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EU JOINT TRANSFER PRICING FORUM

PROFIT SPLIT METHOD (PSM)

SUMMARY OF REPLIES TO THE SURVEY

Meeting of 26 June 2018

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Profit Split Method (PSM) – summary of replies to the survey

1. Background

The work programme of the Joint Transfer Pricing Forum (JTPF) for the 2015-2019 mandate refers to the PSM as one of the topics on which the JTPF will provide output and foresees that work will focus on the practical application of the PSM in the EU. It mentions that another angle for further work could be an evaluation of models available to split the profits, their pros and cons in substance and as regards their practical application as well as the compliance burden they may create.

At the JTPF meeting of 8 March 2018, both Member States and non-governmental members (NGMs) referred to the usefulness of starting off by gathering information on practical issues; identifying which industries the PSM could be applied to; and exploring the reasons that make the PSM an appropriate method in this context. To this end, it was decided to circulate a questionnaire, in order to collect information about the types of cases and facts that the PSM has been used so far, including the sectors of the economy that the PSM has mainly featured in, with a focus on examples/issues, industries and activities where the PSM has been applied.

On the basis of the contributed input and the upcoming revised PSM guidance by the OECD, the JTPF could identify further technical areas of work in relation to the topic.

2. Results of the survey

2.1. Response rate

The Secretariat received 17 replies from Member States and 11 replies from NGMs. The replies varied widely in the level of detail provided. From those, 7 provided by Member States and 3 provided by NGMs did not include examples, sometimes citing either limited experience or concerns with confidentiality.

2.2. Prevalence of the use of the PSM

Member States

While a couple of Member States were not able to give an estimate of the cases involving the use of the PSM, many Member States outlined that this has been limited to only a few cases in the past 10 years. The highest estimated number has been 21 cases (in the context of APAs) of application of the PSM over that period in one Member State. This said, some of the replies mentioned that there are more cases in the recent years and some of those cases refer to APAs and MAPs that are still ongoing. It should also be noted that a number of Member States were not able to obtain an estimate of the application of the PSM in the context of audits, so that aspect is not well represented in the results of the survey. The statistics on the relative use of the PSM in the context of APAs, MAPs, tax audits and the taxpayer's own transfer pricing policy show that from the perspective of the Member States, the majority of the reported application of PSM was in the context of APAs. However, as mentioned, the share of application of PSM in the context of tax audits and the taxpayer's own transfer pricing policy may have been underestimated.

Non-governmental members

Most of the replies by NGMs also reported limited use of the PSM in the past 10 years, some noting increased use in recent years. Half of the responses cited less than 5 cases each, while one respondent cited 40 cases and another one estimated the total global figure for the entities within the network at an order of magnitude higher than that. From the perspective of the experience of the NGMs, understandably, more than two-thirds of the cases were in the context of the taxpayer's own transfer

pricing policy. Most of the other cases were connected to APAs with one respondent showing a particular experience in Patent Box rulings where a PSM-like methodology is employed.

2.3. Sectors and industries where the PSM is applied and common features of the supply chain

Member States

The replies by Member States mentioned a broad array of sectors and industries where the PSM has been applied. From the more specific sectors mentioned, the most prevalent ones were, by order of frequency, the financial sector, industrial equipment, the automotive industry, the IT sector, the trade in consumer goods, the pharmaceutical industry, the food industry and the oil and gas industry.

Most of the replies of Member States did not find a specific feature of the supply chain that was prevalent in cases where the PSM was used. The replies that mentioned a common feature were referring to the presence of unique and valuable contributions, often in the form of IP, as well as high degree of functional integration between entities that act as entrepreneurs/principals.

Non-governmental members

Similarly to the replies by Member States, the sectors mentioned by NGMs varied broadly. Nevertheless, the financial sector was mentioned by the majority of the replies, followed by the trade in consumer goods, the IT sector, industrial equipment, the pharmaceutical industry, the chemical industry, the oil and gas industry and the automotive industry.

Most of the replies that found a common feature in the supply chain outlined highly integrated functions and unique and valuable contributions, often in the form of IP. The presence of the key entrepreneurial risk taking (KERT) functions in different entities in the trading business in the financial sector was seen as a common feature too.

2.4. Why the PSM was found to be the most appropriate method

Member States and Non-governmental members

The reasons why the PSM has been considered as the most appropriate method by both Member States and NGMs follow closely the OECD Transfer Pricing Guidelines, i.e.:

- Both parties have unique and valuable contributions to the core value drivers of the business, especially in terms of existing IP or DEMPE[1] functions on developed IP
- Highly integrated business models
- Common sharing of risks
- Unique business models with no suitable comparable uncontrolled prices (CUPs), one-sided methods not applicable, neither party being suitable to be considered as a tested party (e.g. strong senior management on both sides)

One Member State mentioned the application of the PSM as part of their approach to addressing aggressive BEPS structures.

Another Member State cited cases where the taxpayer's application of the PSM was questioned on the basis that the specific taxpayer did not use valuable intangibles. Having a limited number of "key" persons was not considered sufficient for applying the PSM.

Several replies by NGMs mention the use of the PSM as a "sanity check" to support a benchmarking study, to avoid extreme results from the application of other methods and in the context of reaching an agreement with the tax authorities. In two replies, the application of the PSM followed an assessment

[1] Development, enhancement, maintenance, protection and exploitation

of how independent enterprises would have behaved in similar circumstances. In one case, the PSM was applied in the context of a CCA buy-out with IP migration.

2.5. Main challenges in applying the PSM

Member States

The choice of the appropriate splitting factors, their relative weights and the valuation of the contributions feature in practically all of the replies as one of the main challenges in applying the PSM. The majority of Member States faced problems with the availability, comparability and general quality of data from all parties that should participate to the profit split, mentioning also related issues with subjectivity of the analysis and reliability of forecasts. Having to conduct a separate value-chain analysis and identifying the key value drivers from outside the company was also seen as a practical issue. Several Member States outlined issues related to how to determine the profits that will be split. Another submission pointed out a case in the context of a MAP where the PSM would have been the most appropriate method, but neither the MNE, nor the other competent authority were interested in applying it.

Non-governmental members

The determination of the appropriate splitting factors, the valuation of the contributions and the identification of the profits that will be split were also among the main practical issues that NGMs seem to have faced in applying the PSM. Similarly to Member States' replies, many replies mentioned issues linked to the consistency of the accounting data, obtaining reliable data and accurate financial forecasts.

From the perspective of a number of consulting firms, when dealing with a client, it may be challenging to implement, maintain and monitor the PSM once it is set up. In addition, the implementation can be quite complex and there is a need for deeper understanding of the business of the client. The defence of the PSM in the context of a tax audit and the insufficient guidance and experience in its application (sometimes requiring a "sanity check" vs one-sided methods) were also seen as a challenge. Issues related to VAT, customs and commercial law were also mentioned.

2.6. Choosing the measure of profit

Even though it used the same terminology as the OECD TPG, the question on the "measure of profit to be split" was not interpreted uniformly by all respondents from the side of both Member States and NGMs[2]. It was understood as referring to the applicable accounting standard, the profit splitting factors or the profit splitting methodology (residual vs contribution analysis). Overall, there might be a need to discuss that item and the reasons for determination of the measure of profit in more detail.

Member States

The replies by Member States mentioned mainly the EBIT/operating profit as the measure of profit to be split that was used most often, arguing that it reflected most accurately the level at which the related risks were taken and at which the unique and valuable contributions were made. Sometimes that measure would be adjusted to include interest expenses or exchange rate gains/losses to the extent that they were directly related to the main activities. A couple of replies mentioned the use of EBITA, gross profit or incremental profit (with/without use of IP).

Non-governmental members

[2] The "measure of profit to be split" is meant to refer to the level in the financial statements where profit split is to be applied (e.g. at the level of revenue, gross profit, operating profit or net profit)

Most of the replies by NGMs also mentioned EBIT/operating profit in the first place. That measure of profit was considered most appropriate in case of high volumes of trades or because it reflected the level at which risk was taken and contributions it terms of intangibles were made. Nevertheless, some replies mentioned the use of gross profits in cases of commodities trading where the profit driver was key individuals or in multi-year projects.

2.7. Choosing profit splitting factors

Member States

An often-cited methodology for splitting the profits was the relative contribution of each party to key value drivers identified in the context of value chain analysis. Other Member States mention an analysis of the contribution to functions, assets and risks undertaken by the parties involved.

Other relevant factors were remuneration of key employees, turnover/revenue, value of key business assets (including intangibles), cost-base related to DEMPE functions, operating costs or a combination of those.

As to the reasons why those profit splitting factors were chosen, most of the replies indicated a link between those profit splitting factors and the contribution towards the key value drivers of the business (e.g. intangibles or significant people functions).

The existence of contributions of a different nature by the parties was considered as a challenge both conceptually and in practice; in fact,, a number of Member States did not reply to this question. In terms of solutions in the case of contributions of a different nature, the most widely used approach has been the weighting of the different factors. The weightings were determined through interviews, or the proportion that was estimated for the routine contributions was used to weigh the non-routine contributions, or a simple split (50%/50% or in another case 33%/33%/33%). An example was given where expenses incurred during the early stages of development of an asset would involve stronger weighting, due to the higher risk associated with those expenses. Another approach relates to valuation methods with regard to each contribution.

Non-governmental members

The replies by NGMs mentioned a wide array of splitting factors:

- Relative contribution to key value drivers identified in the context of value chain analysis (derived from interviews)
- Valuation analysis of the contribution to functions, assets and risks
- Significant people functions
- In the financial industry - proportion of assets under management, trader compensation, volume of trades by entity, number of sales, sales revenue, weighting of key significant people functions;
- Salaries, including bonus payments (also capitalised over a number of years) and headcount/FTE(weighted by salary)
- Asset value-based/IP-value-based
- Royalty rates
- Cost-base related to DEMPE functions
- Operating costs
- Working capital
- Operating leverage
- Metrics of risk-taking (economic capital contribution)
- Comparable market opinions identified through expert surveys, including independent industry experts, competitors, and business managers

- Bargaining splits assessed through game theory (Shapley value)
- Observed splitting factors between third-parties, confirmed by benchmarking analysis

The NGMs pointed out that the choice of a profit splitting factor is highly case-by-case specific. Similarly to Member States, NGMs identified the link between the profit splitting factors and the contribution to key value drivers for the business (e.g. intangibles, key employees or other profit-driving expenses/investments) as decisive when choosing a profit splitting factor. To that end, it was argued that a value chain analysis and the analysis of functions, assets and risks based on interviews should naturally also lead to the establishment of the profit splitting factors.

Contributions of different nature were considered as a challenging topic by the NGMs as well. The NGMs also highlighted that the most frequent approach is to weigh, by reference to a functional and value-chain analysis (e.g. based on interviews), the different contributions to key value drivers. When comparing contributions to value creation by way of a function vs an asset (e.g. in pharmaceuticals), valuation techniques have been indicated as a possible approach. One reply mentioned the possibility of carving out factors that are rather fundamentally different from the profit split analysis, as well as the use of "basked approach" (distinction between critical value drivers, enablers and support).

2.8. PSM challenges in the context of a tax audit

This question was asked only to NGMs. Many respondents indicated that in their experience, the application of the PSM application was not challenged in the context of tax audits. For those that had experience in this, the main cases involved:

- Application of the PSM to losses
- Challenges related to the profit splitting factors
- Valuation of routine functions
- Measurement of contributions
- Determination of arm's length range
- Challenges in understanding the business model of the client
- Challenges in terms of objectivity

2.9. Examples

The Secretariat received overall 34 examples, from many industries, involving varying circumstances and profit split methodologies. Those examples are summarised in a table format in Annex I to this document. In Annex II you would find some selected examples that are provided in more detail. As already highlighted in 2.4. above, the main common aspect in those examples is the presence of unique and valuable contributions, most often in the form of intangibles at the different stages of the supply chain, that go beyond routine functions. In many cases those functions amount to co-management of key value-driving elements. Therefore, one-sided methods like the resale price, cost-plus method or TNMM that rely on benchmarking analysis and identification of a less complex tested party performing routine functions were not found appropriate. In addition, in a number of cases a value-chain analysis was performed in the context of applying the PSM.

The highlights and common trends are outlined below.

2.9.1. Industries

In terms of particular industries, the following can be highlighted:

Financial industry

Five examples included the financial industry, of which:

- Two examples concerned asset management of investment funds - in one of these the split was done on the basis of the proportion of assets under management and in the other case on the basis of employment remuneration
- Two examples concerned global trading in financial instruments where the profit was split on the basis of key employee remuneration
- One example concerned private banking in general

IT industry

Three examples included the IT industry, all of which concerned highly integrated co-development and joint maintenance of an IT system and the profits were split in the three cases as follows:

- In the first example the profits were split on the basis of employment remuneration
- In the second example the profits were split based on the square of the transaction volume of the platform attributed to each co-developer
- In the third example the profits were split on the basis of 2 factors (employees and operating costs) with 50/50 weight

Pharmaceutical industry

Two examples included the pharmaceutical industry, dealing with IP development and licensing. The profits were split based on the relative contributions of the parties and the stage of development.

Other industries

In many other replies a specific industry was not mentioned, or a general description of "manufacturing", "services", "trade", etc. were given.

2.9.2. Circumstances and supply chain characteristics

Besides specific industries, specific circumstances and supply chain characteristics also came up. Those are summarised below.

Use of intangibles in both manufacturing and distribution entities along the supply chain

In seven cases the use of intangibles in both manufacturing and distribution entities that acted as entrepreneurs was indicated. In three of those cases the profit was split on the basis of current or capitalised R&D and marketing expenses. In two cases, based on a functional analysis, contribution analysis or value chain analysis. In one case the split was done based on the ratio of the benchmarkable profit for the manufacturer and the distributors and in one case the split was 50%.

Centralised supply chain company and local non-routine distributors

Five cases involved a centralised supply chain company and local distributors that act as co-entrepreneurs. In three of those cases the profit was split based on a value chain analysis and two cases on the basis of salary costs of senior management, marketing and advertising costs and intangible-related costs.

Joint manufacturing

In three cases the parties involved all contributed jointly to the manufacturing of a product as fully-fledged manufacturers either through producing separate components, or through intervening at different stages of production. The profits were split in the three cases as follows:

- In the first example the profits were split on the basis of 3 split factors with equal weightings: (1) Functions, (2) Fixed production assets and (3) Risks

- In the second example the profits were split based on R&D expenses and headcount for key employees
- In the third example the profits were split on the basis of the cost of goods sold (COGS) per entity

Joint provision of services

Six cases highlighted specifically a highly integrated manner of providing services by the group entities. Three of those cases were in the IT industry and were already covered in 2.9.1. above.

Two cases concerned the provision of services involving industrial equipment and key industrial assets; in one of those cases the profit was split on the basis of total costs by each group entity and in the other case – on the basis of employment remuneration of executive employees.

In the last of those cases, concerning an integrated forwarding service, the profit was split based on whether the payment is made at the departure office or the destination office.

3. Evaluation of the results of the survey

The results of the survey showed that even though the PSM featured in a limited number of cases as compared to the other transfer pricing methods, it has been applied more frequently in recent years in various industries, in a number of circumstances and under different methodologies. Thus, it transpired that the PSM was an appropriate solution to a number of transfer pricing challenges such as:

- Dealing with unique and valuable contributions – these contributions are in place when the parties are not performing only routine functions; in many cases whose contributions involve unique and valuable intangibles at different stages of the supply chain
- Highly integrated business models – the group entities are typically involved in a multitude of intra-group transactions and therefore the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with, and cannot reliably be evaluated in isolation from, the way in which another party to the transaction performs functions, uses assets and assumes risk; therefore, suitable comparables are usually not identifiable
- One-sided methods would not have been appropriate. Namely, the resale price, cost-plus method and TNMM rely on identifying a less complex tested party performing routine functions in the context of a controlled transaction. Where both (or all) parties act as co-entrepreneurs or contribute to the business through performing more than routine functions, a one-sided method for allocating profit within a group would not properly reflect the economic interactions among group entities. It would therefore not be considered as a most-appropriate method.

Based on the evidence from the survey, the main challenges related to the application of the PSM were the determination of appropriate splitting factors, their relative weights, valuation of the contributions (especially heterogeneous contributions) and the determination of the profits that will be split.

As far as the determination of the profit splitting factors is concerned, the fact that these may need to be specified on a case-by-case basis indubitably constitutes a challenge that could undermine the prospects for applying the PSM in circumstances where this seems to be the most appropriate method. For instance, the examples showed that even in broadly similar industries and circumstances, different splitting factors were used.

Nevertheless, it appears that there is some degree of convergence in the methodologies used for arriving at the splitting factors. Indeed, the relative contribution by each party to key value drivers in the context of a value chain analysis was the most frequently used criterion. In the financial and services industry in general and especially, in the IT service industry, the employment remuneration for significant people was often used as a splitting factor. In the case of a business where there are unique and valuable contributions (e.g. of intangibles), the value of those contributions (on a current or capitalised cost basis, using valuation techniques, etc.) seems to often become the point of reference.

Another problem was the availability, comparability and general quality of data, including possible subjectivity of the analysis and reliability of forecasts. It would therefore be useful for the JTPF to discuss how additional guidance and consolidation of best practices could serve to alleviate the abovementioned challenges in applying the PSM.

Questions to delegates:

Do you agree that further work of the JTPF in terms of additional guidance and consolidation of best practices in tackling the identified challenges would be useful?

Do the presented circumstances where the PSM is most often applied coincide with your practical experience? Do you have any other circumstances to add to those outlined?

Do you agree that further work should be done in order to arrive at certain common principles for the choice of the profit splitting factors in the individual cases? In this context, should the experience of identifying key value drivers in the context of a value chain analysis be consolidated in guidance?

Do you see room for simplification of the application of the PSM, e.g. by way of standard splitting factors per industry or per specific set of other circumstances?

Annex I – summary of the examples submitted

Member States

The examples provided by Member States covered the following general circumstances and profit split methodologies:

Circumstances	**Profit split methodology**	**Key Aspects**
Centralised supply chain company with local distribution companies that act as co-entrepreneurs	Residual operating profit is split on the basis of value chain analysis of key value drivers and contribution of business processes and related key employees	Supply chain Value chain Marketing intangibles
Pan-EU business model, multitude of interrelated intra-group transactions and various functional contributions	Residual profit is split based on equal weightings of (1) Significant people functions; (2) Fixed assets book value and (3) turnover	Integrated business model
Joint development and installation of machinery at the premises of the customer (joint teams and management)	The profit of the contract is split on the basis of total costs by each party	Industry joint provision of service
Production and sales entities that employ unique IP	Residual profit is split according to the relative share of IP expenses.	Marketing and R&D intangibles
Integrated IT services provided by joint project teams	Profits from the services are split according to the relative share of employment remuneration	Joint provision of service IT
Post-restructuring (anti-BEPS) scenario where the	Total operating profit is split on the basis of	Supply chain

local sales company retains marketing intangibles, so one-sided method not appropriate	number of employees and operating costs	Marketing intangibles
Royalty for licensing of IP in the pharmaceutical industry with no suitable benchmark	Total operating profit is split on the basis of relative contributions of the parties	IP licensing pharma
Central procurement of advertising space	The revenue of the central procurement entity is derived as a share in each of the sales entities depending on the relative employment remuneration	Central procurement
Integrated forwarding service	Gross profit from the project is split based on whether the payment is made at the departure office or the destination office	Joint provision of service
IP development and licensing by several group entities in the pharmaceutical industry	Operating profit is split on the basis of contribution ratios to R&D, clinical research and post marketing surveillance	IP development and licensing pharma
Manufacturer and distributors in the automotive industry (unique contributions on all sides)	Total (routine and residual) consolidated profit is split on the basis of the ratio of the benchmarkable profit for the manufacturer and the distributors	Marketing and R&D intangibles Automotive
Manufacturer and distributor in the trade of food/household/personal care items (unique contributions on both sides)	Residual operating profit is split on the basis of contribution coefficients with regard to each value driver	Value chain analysis Marketing and R&D intangibles
Joint manufacturing by two group entities both involved in strategic functions and decision making	The profit from the project is split on the basis of 3 split factors with equal weightings: (1) Functions, (2) Fixed production assets and (3) Risks	Industry joint manufacturing
Joint "central function" dealing with planning and decision making in which both the Worldwide HQ and an international business hub participated	The residual profit is split based on the contribution to the value drivers of the business (RACI analysis)	Supply chain Value chain
Manufacturer and distributor with unique and valuable contributions	Split of residual operating profit based on functional and contribution analysis.	Marketing and R&D intangibles
Contract R&D services, license of legacy IP and license of old and new IP bundle	Residual profit is split on the basis of contributions to value generating activities and R&D expenditures	Value chain
Global trading	Net income from trading operations is split on the basis total compensation of traders in each entity	Financial industry trading
License to use trade name and trademark by HQ to local operating companies that participate in strategic decision-making.	Residual profit is split on the basis of (1) salary costs of senior management, (2) marketing and advertising costs and (3) intangible-related costs	Supply chain Marketing intangibles

Non-governmental members

The examples provided by NGMs covered the following general circumstances and profit split methodologies:

Circumstances	**Profit split methodology**	**Key aspects**
Use of valuable intangibles: • Customer relationship and marketing intangibles • Technology and brand	Residual profit is split in half	Marketing and R&D intangibles
Highly integrated co-development of electronic	Operating profit is split based on the share of the	Joint provision

trading platform	square of the transaction volume of the platform attributed to each co-developer	of service IT
Global metals trading (highly integrated)	Residual gross profit is split on the basis of the relative contributions of significant persons (senior traders)	trading
Highly integrated co-management of investment funds	Total revenue from the asset management is split on the basis of the share of assets under management	Asset management Financial industry
Highly integrated co-management of investment funds	Total revenue from the asset management is split on the basis of the employment remuneration	Asset management Financial industry
Centralised supply chain company with local distribution companies that act as co-entrepreneurs (fast moving consumer goods)	Process contribution and RACI analysis of the functions of key people to key processes	Supply chain Value chain Marketing intangibles
Determination of IP-related share of profits in the context of the application of a patent box regime	Determination of routine profits from manufacturing and distribution and deriving of residual profit attributable to IP income	Patent box
Three entities with unique and integrated contributions to the R&D, manufacturing (using valuable know-how), key components, quality assurance and finishing	Residual profit is split on the basis of R&D expenses and headcount for key employees	Industry joint manufacturing
Trading business with HQ and foreign branches, each performing integrated trading activities for themselves and for each other	Residual net profits are split on the basis of employment remuneration to significant persons/traders	Financial industry trading
Manufacturing of key components by a number of group entities, each having unique and valuable R&D	Budgeted gross profits are split on the basis of COGS per entity	Industry joint manufacturing
Highly integrated joint provision of a service, with contribution of a key asset, know-how and employees	Residual net profits from the service are split on the basis of employment remuneration of executive employees	Industry joint provision of service
Highly integrated co-development and joint maintenance of online (train) booking IT system	Total operating profit is split on the basis of 2 factors (employees and operating costs) with 50/50 weight	Joint provision of service IT
Manufacturer and distributor with unique and valuable contributions (R&D and marketing intangibles)	Operating profit is split on the basis of operating costs (R&D and marketing costs)	Marketing and R&D intangibles
Manufacturers and distributors with unique and valuable contributions (R&D and marketing intangibles)	Residual operating profit is split on the basis of capitalised intangible development costs (after amortisation)	Marketing and R&D intangibles
Valuation in the context of intra-group technology IP sale	Operating profit is split on the basis of stocks of entrepreneurial capital	IP valuation
Integrated business model of a private banking group	Operating profit is split on the basis of employment remuneration of significant persons	Private banking Financial industry

Annex II – selected detailed examples

The examples have been provided with an illustrative purpose only. They may not present specific cases at hand and may be a combination of different case circumstances. The details of each case are intentionally kept at a level that would enable identification and arguing of a particular practical case. Please use these examples as a basis for discussion of general principles arising thereof and not as a basis of arguing the correct application of the PSM in a particular case.

1. Pharmaceutical industry – IP development and licensing – Member States

General Description

A pharmaceutical case, involving a multinational group with covered transactions relating to sales and licensing of intangible property of pharmaceutical products.

a) the reasons why the PSM was considered to be the most appropriate method;

Both parties were making unique and valuable contributions in the development of intangible assets. The method used was the Residual Profit Split Method, which dealt with both routine and non-routine activities.

b) which measure of profit was used;

Cumulative operating profit

c) which profit splitting factors were used; and

Once the routine functions were addressed, a contribution ratio related to the development of the intangibles was used to split the profits. The contribution ratio has been calculated by reference to contributions for the various stages, including research and development, Clinical research and Post Marketing Surveillance. The contribution factors used were the non-routine expenditure, e.g., research and development costs, clinical studies, and non-routine marketing costs, with higher weighting to the earlier stages of the development of an intangible asset to reflect the greater risk and uncertainty of that research compared to a later stage of development. The risk weightings were based on pharmaceutical industry information such as success rates for developing new drugs at each stage of development.

d) a simplified calculation of the application of the PSM.

Reward the several routine functions, then split the residual profit based on the contribution ratio of the entities involved.

2. Manufacturing and distribution entities with unique R&D and marketing intangibles – Member States

General Description

The case was in the food industry with two entities – a parent and a subsidiary. The entities were responsible for production and distribution respectively. Production and distribution were considered to be routine activities. In addition, the residual profit was substantial and a remuneration for intangibles had to be determined. The intangibles consisted of marketing (building the brand) and R&D and were based on the functional and risk profiles of these entities.

a) the reasons why the PSM was considered to be the most appropriate method;

Intangibles were used by both parties. A routine remunetration (based on other TP methods) would not be correct. Given the functional and risk profiles, the profit element related to the intangibles also needed to be attributed to both entities.

b) which measure of profit was used;

Residual profit split

c) which profit splitting factors were used; and

The allocation key was based on the intangibles related expenses (marketing and R&D expenses in connection with the intangibles)

d) a simplified calculation of the application of the PSM.

Operating profit A = X Routine Profit A = C

Operating profit B = Y Routine Profit B = D

Combined profit/loss = X+Y Combined routine profit = C+D

Residual Profit = (X+Y)-(C+D) = P

Intangibles expenses A (current) = E % of total Intangibles expenses A = E/(E+F)*100%

Intangibles expenses B (current) = F % of total Intangibles expenses B = F/(E+F)*100%

Residual profit for A = P * (E/E+F)*100%

Residual profit for B = P * (F/E+F)*100%

3. Manufacturing and distribution entities with unique R&D and marketing intangibles – NGMs

General Description

Multinational company with substantial intercompany inventory transactions, local manufacturing operations, and disproportionate holdings of critical entrepreneurial intangibles (R&D, marketing, etc.) in different locations

a) the reasons why the PSM was considered to be the most appropriate method;

Value chain analysis indicates substantial multilateral contributions of entrepreneurial intangibles to business results in a given geography or other well-defined business

b) which measure of profit was used;

Residual economic operating profit defined as consolidated value-chain book operating profits before expenditures on allocable intangible development costs less the amortization of those costs less operating profits attributable to routine manufacturing and distribution functions under the TNMM

c) which profit splitting factors were used; and

Capitalized value of allocable intangible development costs less accumulated amortization over the estimated useful lives and including capitalized costs of intangibles under development to account for lead-time differences; sometimes adjusted to reflect time value of money

d) a simplified calculation of the application of the PSM.

Book profit after profit split equals residual economic operating profit times share of entrepreneurial capital plus routine functional profits plus allocable entrepreneurial intangible capitalized costs amortization less allocable entrepreneurial intangible costs.

4. Centralised supply chain company and local non-routine distributors – Member States

General Description

A local sales company has been established in the early 90's. Ten years later the local sales company employs 100 employees and has built up the local market and owns local marketing intangibles.

A regional sales hub is then established in a low-tax jurisdiction and it is claimed that all local sales companies are transformed into limited risk distributors/service providers and remunerated with TNMM, while all residual profits remain with the hub. However, there are no substantial changes in the functional profile. The hub employs 400 employees and has been granted marketing and distribution rights to entire EMEA market by the group. Profit per employee/cost in the hub is 10 times higher than profits per employee in the local distributor.

The audit argues that there are valuable contributions by both parties and with regard to the local market the more valuable contributions come from the local distributor. There are no appropriate comparables.

a) the reasons why the PSM was considered to be the most appropriate method;

Valuable contributions from both parties - and no CUP's or good comparables.

b) which measure of profit was used;

Operating margin.

c) which profit splitting factors were used; and

Employess, operating cost.

d) a simplified calculation of the application of the PSM.

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5. Centralised supply chain company and local non-routine distributors – NGMs

General Description

The parent company (A) of a group involved in the fast moving consumer goods industry acts as supply chain manager and service provider for the group. The controlled enterprise (B) main activities are related to marketing, sales and distribution of products and ownership/exploitation of IPs. The transaction under review relates to the sale of finished goods from A to B.

a) the reasons why the PSM was considered to be the most appropriate method;

The PSM was considered the most appropriate method based on the high integration between the parties (they were both full entrepreneurs and interdependent for the creation of value). Moreover, the integration permitted the creation of valuable synergies (economies of scale, scope and learning) and, therefore, created a generic intangible asset.

b) which measure of profit was used;

Contribution analysis (with a preliminary carve out of the contribution of the IPs)

c) which profit splitting factors were used; and

Process Contribution Analysis (PCA) and RACI, were selected on the basis of the contribution that each member provided. The selection of the profit splitting factors was supported by interviews held with the management of the parties involved and subsequently validated through external references.

d) a simplified calculation of the application of the PSM.

Value Chain is split in process (involving the use of assets and the management of risks). To each process a weight is given in order to assess the importance in the context of the specific business. Weight is based on interviews to the employees of the two entities in order to understand the value drivers (subjective). Weights have been supported through either objective or external data (market research or analysis of the cost of each process)

PROCESS	PROCESS WEIGHT
LOGISTICS	5.2
MANUFACTURING	12.3
PROCUREMENT	5.3
PLANNING	14.2
DISTRIBUTION	6.5
MARKETING	30.3
R&D	26.2
TOTAL VALUE	**100**

For each process, the contribution of the entities involved is evaluated. The contribution is based on interviews and organizational models such as RACI. RACI: R (responsible) A (accountable) C (consulted) I (informed). To each letter is given a weight (e.g., R=50% of the contribution to the process). Weights have been supported through either objective or external data (costs borne by each entity on each process/number of employees involved).

PROCESS	DISTRIBUTOR	MANUFACTURER
LOGISTICS	16.8%	83.20%
MANUFACTURING	3.22%	96.78%
PROCUREMENT	6.72%	93.28%
PLANNING	47.72%	52.28%
DISTRIBUTION	100%	/
MARKETING	100%	/
R&D	/	100%

PROCESS	DISTRIBUTOR	MANUFACTURER	PROCESS WEIGHT	DISTRIBUTOR CONTRIBUTION	SUPPLY CHAIN COMPANY CONTRIBUTION
LOGISTICS	16.8%	83.2%	5.2	0.87	4.33
MANUFACTURING	3,22%	96.78%	12.3	0.40	11.90
PROCUREMENT	6.72%	93.28%	5.3	0.36	4.94
PLANNING	47.72%	52.28%	14.2	6.78	7.42
CUSTOMER DEVELOPMENT	100%	/	6.5	6.50	-
MARKETING	100%	/	30.3	30.30	-
R&D	/	100%	26.2	-	26.2
SPLITTING RATIO				**45.21**	**54.79**

	Method	
A. Combined Profit after adjustment		100
B. Remuneration for the contribution of the Distributor	A*45.21%	45.21
C. Remuneration for the contribution of the Manufacturer	A*54.79 %	54.79

6. Joint Manufacturing

General Description

Company A, part of X Group, is located in Europe and engaged in the manufacturing of specialized products. Company A performs highly valuable R&D activities and has years of know how development. Sister company B in Asia has years of know how experience and produces at lower costs than Europe with Company A technology. Customers located in Asia want the X group to develop new products and purchase them from B. The clients' main contact is Company B in their own language. These products will need the technology of A, the know how and production of B and some machining elements that another company C also part of X Group in Europe can perform. Company C not only performs machining activities it is also in charge of quality assurance. A takes the risk for the R&D activities, B takes the risk for manufacturing and market (relationship with the customer) conditions, and C takes quality assurance and performs the finishing of the product..

a) the reasons why the PSM was considered to be the most appropriate method;

There were no comparable transactions with third parties. The three parties were engaged in valuable contributions within the supply chain and assumed important risks. No other method would have been more appropriate due to the synergies among related parties. Transaction highly integrated. It was not possible to find an internal/external CUP and the TNMM was not applicable identify a "tested party", so the Profit Split Method was applied.

b) which measure of profit was used;

Residual Profit

c) which profit splitting factors were used; and

Expenses on R&D and head count for highly qualified people involved.

d) a simplified calculation of the application of the PSM.