangible asset expenditure)	52.43
Total		85

i.e. A and B are allocated the same profits as in the case where the profit to be split is determined as the operating profit after intangible asset expenditure, see case a) above.

9. This example illustrates the fact that, when the allocation key used to split the residual profit relies on a category of expenses incurred during the period, it is indifferent whether the residual profit to be split is determined before said expenses and the expenses are deducted by each party, or whether the residual profit to be split is determined after said expenses. The outcome can however be different in the case where the split factor is based on the accumulated expenditure of the prior as well as current years (see paragraph 2 above).



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