

Base Erosion and Profit Shifting (BEPS)

Public Discussion Draft

## **BEPS ACTIONS 8-10**

### **Revised Guidance on Profit Splits**

22 June - 15 September 2017



## DISCUSSION DRAFT ON THE REVISED GUIDANCE ON PROFIT SPLITS

22 June 2017

Public comments are invited on this discussion draft which deals with the clarification and strengthening of the guidance on the transactional profit split method, as set out in the BEPS Actions 8-10, 2015 Final Report.<sup>1</sup> This draft sets out the text of proposed revised guidance on the application of the transactional profit split method, together with a number of questions. The questions are intended to elicit responses which will then be taken into account by Working Party No. 6 in considering revisions to the relevant guidance in Chapter II of the Transfer Pricing Guidelines. The discussion draft necessarily concentrates on the guidance proposed to be included in Chapter II, but respondents are reminded that such guidance is provided within a framework of other relevant guidance. In particular the revisions to Chapter I set out guidance on how accurately to delineate the actual transaction between the associated enterprises, including an understanding of the broader context of the value chain to which they contribute, and of a requirement to select the most appropriate transfer pricing method to the circumstances of the case which underpins the discussion of transfer pricing methods in Chapter II. In addition, the revisions to Chapter VI include relevant guidance on identifying and evaluating intangibles. The discussion of the transactional profit split method in this discussion draft should not be taken to imply any change to this wider framework.

Responses are invited to the questions included below, but commentators should feel able to comment on points that may not be specifically covered by those questions.

**The views and proposals included in this discussion draft do not represent the consensus views of the CFA, the Inclusive Framework on BEPS or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comment. Therefore, to the extent the approaches discussed herein differ from the established guidance set out in the OECD Transfer Pricing Guidelines, they should not be relied upon by taxpayers or tax administrations. Moreover, all examples used herein are for illustrative purposes only and are necessarily presented with limited facts. The examples do not have applicability beyond the purpose of seeking comments on the approaches they serve to illustrate and should not be used by taxpayers or tax administrations to interpret superficially similar cases.**

This discussion draft is submitted for comment by interested parties. Comments should be submitted by **15 September 2017** (no extension will be granted) and should be sent by email to [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org) in Word format (in order to facilitate their distribution to government officials). They should be addressed to the Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA. Comments in excess of ten pages should attach an executive summary limited to two pages.

### Specific questions for commentators

1. The discussion draft addresses situations in which profit splits of anticipated profits or profit splits of actual profits are appropriate. Where it is established that the transactional profit split is the most appropriate method, please comment on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used.
2. A number of profit splitting factors are addressed in the discussion draft. Comments are particularly invited on:
  - a Whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained, and if so, what factors need to be taken into account for its selection and application as a reliable profit splitting factor.
  - b Should headcount of similarly skilled and competent employees be included as a potential profit splitting factor, and if so, in what circumstances would it be relevant?
  - c Given the existing guidance in Chapters I and IX of the Transfer Pricing Guidelines, should adjustments

for purchasing power parity be made for profit splitting factor amounts, and if so, in what circumstances?

d What other profit splitting factors should be included in the guidance, and in what circumstances?

3. Additional examples of scenarios in which a transactional profit split is found to be the most appropriate method due to the high level of integration of the business operations are sought, together with an explanation as to the reasoning thereto.

## DRAFT REVISED GUIDANCE ON THE TRANSACTIONAL PROFIT SPLIT METHOD

### C.1 General

1. The transactional profit split method seeks to establish arm's length outcomes or test reported outcomes for controlled transactions by determining the division of profits that independent enterprises would have expected to realise from engaging in a comparable transaction or transactions. The method first identifies the profits to be split from the controlled transactions—the relevant profits—and then splits them between the associated enterprises on an economically valid basis that approximates the division of profits that would have been agreed at arm's length. As is the case with all transfer pricing methods, the aim is to ensure that profits of the associated enterprises are aligned with the value of their contributions.

2. References to “profits” in this section should generally be taken as applying equally to losses. That is, where a transactional profit split method is determined to be the most appropriate method, it should generally also apply, and apply in the same way, regardless of whether the transaction(s) result in a relevant profit or loss. Asymmetrical splits of profits and losses (i.e. where the parties apply different considerations depending on the results of the transaction) are likely to be rare in analogous situations at arm's length.

### C.2 When is a transactional profit split method likely to be the most appropriate method?

3. As is noted in paragraph 2.2,<sup>1</sup> the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case, taking into account the respective strengths and weaknesses of each method, its appropriateness in view of the nature of the accurately delineated controlled transaction, the availability of reliable information (in particular on uncontrolled comparables) needed for application, and the degree of comparability between the controlled and uncontrolled transactions. See also paragraphs 2.4 to 2.7.

4. Guidance on how to determine whether the transactional profit split method is likely to be the most appropriate method is set out below, including the identification of certain features of a transaction which may be relevant. However it is important to note that there is no deterministic rule for establishing when a particular transfer pricing method is the most appropriate method and a transactional profit split method should not be automatically selected on the basis that one or more of the listed indicators applies. Similarly, the absence of one or more of these indicators should not prevent a transactional profit split method from being applied where it is determined to be the most appropriate method.

5. While there is no requirement in these Guidelines to undertake exhaustive analysis or testing of every method in each case, the selection of the “most appropriate” method should take into account the *relative* appropriateness and reliability of the selected method as compared to other methods which could be used.

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<sup>1</sup> Note that all references are to the 2017 OECD Transfer Pricing Guidelines

### ***C.2.1 Strengths and weaknesses of the transactional profit split method***

6. The main strength of the transactional profit split method is that it can offer a solution for cases where both parties to a transaction make unique and valuable contributions (*e.g.* contribute unique and valuable intangibles) to the transaction. In such a case independent parties might effectively share the profits of the transaction in proportion to their respective contributions, making a two-sided method more appropriate. Furthermore, since those contributions are “unique” and “valuable” there will be no reliable comparables information which could be used to price the entirety of the transaction in a more reliable way, through the application of another method. In such cases, the allocation of profits under the transactional profit split method may be based on the contributions made by the associated enterprises, by reference to the relative values of their respective functions, assets and risks. See section C.2.2 below on the nature of the transaction.

7. The transactional profit split method can also provide a solution for highly integrated operations in cases for which a one-sided method would not be appropriate. See section C.2.2.2, below.

8. Another strength of the transactional profit split method is that it offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises. Moreover, where there is a high degree of uncertainty for each of the parties in relation to a transaction, for example in transactions involving the shared assumption of economically significant risks by all parties, the flexibility of the transactional profit split method can allow for the determination of arm’s length profits for each party that vary with the actual outcomes of the risks associated with the transaction.

9. A further strength of the transactional profit split method is that both parties to the transaction are directly evaluated as part of the pricing of the transaction. .

10. A weakness of the transactional profit split method relates to difficulties in its application. On first review, the transactional profit split method may appear readily accessible to both taxpayers and tax administrations because it tends to rely less on information about independent enterprises. However, associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates. In addition, it may be difficult to measure the relevant revenue and costs for all the associated enterprises participating in the controlled transactions, which could require stating books and records on a common basis and making adjustments in accounting practices and currencies. Further, when the transactional profit split method is applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises' other activities. Identifying the appropriate profit splitting factors can also be challenging. It will therefore be particularly important to document how the transactional profit split method has been applied, including the determination of the combined profits to be split, and how the profit splitting factors were arrived at.

11. It is sometimes argued that a transactional profit split method is rarely used among independent enterprises, and thus its application in controlled transactions should be similarly rare. However where such a method is determined to be the most appropriate, this should not be a factor since transfer pricing methods are not necessarily intended to replicate arm’s length behaviour, but rather to serve as a means of establishing and/or verifying arm’s length outcomes for controlled transactions.

### ***C.2.2 Nature of the transaction***

12. The accurate delineation of the actual transaction will be important in determining whether a transactional profit split is potentially applicable. This process should have regard to the commercial and

financial relations between the associated enterprises, including an analysis of what each party to the transaction does, and the context in which the controlled transactions take place. That is, the accurate delineation of a transaction requires a two-sided analysis (or a multi-sided analysis of the contributions of more than two associated enterprises, where necessary) irrespective of which transfer pricing method is ultimately found to be the most appropriate. (See paragraphs 1.33-1.35)

13. The existence of unique and valuable contributions by each party to the controlled transaction is perhaps the clearest indicator that a transactional profit split may be appropriate. The context of the transaction, including the industry in which it occurs and the factors affecting business performance in that sector, can be particularly relevant to evaluating the contributions of the parties and whether such contributions are unique and valuable. Depending on the facts of the case, other indicators could include a high level of integration in the business operations to which the transactions relate and the shared assumption of economically significant risks (or the separate assumption of closely related economically significant risks) by the parties to the transactions. It is important to note that the indicators are not mutually exclusive and on the contrary may often be found together in a single case.

14. Where the accurate delineation of the transaction determines that one party to the transaction performs only simple functions, does not assume economically significant risks in relation to the transaction and does not otherwise make any contribution which is unique and valuable (e.g. contract manufacturing or contract service activities in relevant circumstances), a transactional profit split method typically would not be appropriate since a share of profits (which may be impacted by the playing out of the economically significant risks) would be unlikely to represent an arm's length outcome for such contributions or risk assumption. A lack of information on closely comparable, uncontrolled transactions which would otherwise be used to benchmark an arm's length return for the party performing the simple functions should not *per se* lead to a conclusion that the transactional profit split is the most appropriate method. Depending on the facts of the case, an appropriate method using uncontrolled transactions that are comparable, but not identical to the controlled transaction is likely to be more reliable than an inappropriate use of the transactional profit split method. See paragraphs 3.38-3.39 for a discussion of limitations in available comparables. See also section C.2.3.

15. It may also be relevant to consider industry practices. For instance, if information is available that independent parties do commonly use profit splitting approaches in similar situations, careful consideration should be given to whether the transactional profit split method may be the most appropriate method for the controlled transactions. Such industry practices may be a pointer to the fact that each party makes unique and valuable contributions, and/or that the parties are highly inter-dependent upon each other. Conversely, if independent parties engaged in comparable transactions are found to make use of other pricing methods, this should also be taken into account in determining the most appropriate transfer pricing method.

#### *C.2.2.1 Unique and valuable contributions by each of the parties to the transactions*

16. Contributions (for instance functions performed, or assets used or contributed) will be "unique and valuable" in cases where (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) their use in business operations represents a key source of actual or potential economic benefits. The two factors are often linked: comparables for such contributions are seldom found *because* they are a key source of economic advantage. It may be the case that in these situations, the risks associated with the respective unique and valuable contributions cannot be controlled by the other party or parties. This may impact the assumption of risk under the accurate delineation of the transaction. For example, the developer and manufacturer of a key component of a product together with the developer and manufacturer of another key component that together with the first component, form the ready to sell product, may both make unique and valuable contributions in terms of functions and

intangibles that represent a key source of economic benefits. (See also paragraphs 6.50 to 6.58 and 6.133.) In practice, neither of them may be able to control the development risk in relation to the product as a whole, but instead they together control the development risks and share in the relevant profits resulting from their contributions. The principles of this section are illustrated by Examples 1, 2, 3 and 4.

#### Transactions involving unique and valuable intangibles

17. Where each party to the transaction legally owns unique and valuable intangibles that are relevant to the transaction, it will also be necessary to consider whether, under the accurate delineation of the transaction, they each assume the economically significant risks relating to those intangibles, e.g. risks related to development, obsolescence, infringement, product liability and exploitation (see paragraphs 6.65 to 6.68).

18. As set out in paragraphs 6.148 to 6.149 and 6.152, in some cases, the transactional profit split method may be the most appropriate method for a transfer of fully developed intangibles (including rights in intangibles) where it is not possible to identify reliable comparable uncontrolled transactions. The transactional profit split method may also be appropriate for transfers of partially developed intangibles. See paragraphs 6.150 to 6.151 and Example 5. Where the intangibles transferred are Hard-to-value intangibles, the provisions of section D.4 of Chapter VI should be considered.

#### *C.2.2.2 Highly integrated business operations*

19. Although most MNE groups are integrated to some extent, a particularly high degree of integration in certain business operations is an indicator for the consideration of the transactional profit split method. A high degree of integration means that 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 risks. In contrast, many instances of integration within an MNE result in situations in which the contribution of at least one party to the transaction can in fact be reliably evaluated by reference to comparable uncontrolled transactions. This needs to be borne in mind in considering which transfer pricing method is the most appropriate in a particular case. See Example 6.

20. In some cases the parties may perform functions jointly, own assets jointly and/or share assumption of risks to such an extent that it is impossible to evaluate their respective contributions in isolation from those of others. As an example, the transactional profit split method can be applied to the global trading of financial instruments by associated enterprises. See in Part III, Section C of the Report on the Attribution of Profits to Permanent Establishments,<sup>2</sup> and Example 7.

21. Another example may be where the integration between the parties takes the form of a high degree of inter-dependency. For example, profit split approaches may be used by independent enterprises engaged in long-term arrangements where each party has made a significant contribution (e.g. of an asset) whose value depends on the counterparty to the arrangement. In this kind of case, where each party makes such a contribution, and is dependent on the other party, some form of flexible pricing that takes into account the risks assumed by each party arising from its dependence on the other party may be observed.

22. Where the contributions are highly inter-related or inter-dependent upon each other, the evaluation of the respective contributions of the parties may need to be done holistically. For instance, the contribution by each party may be unique and valuable, or may have a greater value when considered in

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<sup>2</sup> See the *Report on the Attribution of Profits to Permanent Establishments* (OECD, 2010).

combination with the particular contribution of the other party, even if it may not have such significant value on a purely standalone basis. See paragraph 6.94.

23. Where business operations are highly integrated, the extent to which the parties share the assumption of the same economically significant risks or separately assume closely related, economically significant risks will be relevant to the determination of the most appropriate method and, if a transactional profit split is considered the most appropriate method, how it should be applied.

24. Where a party contributes to the control of economically significant risk, but that risk is assumed by the other party to the transaction, this may, in some cases, demonstrate that it is appropriate for the first party to share in the potential upside and downside associated with that risk, commensurate with its contribution to control, . See paragraph 1.105. However, the mere fact that an entity performs control functions in relation to a risk will not necessarily lead to the conclusion that the transactional profit split is the most appropriate method in the case.

#### *C.2.2.3 Shared assumption of economically significant risks, separate assumption of closely related risks*

25. A transactional profit split may be found to be the most appropriate method where, according to the accurately delineated transaction, each party to the controlled transaction shares the assumption of one or more of the economically significant risks in relation to that transaction (see paragraph 1.95).

26. A transactional profit split may also be found to be the most appropriate method where, according to the accurately delineated transaction, the various economically significant risks in relation to the transaction are separately assumed by the parties, but those risks are closely inter-related such that the playing out of the risks of each party cannot reliably be isolated. The relevance of such a factor as an indicator for the transactional profit split method will depend in large measure on the extent to which the risks concerned are economically significant such that a share of relevant profits would be warranted for each party. The economic significance of the risks should be analysed in relation to the business operations of which the transactions are a part, rather than in respect of their importance to the individual enterprise.

27. If each party shares the assumption of economically significant risks or separately assumes inter-related, economically significant risks and a transactional profit split is considered to be the most appropriate method, it is likely that a split of actual profits, rather than anticipated profits, will be warranted since those actual profits will reflect the playing out of the risks of each party. That is, the transfer pricing outcome—a sharing of actual profits—should align with the accurate delineation of the transaction. See section C.4.1 below on splits of actual and anticipated profits.

#### ***C.2.3 Availability of reliable information***

28. In general, it will tend to be the case that the presence of factors indicating that a transactional profit split is the most appropriate method will correspond to an absence of factors indicating that an alternative transfer pricing method—one which relies entirely on comparables—is the most appropriate method, determined in accordance with paragraph 2.2 of these Guidelines. Put another way, if information on reliable comparable uncontrolled transactions is available to price the transaction in its entirety, it is less likely that the transactional profit split method will be the most appropriate method. However, a lack of comparables alone is insufficient to warrant the use of a transactional profit split. See paragraph 14.

29. While the transactional profit split method can be applied in cases where there are no uncontrolled comparables, information from transactions between independent parties may still be relevant



to the application of the method, for example to guide the splitting of relevant profits (see section C.3.1.1), or where a residual analysis approach is used (see section C.3.1.2).

#### **C.2.4 Conclusions**

30. This section has described certain characteristics of the transactional profit split method and provided a number of potential indicators as to when it may be found to be the most appropriate method as well as a number of factors which may point in the opposite direction. The guidance in this regard does not seek to be comprehensive, nor is it prescriptive. The presence or absence of one or more of the indicators described in this section will not necessarily lead to the conclusion that the transactional profit split will (or will not) be the most appropriate method in a particular case. Each case needs to be analysed on its own facts, and it will be important to consider the relative merits and shortcomings of available transfer pricing methods.

### **C.3 Guidance for application - in general**

31. These Guidelines do not seek to provide an exhaustive catalogue of ways in which the transactional profit split method may be applied. Application of the method will depend on the facts and circumstances of the case and the information available, but the overriding objective should be to approximate as closely as possible the split of profits that would have been realised had the parties been independent enterprises.

32. Under the transactional profit split method, the relevant profits are to be split between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. In general, the determination of the relevant profits to be split and of the profit splitting factors should:

- Be consistent with the functional analysis of the controlled transaction under review, and in particular reflect the assumption of economically significant risks by at least one of the parties, and
- Be capable of being measured in a reliable manner.

33. In addition,

- If the transactional profit split method is used to set transfer pricing in controlled transactions (*ex ante* approach), it would be reasonable to expect the life-time of the arrangement and the criteria or profit splitting factors to be agreed in advance of the transaction,
- The person using the transactional profit split method (taxpayer or tax administration) should be prepared to explain why it is regarded as the most appropriate method in the circumstances of the case, as well as the way it is implemented, and in particular the criteria or profit splitting factors used to split the relevant profits, and
- The determination of the relevant profits to be split and of the profit splitting factors should generally be used consistently over the life-time of the arrangement, including during loss years, unless the rationale for using differing relevant profits or profit splitting factors over time is supported by the facts and circumstances and is documented.

### ***C.3.1 Approaches to splitting profits***

34. There are a number of approaches to the application of the transactional profit split method, depending on the characteristics of the controlled transactions, and the information available. As has been described above, the method seeks to split the relevant profits from controlled transactions on an economically valid basis. This may be done by considering the relative contributions of each party (a “contribution analysis”). Where the transactional profit split method is the most appropriate method but at least one party also makes some simpler, “routine” contributions which are capable of being benchmarked by reference to comparable, uncontrolled transactions, a two-stage “residual analysis” may be appropriate.

#### ***C.3.1.1 Contribution analysis***

35. Under a contribution analysis, the relevant profits, which are the total profits from the controlled transactions under examination, are divided between the associated enterprises in order to arrive at a reasonable approximation of the division that independent enterprises would have achieved from engaging in comparable transactions. This division can be supported by comparables data where available. In the absence thereof, it should be based on the relative value of the contributions by each of the associated enterprises participating in the controlled transactions, determined using information internal to the MNE group (see section C.5.2). In cases where the relative value of the contributions can be measured directly, it may not be necessary to estimate the actual market value of each party’s contributions.

36. It can be difficult to determine the relative value of the contribution that each of the associated enterprises makes to the controlled transactions, and the approach will depend on the facts and circumstances of each case. The determination might be made by comparing the nature and degree of each party’s contribution of differing types (for example, provision of services, development expenses incurred, assets used or contributed, capital invested) and assigning a percentage based upon the relative comparison and external market data. See section C.5 for a discussion of how to split the relevant profits and Example 8 in the annex to this guidance.

#### ***C.3.1.2 Residual analysis***

37. A residual analysis is appropriate where the contributions of the parties can be separated into two categories and analysed in two stages. Where the contributions of the parties are such that some can be reliably valued by reference to a one-sided method and benchmarked using comparables (*e.g.* because the risks assumed in relation to these contributions are not shared, the integration in relation to these transactions is low, and the contributions are not unique and valuable), while others cannot, the application of a residual analysis may be appropriate. A residual analysis divides the relevant profits from the controlled transactions under examination into two categories. In the first category are profits attributable to contributions which can be reliably benchmarked: typically simpler, “routine” contributions for which reliable comparables can be found. Ordinarily this initial remuneration would be determined by applying one of the traditional transaction methods or a transactional net margin method to identify the remuneration of comparable transactions between independent enterprises. Thus, it would generally not account for the return that would be generated by a second category of contributions which may be unique and valuable and/or are attributable to a high level of integration or the shared assumption of economically significant risks. Typically, the allocation of the residual profit among the parties will be based on the relative value of the second category of contributions of the parties in the same way as in the application of the contribution analysis outlined above and in accordance with the guidance as described in section C.3.1.1.

38. An example illustrating the application of a residual analysis under a transactional profit split method can be found at Annex II to Chapter II.<sup>3</sup>

#### **C.4 Guidance for application - Determining the profits to be split**

39. The relevant profits to be split under the transactional profit split method are the profits of the associated enterprises relating to the controlled transactions in which the associated enterprises are engaged. It is essential to identify the level of aggregation, see paragraphs 3.9-3.12. The relevant profits to be split should only be those arising in relation to the controlled transaction or transactions under review. In determining those profits, it is therefore essential to first identify and accurately delineate the transactions to be covered by the transactional profit split method, and from this identify the relevant income and expense amounts for each party in relation to those transactions. See section C.4.2, below.

40. Where the relevant profits to be split are comprised of profits of two or more associated enterprises, the relevant financial data of the parties to the transaction to which a transactional profit split is applied need to be put on a common basis as to accounting practice and currency, and then combined. Because accounting standards can have significant effects on the determination of the profits to be split, accounting standards should, in cases where the taxpayer chooses to use the transactional profit split method, be selected in advance of applying the method and applied consistently over the lifetime of the arrangement. Differences in accounting standards may affect the timing of revenue recognition as well as the treatment of expenses in arriving at profits. Material differences between the accounting standards used by the parties should be identified and aligned.

41. Financial accounting may provide the starting point for determining the profit to be split in the absence of harmonised tax accounting standards. The use of other financial data (e.g. cost accounting) should be permitted where such accounts exist, are reliable, auditable and sufficiently transactional. In this context, product-line income statements or divisional accounts may prove to be the most useful accounting records.

42. However, except in circumstances where the total activities of each of the parties are the subject of the profit split, the financial data will need to be segregated and allocations made in accordance with the accurately delineated transaction(s) so that the profits relating to the combined contributions made by the parties are identified. For example, a product supplier in a profit split with an associated enterprise engaged in European marketing and distribution would need to identify the profits arising from its production of goods for the European market, and exclude the profits arising from the production of goods for other markets. The exercise may be relatively simple if the same goods are supplied to all markets, but will be more complex if different goods with different production costs or with different embedded technology, for example, are supplied to different markets. Similarly, if the associated enterprise engaged in European marketing and distribution buys products from other sources, it will need to segregate its financial data in a way that reflects the revenues, costs, and profits relating to the goods purchased from the associated product supplier in the profit split. Experience suggests that this initial stage in performing a profit split can in some circumstances be extremely complex, and the method of identifying the profits relevant to the transaction and any assumptions made in doing so need to be documented.

##### ***C.4.1 Transactional profit splits of actual or anticipated profits***

43. The determination of the profits to be split, including whether those profits are actual profits or anticipated profits, should be aligned with the accurately delineated transaction.

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<sup>3</sup> The text of Annex II to Chapter II may need to be modified to ensure consistency with the revised guidance.

44. Where the transactional profit split method is found to be the most appropriate, the splitting of actual profits, i.e. profits which have been affected by the playing out of economically significant risks, would therefore only be appropriate where the accurate delineation of the transaction shows that the parties either share the assumption of the same economically significant risks associated with the business opportunity or separately assume closely related, economically significant risks associated with the business opportunity and consequently should share in the resulting profits or losses. These kinds of risk assumption may occur in scenarios where the business operations are highly integrated and/or each party makes unique and valuable contributions.

45. Alternatively, if the transactional profit split is found to be the most appropriate method (e.g. because each party to the transaction makes unique and valuable contributions) but one of the parties does not share in the assumption of the economically significant risks which might play out after entering into the transaction, a split of anticipated profits would be more appropriate. Example 9 illustrates the principles of this section.

46. In any application of a transactional profit split, care should be exercised to ensure that the method is applied on the basis of information known or reasonably foreseeable by the associated enterprises at the time the transactions were entered into, in order to avoid the use of hindsight. See paragraphs 2.12 and 3.74. That is, irrespective of whether a transactional profit split of anticipated or actual profits is used, unless there are major unforeseen developments which would have resulted in a renegotiation of the agreement had it occurred between independent parties, the basis upon which those profits are to be split between the associated enterprises, including the profit splitting factors, the way in which relevant profits are calculated, and any adjustments or contingencies, must generally be determined on the basis of information known or reasonably foreseeable by the parties at the time the transactions were entered into. Additionally, it should be remembered that the starting point in the delineation of any transaction will generally be the written contracts which may reflect the intention of the parties at the time the contract was concluded. See paragraph 1.42.

#### ***C.4.2 Different measures of profits***

47. Generally, the relevant profits to be split under the transactional profit split method are operating profits. Applying the transactional profit split method in this manner ensures that both income and expenses of the MNE are attributed to the relevant associated enterprise on a consistent basis. However, in some cases it may be appropriate to split a different measure of profits such as gross profits, and then deduct the expenses incurred by or attributable to each relevant enterprise (and excluding expenses already taken into account). In such cases, care must be taken to ensure that the expenses incurred by or attributable to each enterprise are consistent with the accurate delineation of the transaction, particularly the activities and risks undertaken by each party, and that the allocation of profits is likewise consistent with the contributions of the parties.

48. That is, the measure of profits to be split will depend on the accurate delineation of the transaction. For instance, if the accurate delineation of the transaction reflects that the parties share the assumption of not only market risk, which affects the volume of sales and prices charged, but also risks associated with producing or otherwise acquiring goods and services, which affect the level of gross profit, it would be most appropriate to use gross profits as the basis of the split. In such a scenario, the parties may have integrated or joint functions and assets relating to the production or acquisition of goods and services. If the accurate delineation of the transaction reflects that the parties share the assumption of, in addition to market and production risks, a further range of risks that affect the level of operating expenses that may include investment in intangibles, it would be most appropriate to use operating profits as the basis of the split. In this scenario, the parties may have integrated or joint functions relating to the entire value chain.

49. For example, two associated enterprises, each with its own manufacturing specialisation and unique and valuable intangibles, agree to contribute the intangibles to produce innovative, complex products. The accurate delineation of the transaction reflects that the enterprises in this example share the assumption of risks associated with the success or otherwise of the products in the marketplace. However, they do not share the assumption of risks associated with their selling and other expenses, which are largely unintegrated. Using a profit split based on combined operating profits after all expenses of both parties would have the potential result of sharing the consequences of risks that are assumed by only one of the parties. In such cases, a splitting of gross profits may be more appropriate and reliable since this level of profits captures the outcomes of market and production activities that the parties share together with the assumption of associated risks. Similarly, in the case of associated enterprises that engage in highly integrated worldwide trading operations, if the accurate delineation of the actual transaction determines that the shared assumption of risks and level of integration does not extend to operating costs, it may be appropriate to split the gross profits from each trading activity, and then deduct from the resulting share of the overall gross profits allocated to each enterprise its own operating expenses incurred.

50. An example illustrating different measures of profits when applying the transactional profit split method can be found in Annex III to Chapter II.<sup>4</sup>

### **C.5 Splitting the profits**

51. Profits should be split on an economically valid basis that reflects the relative contributions of the parties to the transaction and thus approximates the division of profits that would have obtained at arm's length. The relevance of comparable uncontrolled transactions or internal data (see section C.5.2) and the criteria used to achieve an arm's length division of the profits depend on the facts and circumstances of the case. It is therefore not desirable to establish a prescriptive list of criteria or allocation keys. See paragraphs 32-34 for general guidance on the consistency of the determination of the splitting factors. In addition, the criteria or splitting factors used to split the profit should:

- Be independent of transfer pricing policy formulation, i.e. they should be based on objective data (e.g. sales to independent parties), not on data relating to the remuneration of controlled transactions (e.g. sales to associated enterprises),
- Be verifiable, and
- Be supported by comparables data, internal data, or both.

52. One possible approach is to split the relevant profits based on the division of profits that actually is observed in comparable uncontrolled transactions. Examples of possible sources of information on uncontrolled transactions that might usefully assist the determination of criteria to split the profits, depending on the facts and circumstances of the case, include joint-venture arrangements between independent parties under which profits are shared, such as development projects in the oil and gas industry; pharmaceutical collaborations, co-marketing or co-promotion agreements; arrangements between independent music record labels and music artists; uncontrolled arrangements in the financial services sector; etc.

53. However, it can be difficult to find reliable comparables data that can be used in this manner. Nevertheless, external market data can be relevant in the profit split analysis to assess the value of contributions that each associated enterprise makes to the transactions. In effect, the assumption is that independent parties would have split relevant profits in proportion to the value of their respective

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<sup>4</sup> The text of Annex III to Chapter II may need to be modified to ensure consistency with the revised guidance.

contributions to the generation of profit in the transaction. Thus, where there is no more direct evidence of how independent parties in comparable circumstances would have split the profit in comparable transactions, the allocation of profits may be based on the relative contributions of the parties, as measured by their functions, assets used and risks assumed.

### ***C.5.1 Profit splitting factors***

54. As noted above, arm's length parties can be assumed to split profits on the basis of their relative contributions to the creation of those profits. The division of the relevant profits under the transactional profit split method is generally achieved using one or more profit splitting factors. The determination of appropriate profit splitting factor(s) should, therefore, reflect the key contributions to value in relation to the transaction. The functional analysis and an analysis of the context in which the transactions take place (e.g. the industry and environment) may be helpful in the process of determining the relevant factors to use in splitting profits, including determining the weighting of applicable profit splitting factors, in cases where more than one factor is used.

55. Depending on the facts and circumstances of the case, the factor can be a figure (e.g. a 30%-70% split based on evidence of a similar split achieved between independent parties in comparable transactions), or a variable (e.g. relative value of participant's marketing contributions or other possible factors as discussed below). Where more than one profit splitting factor is used, it will also be necessary to weight the factors used to determine the relative contribution that each factor represents to the earning of the relevant profits.

56. In practice, profit splitting factors based on assets or capital (operating assets, fixed assets (e.g. production assets, retail assets, IT assets), intangibles, capital employed), or costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) are often used where these capture the relative contributions of the parties to the profits being split. Note that while costs may be a poor measure of the value of intangibles contributed (see paragraph 6.142), the relative costs incurred by parties may provide a reasonable proxy for the relative value of those contributions where such contributions are similar in nature (see paragraphs 8.27-8.28).

57. Other profit splitting factors that may be appropriate in the circumstances of the case are incremental sales, or employee compensation (relating to the individuals involved in the key functions that generate value to the transaction, for example in relation to the global trading of financial instruments), or time spent by a certain group of employees if there is a strong correlation between the time spent and the creation of value represented by the relevant profits.

58. In addition to the Local File, which should contain a detailed functional analysis of the taxpayer and its relevant associated enterprises, the MNE group's Master File might be a useful source of information relevant to the determination of appropriate profit splitting factors. As is set out in Annex 1 to Chapter V, the Master File should include information on the important drivers of business profit, the principal contributions to value creation by entities within the group, and key group intangibles. However, it should be borne in mind that the Master File is intended only to provide a high-level overview of an MNE group, and not granular or detailed information as to all of the group's transactions.

### ***C.5.2 Reliance on data from the taxpayer's own operations (internal data)***

59. Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the relevant profits, consideration should be given to internal data, which may provide a reliable means of establishing or testing the arm's length nature of the division of profits. The types of such internal data that are relevant will depend on the facts and circumstances of the case and should satisfy the

conditions outlined in this section and in particular at paragraphs 32-33 and 41. They will frequently be extracted from the taxpayers' cost accounting or financial accounting.

60. For instance, where an asset-based profit splitting factor is used, it may be based on data extracted from the balance sheets of the parties to the transaction. It will often be the case that not all the assets of the taxpayers relate to the transaction at hand and that accordingly some analytical work is needed for the taxpayer to draw up a "transactional" balance sheet that will be used for the application of the transactional profit split method. In addition, certain assets, such as self-developed intangibles, may not be reflected on the balance sheet at all, and accordingly must be separately evaluated. In this regard, valuation techniques, such as those based on the discounted value of projected future income streams or cash flows derived from the exploitation of the intangible may be useful. See Section D.2.6.3 of Chapter VI of these guidelines.

61. Similarly, where cost-based profit splitting factors are used that are based on data extracted from the taxpayers' profit and loss accounts, it may be necessary to draw up transactional accounts that identify those expenses that are related to the controlled transaction at hand and those that should be excluded from the determination of the profit splitting factor. The type of expenditure that is taken into account (e.g. salaries, depreciation, etc.) as well as the criteria used to determine whether a given expense is related to the transaction at hand or is rather related to other transactions of the taxpayer (e.g. to other lines of products not subject to this profit split determination) should be applied consistently to all the parties to the transaction. See also paragraph 2.104 for a discussion of valuation of assets in the context of the transactional net margin method where the net profit is weighted to assets, which is also relevant to the valuation of assets in the context of a transactional profit split where an asset-based profit splitting factor is used.

62. Internal data may also be helpful where the profit splitting factor is based on a cost accounting system, e.g. employee costs related to some aspects of the transaction, or time spent by a certain group of employees on certain tasks, etc.

63. Internal data are essential to assess the values of the respective contributions of the parties to the controlled transaction. The determination of such values should rely on a functional analysis that takes into account all the economically significant functions, assets and risks contributed by the parties to the controlled transaction. In those cases where the profit is split on the basis of an evaluation of the relative importance of the functions, assets and risks to the value added to the controlled transaction, such evaluation should be supported by reliable objective data in order to limit arbitrariness. Particular attention should be given to the identification of the relevant contributions of unique and valuable intangibles and the assumption of significant risks and the importance, relevance and measurement of the factors which gave rise to these.

### ***C.5.3 Examples of profit splitting factors***

#### *Asset-based factors*

64. Asset-based or capital-based profit splitting factors can be used where there is a strong correlation between tangible assets or intangibles, or capital employed and creation of value in the context of the controlled transaction. In order for a profit splitting factor to be meaningful, it should be applied consistently to all the parties to the transaction. See paragraph 2.104 for a discussion of comparability issues in relation to asset valuation in the context of the transactional net margin method, which is also valid in the context of the transactional profit split method.

65. Where one or more of the parties to a transaction for which the transactional profit split method is found to be the most appropriate makes a contribution in the form of intangibles, difficult issues can arise in relation both to their identification and to their valuation. Guidance on the identification and valuation of intangibles is found at Chapter VI of these Guidelines. See also the examples in the Annex to Chapter VI “Examples to illustrate the guidance on intangibles.”

#### *Cost-based profit splitting factors*

66. A profit splitting factor based on expenses may be appropriate where it is possible to identify a strong correlation between relative expenses incurred and relative value contributed. For example, marketing expenses may be an appropriate factor for distributors-marketers if advertising generates unique and valuable marketing intangibles, e.g. in consumer goods where the value of marketing intangibles is affected by advertising. Research and development expenses may be suitable for manufacturers if they relate to the development of unique and valuable intangibles such as patents. However, if, for instance, each party contributes different valuable intangibles, then it is not appropriate to use a cost-based factor unless cost is a reliable measure of the relative value of those intangibles or costs can be risk-weighted to achieve a reliable measure of relative value. Even where each party contributes the same kind of intangibles, risk-weighting will be an appropriate consideration. For example, where the risk of failure at an early stage of development is several times higher than the risk of failure at a later stage or in the development of incremental improvements to an already proven concept, then the costs incurred in that early stage will have a higher risk weighting than the costs incurred at a later stage or on incremental improvements. Employee remuneration may be relevant in situations where functions relating to the skills and experience of staff are the primary factor in generating the relevant profits.

67. In identifying and applying appropriate cost-based profit splitting factors a number of issues may need to be considered. One is that there may be differences between the parties in the timing of expenditure. For example, research and development costs that are relevant to the value of a party's contributions may have been incurred several years in the past, whereas the expenditure for another party may be current. As a result, it may be necessary to bring historic costs to current values (as discussed further below) in addition to the risk weighting described in paragraph 66. The relevant costs may be part of a larger cost pool that needs to be analysed and allocated to the contributions made to the profit split transaction. For example, marketing costs may be incurred and recorded across several product lines, whereas only one product line is the subject of the profit split transaction. Where location savings retained by member(s) of the MNE group are a significant contributor to profits, and such costs are included in the profits to be split, then the manner in which independent parties would allocate retained location savings would need to be reflected in the profit split, taking into account the guidance in section D.6 of Chapter I. Cost-based profit splitting factors can be very sensitive to differences and changes in accounting classification of costs. It is therefore necessary to clearly identify in advance what costs will be taken into account in the determination of the factor and to determine the factor consistently among the parties.

68. In some cases, a significant issue for the reliability of cost-based splitting factors is the determination of the relevant period of time from which the elements of determination of the profit splitting factor(s) (e.g. assets, costs, or others) should be taken into account. A difficulty arises because there can be a time lag between the time when expenses are incurred and the time when value is created, and it is sometimes difficult to decide which period's expenses should be used. For example, in the case of a cost-based factor, using the expenditure on a single-year basis may be suitable for some cases, while in some other cases it may be more suitable to use accumulated expenditure (net of depreciation or amortisation, where appropriate in the circumstances) incurred in the previous as well as the current years. Depending on the facts and circumstances of the case, this determination may have a significant effect on the allocation of profits amongst the parties. As noted at section C.5.1 above, the selection of the profit splitting factor should be appropriate to the particular circumstances of the case and provide a reliable



approximation of the division of profits that would have been agreed between independent parties. The principles of this section are illustrated by Example 10 in the annex to this guidance.

## **Annex I – Examples to illustrate the guidance on the transactional profit split method**

All examples used herein are for illustrative purposes only and are necessarily presented with limited facts. The examples do not have applicability beyond the purpose of seeking comments on the approaches they serve to illustrate and should not be used by taxpayers or tax administrations to interpret superficially similar cases.

### ***Example 1***

69. Company A is the parent company of an MNE group in the pharmaceutical sector. Company A owns a patent for a new pharmaceutical formulation. Company A designed the clinical trials and performed the research and development functions during the early stages of the development of the product, leading to the granting of the patent. Company A also has the trade name of the new compound registered.

70. Company A enters into a contract with Company S, a subsidiary of Company A, according to which Company A licenses the patent rights relating to the potential pharmaceutical product to Company S. In accordance with the contract, Company S conducts the subsequent development of the product, performing important development and enhancement functions and obtains the authorisation from the relevant regulatory body. The development of the product is successful and it is sold in various markets around the world.

71. Under these circumstances, the transactional profit split method is likely to be the most appropriate method for determining the profits of Company A and Company S from the sale of the patented product provided that the functional analysis indicates that Company A and Company S performed important functions that were unique and valuable in the creation of those profits.

### ***Example 2***

72. A Co, a member of T Group, is a company incorporated in Country A whose principal activity is the growing and processing of tea. A Co identifies, acquires and cultivates land with extremely good soil for growing tea. A Co has developed extensive know-how in respect of tea-growing, including maximising the desirable qualities of the tea it grows through its cultivation methods. The properties of the soil together with the cultivation methods give A Co's tea a highly sought after flavour.

73. A Co processes tea by undertaking the following activities: sorting leaf, grading, full or partial fermenting, blending and packaging for export as per customer order specifications. Blending entails using extensive proprietary know-how to mix the various teas in order to get blends with the unique tastes appreciated by customers of T Group. Tea produced by A Co has won international acclaim for its unique taste and aroma.

74. A Co sells its tea to B Co, its parent company located in Country B. B Co then repackages and brands the teas for sale in the target markets.

75. B Co owns the tradename and trademark which are both unique and valuable, however, the branding features the origin of the tea and the unique blend developed by A Co. B Co has carried out extensive advertising campaigns through electronic media, internet, trade fairs and publications in industry magazines resulting in the product range becoming market leader in a number of geographic markets. Tea sold by T Group commands a premium price.

76. The accurate delineation of the transaction in this particular case determines that both A Co and B Co are making a unique and valuable contribution and the most appropriate transfer pricing method is likely to be the transactional profit split method.

### ***Example 3***

77. Company A and Company B are members of an MNE group that sells electronic appliances. For the launch of a new line of products, Company A will be responsible for its design, development and manufacturing whereas Company B will undertake the marketing functions and the global distribution of the goods.

78. In particular, Company A performs the research and development functions and decides on the lines of research and the timelines. For the manufacturing of the new line of products, Company A decides on the levels of production and performs the quality controls. In doing so, Company A uses its valuable know-how and expertise regarding the manufacturing of electronic appliances.

79. Once the products are manufactured, they are sold to Company B, which will develop and execute cutting-edge global marketing activities relating to the new line of products. In particular, Company B will be responsible for designing the marketing strategy, deciding on the level of marketing expenditure in each country where the products will be released, and validating the impact of the marketing campaigns on a monthly basis. The marketing activities performed by Company B result in a valuable trademark and associated goodwill by which the new line of products is favourably differentiated from competitors' alternatives in the market.

80. Company B is also responsible for the global distribution of the products. The distribution activities performed by Company B are a key source of economic advantage over competitors. In particular, Company B has developed a sophisticated algorithm to get feedback from customers on the performance of their products. This information is highly valuable in accurately forecasting demand and managing inventory and distribution logistics so that customers are assured of receiving their orders within 48 hours.

81. The functional analysis concludes that the economically significant risks in relation to the transaction relate to the design, development, manufacturing, marketing and distribution of the products. In accordance with the risk analysis framework described in Section D.1.2.1 of Chapter I of these Guidelines, it is determined that Company A assumes the risks relating to the design, development and manufacturing of the product and that Company B assumes the risks relating to the marketing and distribution.

82. While Company A and Company B each assume separate economically significant risks, the delineation of the actual transaction determines that those risks are closely inter-related and inter-dependent upon each other. The performance of each of the parties and the outcomes of each of their respective risks have a very significant influence on the other and the contributions of Company A and Company B are unique and valuable. Under these circumstances, the transactional profit split method is likely to be the most appropriate method for determining the profits of Company A and Company B from the sales of the products as both parties to the transaction assume closely related risks that are economically significant for their business operations.

### ***Example 4***

83. The facts in this example are the same as in the previous one, except that the marketing activities performed by Company B are more limited and do not significantly enhance the goodwill or reputation associated with the trademark and its distribution activities are not a particular source of competitive

advantage in its industry. In particular, the potential success of the new line of products is largely dependent on its technical specifications, its design, and the price at which the products are sold to final customers.

84. As in the previous scenario, the functional analysis concludes that Company A assumes the risks associated with the design, development and manufacturing of the product and Company B assumes the risks relating to marketing and distribution.

85. Marketing and distribution risks assumed by Company B may impact on the ultimate profitability of Company A. However, the functional analysis determines that the risks assumed by Company B are not economically significant for the business operations. Under these circumstances, the transactional profit split method may not be the most appropriate method as it is likely that the appropriate return to Company B can be determined using a one-sided method.

#### ***Example 5***

86. WebCo is a member of an MNE group that develops IT solutions for business customers. Recently, WebCo has designed the architecture of a web crawler to collect pricing data from internet sites. WebCo has written the code of the program so it is able to systematically scan web pages in a more efficient and faster way than any other similar search engines available in the market.

87. At this stage, WebCo transfers the program to ScaleCo, a company in the same MNE group. ScaleCo will be responsible for scaling-up the web crawler and for deciding the crawling strategy. Without these contributions, the system would not be able to meet potential customers' needs.

88. Under these circumstances, the transactional profit split method is likely to be the most appropriate method for determining the profits of WebCo and ScaleCo from the sale of the system to customers provided that the accurate delineation of the transaction indicates that WebCo's and ScaleCo's contributions are unique and valuable to the creation of those profits.

#### ***Example 6***

89. Company A is the parent company of M Group, an MNE group engaged in the manufacturing and distribution of electronic devices. Company A owns the trademark under which the products will be sold and has the exclusive right to sell the devices in all territories.

90. Company A decides to subcontract the manufacturing of the electronic devices to Company B, a member of M Group. Under the terms of the contract, Company B will follow the directions of Company A to produce the devices. Company B will source and supply the materials necessary to produce the different parts of the final products. One key component in the manufacturing process is sourced from Company A. Company B sells the finished goods to Company A, which in turn will market and distribute the product to arm's length customers.

91. To perform the manufacturing activities, Company B has invested in machinery and tooling that is specifically adapted to the production of the electronic devices sold by M Group. Company B has no other customer than Company A so the entire production is acquired by Company A.

92. The accurately delineated transaction shows that Company B does not make any unique and valuable contributions in relation to the controlled transactions and the business of M Group. Furthermore, the risks assumed by Company B are not economically significant for the business operations of the group. While the operations of Company B are integrated to some degree with those of Company A and are dependent upon Company A, a reliable return for the contributions of Company B can be benchmarked by

reference to comparable uncontrolled transactions and the application of a one-sided transfer pricing method or methods. Under these circumstances, the transactional profit split method is unlikely to be the most appropriate method.

### ***Example 7***

93. ASSET Co is the parent company of an MNE group that provides asset management services to unrelated parties. It has two subsidiaries, Company A in Country A and Company B, located in Country B.

94. FUND Co is an independent asset management company that offers collective investment vehicles to retail investors in Country A and Country B. The investment vehicles commercialised by FUND Co are mirror funds that contain equity holdings from both Country A and Country B.

95. FUND Co hires ASSET Co to provide portfolio management services for the funds. FUND Co pays ASSET Co a fee based on the combined assets under management of the funds sold to retail investors in Country A and Country B.

96. Company A employs portfolio managers who specialise in Country A equity and Company B employs portfolio managers who specialise in Country B equity.

97. ASSET Co has an investment management committee that decides on the funds' investment management. This committee meets regularly and is composed of equal numbers of portfolio managers from Company A and Company B that determines the composition of the funds. The composition of the funds between equities of countries A and B will vary according to the decisions of the committee.

98. The accurately delineated transaction shows that Company A and Company B share the assumption of risks related to the performance of the funds and perform the portfolio management services in a highly integrated fashion.

99. Under these circumstances, the transactional profit split method is found to be the most appropriate method for determining the profits of Company A and Company B as their operations are highly integrated and interdependent.

100. While Company A and Company B provide valuable services, an active arm's length market for portfolio management services indicates that these services are not unique. Comparables for such portfolio management services (i.e. the services performed by Company A and B together) are available, but these provide no information on how to split those profits between Company A and Company B.

### ***Example 8***

101. Company A, Company B and Company C, members of the same MNE group, jointly agree to share the "greenfield" development of a new product. Each associated enterprise will be responsible for developing and manufacturing one of the three key components of the product. The accurately delineated transaction shows that the parties are sharing the assumption of the same economically significant risk, i.e., the development risk.

102. In this case, assume that the transactional profit split is determined to be the most appropriate method for determining the profits of the three companies from the sale of the product. The functional analysis concludes that the relative contributions of the parties may be measured by reference to the expenses incurred by each company in the development of the components as there is a direct correlation between these expenses and the performance of each company. Accordingly, the combination of profits (losses) can be split based on the development costs incurred by each of the parties.

### *Example 9*

103. Company A, resident in Country A, is the parent company of Retail Group, a MNE group engaged in the retail fashion industry. Over the years, Company A has developed know-how and has enhanced the value of the trademark and associated goodwill of its business through intensive marketing activities. In this case, the intangibles developed and owned by Company A do not qualify as Hard-to-value intangibles.

104. To expand the business into a new market, Company A enters into an agreement with Company B, a member of Retail Group resident in Country B. Under this agreement, Company A grants to Company B the rights to utilise the know-how and to use the trademarks for the purpose of fashion retailing in Country B. Company B will distribute the products and introduce the trademark in the new market by performing innovative marketing activities. The contributions of both companies are determined to be unique and valuable to the Retail Group's business in Country B.

105. In the scenarios presented below, the transactional profit split is determined to be the most appropriate method for determining the profits of Company A and Company B from the sale of the products on the basis that both parties of the transaction are making unique and valuable contributions.

#### *Scenario 1*

106. The accurately delineated transaction shows that Company A does not share in the assumption of any of the economically significant risks associated with the marketing and exploitation activities of Company B related to the licensed intangibles.

107. Under these circumstances, the application of the transactional profit split should be based on the profits anticipated to be generated by Company B from commercialising the products over an appropriate period (e.g. using a discounted cash flow valuation technique as described in Chapter VI, Sections D.2.6.3 to D.2.6.5 of these Guidelines).

108. The relative value of the contributions made by Company A and Company B will be used to determine a split of the anticipated profits of Company B resulting from the combined contributions of the enterprises. The payment for the transaction may take a variety of forms, including a lump sum payment to Company A or a sales-based royalty.

#### *Scenario 2*

109. In this scenario the accurately delineated transaction shows that:

- Company A and Company B agree to a split of the actual profits from the sale of the products by Company B
- Company A and Company B will jointly perform the marketing and distribution activities related to the trademarked products and
- Both Company A and Company B assume risks associated with the success or otherwise of the marketing and commercialisation of the products by Company B

110. Under these circumstances, the transactional profit split method applies on the actual profits achieved from the sales of the products and the relative value of the contributions made by Company A and Company B will be used to determine the split of those profits.

### *Example 10*

111. Company A, resident in Country A, and Company B, resident in Country B, are members of an MNE group in the automotive industry. Both companies undertake the manufacturing of vehicles and their activities in this regard are highly integrated. Additionally, Company A and Company B are responsible for the distribution of the vehicles to final customers in Country A and in Country B, respectively.

112. Company A and Company B enter into an agreement to buy and sell pieces, moulds and different components to manufacture the different models of vehicles. These transactions may also relate to semi-finished products to effectively meet customers' demands in a timely fashion. As a result of their broad experience in the sector, Company A and Company B have each developed valuable and unique know-how in their respective manufacturing processes.

113. The functional analysis shows that Company A and Company B are engaged in a complex web of intragroup transactions where the performance of each company heavily depends on the capacity of the other to provide the different components. Under these circumstances, the transactional profit split method is likely to be the most appropriate method for determining the profits of each company from the sale of the vehicles as the manufacturing risks assumed by Company A and Company B are highly interdependent and both companies make unique and valuable contributions to the manufacturing process.

114. In the absence of comparable uncontrolled transactions or direct evidence of how independent parties would have split the profits in comparable circumstances, the allocation of profits can be based on the relative unique and valuable contributions of Company A and Company B. In particular, an asset-based splitting factor may be appropriate, provided that the functional analysis concludes that there is a strong correlation between the assets of Company A and Company B and the creation of value in the context of their controlled transactions.