

Aatma Capital
Nurturing Relationships



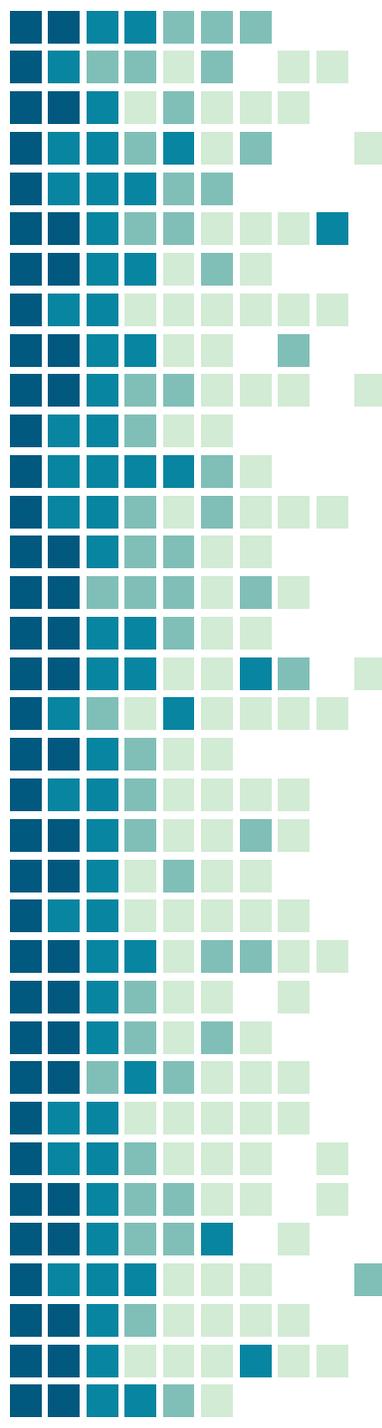
Profit Split Method

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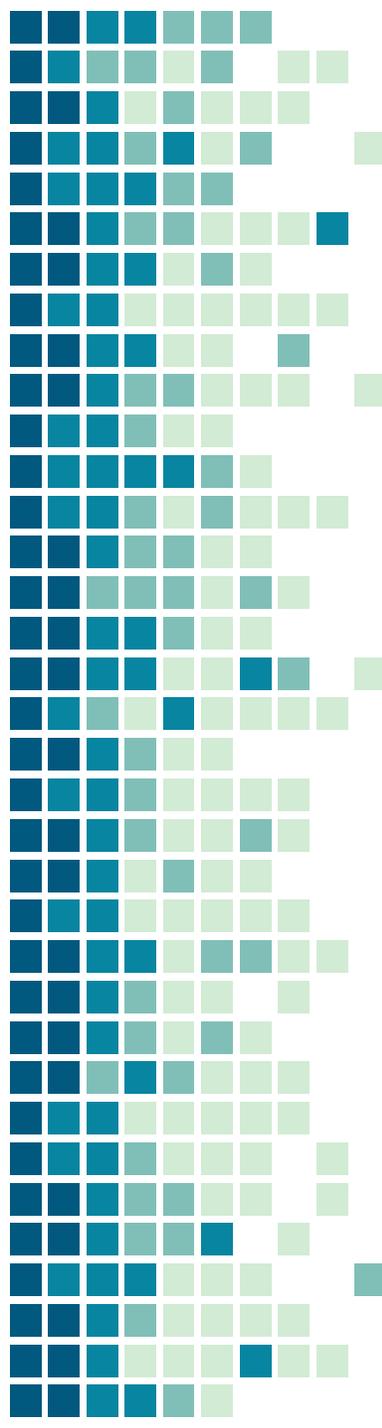
Independent legal & accounting firms



Research Credits

Sundarrajan S

Legends used in the Presentation



ALP	Arm's Length Price
MNE	Multi National Enterprise
OECD	Organization for Economic Cooperation and Development
PSM	Profit Split Method
TP	Transfer Pricing
R&D	Research and Development

Presentation Scheme



Introduction

Overview

Profit Split Method (PSM) is **one of the methods of transfer pricing** used in determining computation of arm's length price

PSM is a **useful, but often, complex method of determining transfer prices** based on an allocation of the relevant, combined profits made by the related parties in relation to the transaction

PSM **seeks to eliminate the effect on profits of special conditions** made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction(s)

PSM starts by identifying the relevant profits, or indeed losses in relation to the controlled transactions

It then seeks to split those profits or losses between the associated enterprises involved on an **economically valid basis** in order to achieve an arm's length outcome for each party

Typically, the **split should reflect the relative value of each enterprise's contribution**, including its functions performed, risks assumed and assets used or contributed

Strengths and Weaknesses of PSM

Strengths

It can provide a solution in cases where **one-sided methods** (where one party to the controlled transaction performs benchmark functions. E.g. cost plus method, resale price method, etc.) **are not appropriate** because each party to the transaction makes a unique and valuable contribution which cannot be benchmarked

It can be used where the level of integration, or the sharing of risks between the related parties means that the **contribution of each party cannot be evaluated in isolation from those of other parties**

As a two-sided method (where both the parties to the controlled transactions are tested), all relevant parties to the transaction are directly evaluated, helping to ensure an arm's length result for each entity **based on the relative value of its specific contributions**

It is able to **deal with returns to synergies between contributions or profits arising from economies of scale**

Weakness

PSM is often complex to apply; It may be **difficult to measure the relevant revenues and costs** to be split between the related parties

In addition to measurement difficulties, the method is typically **highly reliant on detailed data from the MNE group**

Determining an appropriate way to split the profits can at times be challenging

Since reliable, direct information on the allocation of profits in comparable independent transactions is relatively rare, the **PSM often relies on less direct information or proxies (e.g. relative value of the contributions of each party)** in its application of the arm's length principle

Appropriateness of PSM

When to Use PSM?

As with any transfer pricing method, PSM should be used where it is found to be the most appropriate method to the circumstances of the case

Primarily, this **determination is based on the nature of the accurately delineated transaction*** in the context of its circumstances

The analysis to determine the accurately delineated transaction should consider

- the **commercial and financial relations between the related parties**, a consideration of their functions performed, assets used or contributed, and risks assumed, and
- **how the activities of the parties impact the transaction** given the market context in which the transaction occurs

PSM can be a complex method to apply reliably, the determination of when it is the most appropriate method should be done as objectively as possible. That is, the **PSM should not simply be regarded as a method of last resort**

PSM is **most often applied by companies in complex industries with relatively high profits**, such as high technology and pharmaceutical organizations. It's **especially useful when dealing with intangible goods, such as intellectual property**, as these transactions are often too complex for the other methods to be applied

- ***Accurate delineation of a transaction is about assessing how the actual behaviour of the parties to the transaction stacks up against what is provided in the written contract**
- Through this process, TP exercise **focuses on pricing the “real deal” as opposed to pricing a written contract** that may not reflect the true contributions of the parties to value creation

Indicators of PSM

Indicators of PSM

The profit split method may be appropriate where:

- **each related party to the transaction makes unique and valuable contributions; and/or**
- **the business operations of the related parties are so highly integrated that they cannot be reliably evaluated in isolation from each other; and/or**
- **the parties share the assumption of economically significant risk or separately assume closely related risks**

The presence of any one or more of the above indicators suggests that PSM may be the most appropriate method

Where one or more of the above indicators is present, it is highly unlikely that reliable comparable transactions will be available

However, a lack of comparables per se is insufficient evidence to conclude that PSM will be the most appropriate method

That is, **PSM should not become a convenient method to be applied in every case where close comparables cannot be identified**

Contd.

- In contrast, where none of the indicators are present and the accurate delineation of the transaction shows that one of the related parties to the transaction performs functions, uses or contributes assets and assumes risks that can be reliably benchmarked by reference to uncontrolled comparables, PSM is unlikely to be the most appropriate method

- In such cases, it is **likely to be more reliable to apply a transfer pricing method making use of the uncontrolled comparables**, even in cases where 'perfect' or closely comparable uncontrolled transactions are lacking

- As with any other method, pricing practices used between independent parties engaged in similar transactions in the same industry or market can provide information relevant to the analysis of the most appropriate transfer pricing method

Unique and Valuable Contribution

The clearest indicator that PSM may be the most appropriate method involves situations in which **each party to the controlled transaction makes unique and valuable contributions**

Such contributions (e.g. functions performed, assets used or contributed, including intangibles) will be “unique and valuable” where:

they are not comparable to contributions made by uncontrolled parties in comparable circumstances; and

they represent a key source of actual or potential economic benefits in the business operations

Together, these factors mean that the application of other transfer pricing methods may not be capable of reliably determining an arm’s length outcome because **related party cannot be reliably benchmarked by reference to comparables**

When evaluating whether certain contributions are unique and valuable, a **consideration of the context of the transaction, including the industry and market in which it occurs and the factors which affect business performance in that context are particularly relevant**

Highly Integrated Operations

All MNE groups have business operations which are integrated to some degree

However PSM is likely to be the most appropriate method **only in those cases where the integration is so significant**

that the way in which each party performs functions, uses assets, and assumes risks is interlinked with and

cannot be reliably evaluated in isolation from the way in which another related party to the transaction performs functions, uses assets and assumes risks

One example of highly integrated operations which may warrant the determination that PSM is the most appropriate method could be

where the related parties perform functions jointly, use common assets jointly and/or share the assumption of economically significant risks,

and do so to such an extent that their respective contributions cannot be evaluated in isolation

Another example may be where the integration between the related parties takes the form of a high degree of interdependency

For instance, PSM may be found to be the most appropriate method where, under a long-term arrangement, each party has made a significant contribution (e.g. of an asset) whose value depends in large degree on the other party

In such cases, PSM could allow for pricing which appropriately takes into account and varies with the outcome of the risks assumed by each party

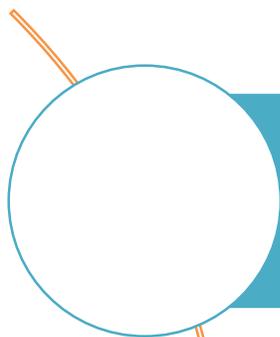
Shared Risks

A further indicator that PSM may be the most appropriate method is where the **parties to controlled transaction share the assumption of the economically significant risks in relation to the transaction**

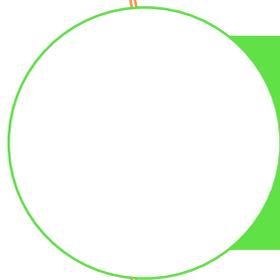
It may also be the most appropriate method in cases where the **parties separately assume risks that are so closely related or inter-linked** that the playing out of the risks of each party cannot be reliably isolated from the risks assumed by the counterparties

The relevance of risk-sharing to the determination of the most appropriate transfer pricing method will depend greatly on the **extent to which the risks concerned are economically significant** such that each party should be entitled to a share of the relevant profits associated with the controlled transaction(s) had the transaction occurred at arm's length

Availability of Information



It will often be the case that where PSM is found to be the most appropriate method, **direct comparable transactions that may otherwise be used to price the transaction will not be found**



However, information from uncontrolled transactions may still be relevant to the application of PSM



For example in terms of how the relevant profits should be split amongst the parties

Approaches to PSM

How to Apply PSM?

In general, **PSM first determines the relevant profits**, being the total profits in relation to the controlled transactions under examination, and then **splits those profits on an economically valid basis**

There are a **number of different approaches** as to how those relevant profits are allocated between the **associated enterprises**

Some of them are.

- Contribution analysis approach
- Residual analysis approach
- Comparable profit split approach

Contribution Analysis

Under a contribution analysis, the relevant profits are allocated between the associated enterprises engaged in the controlled transactions in a way



that aims to reflect a reasonable approximation of the divisions that would have been agreed by independent enterprises in similar circumstances

Relevant external market data, i.e. from comparable independent transactions between unrelated enterprises or between the taxpayer and an unrelated enterprise, should be used to support this allocation where available



However more commonly, **such external data will not be obtainable**, in which case, the arm's length principle can be applied by **using data internal to the taxpayers themselves to determine the relative value of the contributions of each party to the controlled transaction(s)**



For example, this might be done by comparing the nature and degree of each party's contributions to the controlled transactions and assigning a percentage based on that relative comparison (and any external market data that may be available)

Residual Analysis

While a contribution analysis takes the relevant profits in relation to the transaction and splits them between the parties in a single step, **PSM can be applied using a staged approach under a residual analysis**

Such an approach is likely to be appropriate where **one or more parties to the controlled transaction(s) makes a contribution(s) which is routine and could be benchmarked based on comparables**

Step 1

- Allocation of an arm's length profit to each enterprise to **compensate it for its routine or benchmarkable contributions**
- Typically this is done by the **application of one-sided transfer pricing methods** such as consideration of the returns earned by independent enterprises engaged in activities which are comparable to those routine or benchmarkable contributions
- In this first step, other contributions, such as **those which are unique and valuable, are not taken into account**. Each related party is allocated an appropriate 'routine' return from the pool of relevant profits

Step 2

- **Allocation of residual profit (i.e. remaining relevant profits after the Step 1 allocation) on an economically valid basis** where other contributions not already accounted for, including those which are unique and valuable, are considered
- As was described above in relation to a contribution analysis, this allocation must be done on an economically valid basis, and aim to achieve a reasonable approximation of the divisions that would have been agreed by independent enterprises in similar circumstances
- This step allocation will thus **typically consider the relative value of the contributions of each party to the residual profits**, supplemented where possible by external market information on how independent parties would have divided such profits in similar circumstances

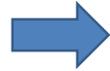
Illustration

XYZ Inc.



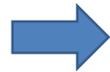
- Develops, manufactures and markets a line of products for use by the police in Country A
- Developed a bulletproof material for use in protective clothing and headgear (Stelon)
- Obtains patent protection for the chemical formula for Stelon

XYZ Asia
(subsidiary)



- Manufactures and markets XYZ products in Asia
- Obtains license to manufacture and market Stelon in Asia
- Its research unit alters Stelon to adapt it to military specifications and develops a high-intensity marketing campaign

For the
Y1 tax
year



- XYZ has no direct expenses associated with the license of Stelon to XYZ-Asia
- No expenses incurred relating to the marketing of Stelon in Asia

XYZ-Asia's
figures



- Stelon sales = \$500 million
- Pre-royalty expenses = \$300 million
- Net pre-royalty profit = \$200 million
- Operating assets employed in Stelon business = \$200 million

Contd.

Step – 1: Removing routine profit based on arm’s length return

Based on an examination of a sample of Asian companies performing functions similar to the routine functions of XYZ-Asia



it is determined that an **arm’s length return** on XYZ-Asia’s operating assets in the Stelon business is **10 %**



resulting in a **profit on those routine functions of \$20 million** (10% x \$200 million) for XYZ-Asia’s Stelon business, and a **residual profit of \$180 million**

Step – 2: Splitting of residual profit based on unique and valuable contribution

Residual profit of \$180 million is attributable to the unique and valuable intangibles related to Stelon

To estimate the relative values of these intangibles, the ratios of the capitalized value of expenditures as of Y1 on Stelon-related research and development and marketing over the Y1 sales related to such expenditures are compared

- **XYZ’s** capitalized R&D expenditures have a value of **\$0.20 per dollar of global protective product sales**
- **XYZ Asia’s** capitalized R&D expenditures have a value of **\$0.40 per dollar of XYZ-Asia’s Stelon sales**

Accordingly, it is determined that an arm’s length split of the residual profits would see **one third of those profits being allocated to XYZ (\$60 million)** and **two thirds being allocated to XYZ-Asia (\$120 million)**

Contribution vs. Residual Approach

The residual approach 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 or benchmarkable functions** based on comparables and the application of a one-sided method or methods

The second step analyses **returns to unique and valuable contributions** or other elements which are un-benchmarkable

Rather than trying to determine absolute values for these contributions based on comparables, the **method focuses on their relative value which may often be determined more reliably**

Secondly, **potential 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

Comparable Profit Split Method

In some countries, reference is made to the comparable PSM

This application of PSM relies on a **comparison of the allocation of profits between independent enterprises engaged in comparable activities under comparable circumstances to those of the controlled transaction(s)**

That is, it **relies heavily on external market data to determine how the relevant profits should be split between the related parties**. Such information may be very useful, but is rarely available in practice. Hence it is **practically difficult to use this method**

Determining the Profits to be Split

The relevant profits to be split under PSM are those **which arise to the associated enterprises as a result of the controlled transaction(s) under examination**

It will be important to consider the **level of aggregation of transactions** in this regard and then to examine the relevant income and expense amounts of each party in relation to those transactions

In most cases, since the relevant profits will be comprised of income and expense amounts from more than one related party in more than one jurisdiction, the **relevant financial data of the entities will need to first be put on a common basis**, including with regard to the accounting practice and currency used

As this can materially affect the application of the method, **consistency over time is important in this regard**

Other than in cases where the profit split covers all the activities of each of the related parties, the financial data will need to be segmented in accordance with the accurately delineated transaction(s) covered by the profit split approach

In cases where reliable product-line or divisional accounts are available, these may be useful to the determination of the relevant profits to be split

Measures of Profit and Profit Splitting Factors

Measures of Profit

PSM is most commonly used to **split net or operating profits**

Applying the method in this way means that all the related parties are exposed to both the income and expenses associated with the relevant transactions in a consistent manner

However, **depending on the accurate delineation of the transaction, other measures of profits may be appropriate**

For example,

If gross profits are split, each related party would then deduct its own operating expenses

Such an application may be appropriate where the parties do not share the risks associated with the operating expenses relating to the controlled transaction, but do share the risks associated with the volume of sales and prices charged, as well as those associated with the production or acquisition of the goods or services

Actual or Anticipated Profits

PSM is most commonly applied to **split the actual relevant profits** of the related parties in relation to controlled transactions

Since actual profits will reflect the risks which affect the transactions, split of such profits will typically result in each related party being subject to those risks

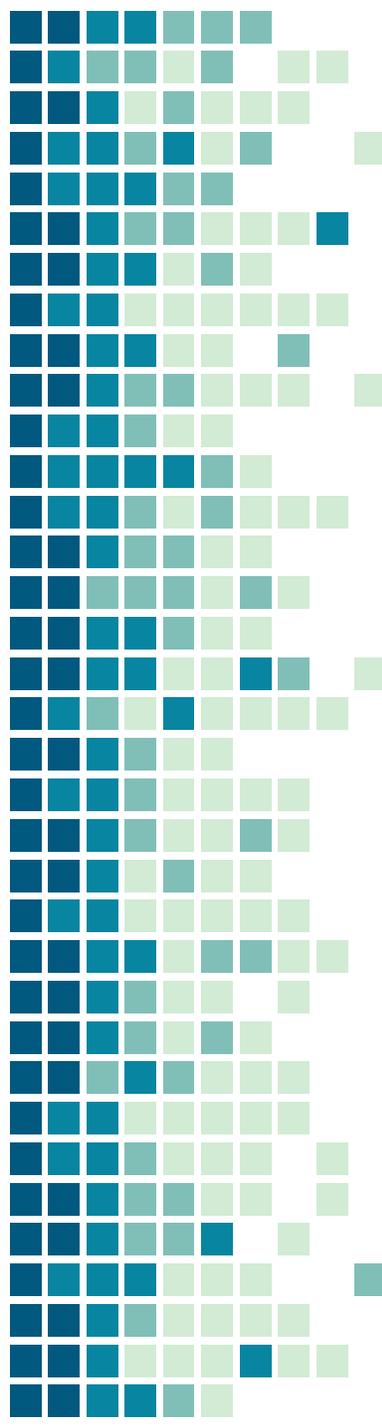
Split of actual profits would thus be appropriate **where the accurate delineation of the transaction shows that each related party shares such risks**

For example,

- Where the parties to the controlled transaction **share or separately assume significant risks related to the transaction**, it would be expected that a **split of actual profits would apply**
- On the other hand, where the profit split is found to be the most appropriate method but the actual behaviour of the parties to the transaction shows that **one or more of the related parties does not share the significant risks**, a **split of anticipated profits is likely to be more appropriate**

In all cases, the measure of relevant profits to be split should be **aligned with the accurate delineation of the transaction in order to produce an arm's length outcome**

Profit Splitting Factors

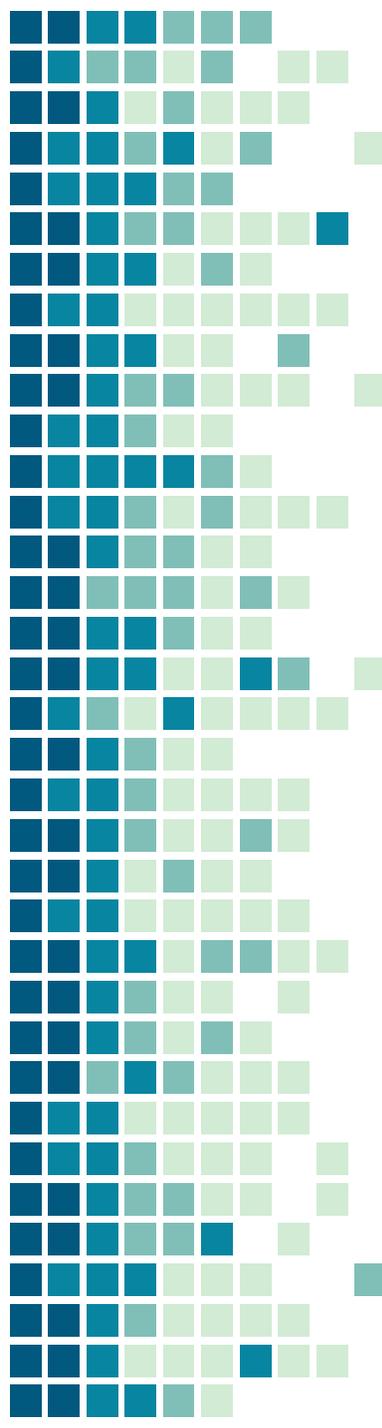


PSM aims to determine transfer prices by **reference to the manner in which independent parties would have divided profits amongst themselves** had they engaged in comparable transactions

However, **information on comparable profit splits or similar arrangements are often not available**

So the method is more often applied by reference to some other measure of the relative contributions to those profits of each associated enterprise, as a way of approximating the outcome that would have been achieved between independent parties

Contd.



Depending on the circumstances, **profit splitting factors might be based on the value of (certain types of) assets or capital**, where there is a strong correlation between tangible assets or intangibles, or capital employed, and the creation of value in the controlled transaction

In other cases, **cost-based factors may be found to be appropriate**, e.g. costs related to the unique and valuable contributions such as R&D, engineering, design, marketing, etc., or the development of unique and valuable intangibles

Although cost is often a poor measure of the absolute value of unique and valuable intangibles, the relative costs incurred by each party may provide a reasonable approximation of the relative value of their respective contributions

Other examples of profit splitting factors could include **incremental sales, employee remuneration or bonus payments, time spent, headcount, etc.**

Such factors may be found to be appropriate **where they provide a strong and sufficiently consistent correlation to the creation of value** represented by the relevant (residual) profits

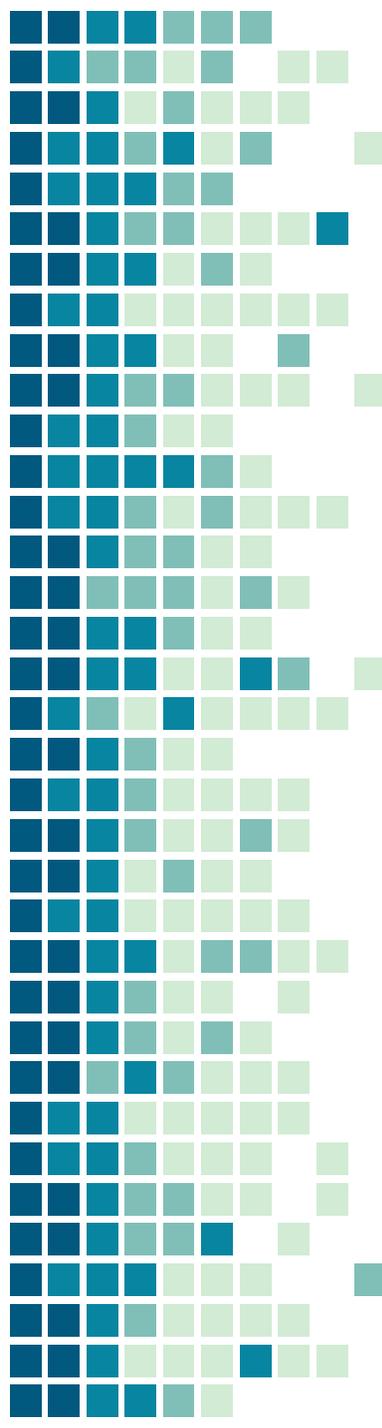
Conclusion

PSM is **not often** a method used more in practice

Especially used in cases **where the controlled transaction is highly integrated**, it can be a **very useful TP method**

PSM can be a **risky method because profit splitting is often very subjective** such that even minor split shifts can lead to significantly different results

Since PSM is a two-sided method, it **requires a lot of information and a significant amount of analysis**, and, as a result, is usually a complex and expensive method to carry out



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