



Revised Guidance on the Application of the Transactional Profit Split Method

INCLUSIVE FRAMEWORK ON BEPS: ACTIONS 10

June 2018



OECD/G20 Base Erosion and Profit Shifting Project

Revised Guidance on the Application of the Transactional Profit Split Method

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Foreword

The integration of national economies and markets has increased substantially in recent years, putting a strain on the international tax rules, which were designed more than a century ago. Weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created.

Following the release of the report *Addressing Base Erosion and Profit Shifting* in February 2013, OECD and G20 countries adopted a 15-point Action Plan to address BEPS in September 2013. The Action Plan identified 15 actions along three key pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty.

After two years of work, measures in response to the 15 actions were delivered to G20 Leaders in Antalya in November 2015. All the different outputs, including those delivered in an interim form in 2014, were consolidated into a comprehensive package. The BEPS package of measures represents the first substantial renovation of the international tax rules in almost a century. Once the new measures become applicable, it is expected that profits will be reported where the economic activities that generate them are carried out and where value is created. BEPS planning strategies that rely on outdated rules or on poorly co-ordinated domestic measures will be rendered ineffective.

Implementation is now the focus of this work. The BEPS package is designed to be implemented via changes in domestic law and practices, and in tax treaties. With the negotiation for a multilateral instrument (MLI) having been finalised in 2016 to facilitate the implementation of the treaty related measures, over 75 jurisdictions are covered by the MLI. The entry into force of the MLI on 1 July 2018 paves the way for swift implementation of the treaty related measures. OECD and G20 countries also agreed to continue to work together to ensure a consistent and co-ordinated implementation of the BEPS recommendations and to make the project more inclusive. Globalisation requires that global solutions and a global dialogue be established which go beyond OECD and G20 countries.

A better understanding of how the BEPS recommendations are implemented in practice could reduce misunderstandings and disputes between governments. Greater focus on implementation and tax administration should therefore be mutually beneficial to governments and business. Proposed improvements to data and analysis will help support ongoing evaluation of the quantitative impact of BEPS, as well as evaluating the impact of the countermeasures developed under the BEPS Project.

As a result, the OECD established an Inclusive Framework on BEPS, bringing all interested and committed countries and jurisdictions on an equal footing in the Committee on Fiscal Affairs and all its subsidiary bodies. The Inclusive Framework, which already has more than 110 members, is monitoring and peer reviewing the implementation of the minimum

standards as well as completing the work on standard setting to address BEPS issues. In addition to BEPS members, other international organisations and regional tax bodies are involved in the work of the Inclusive Framework, which also consults business and the civil society on its different work streams.

This report was approved by the Inclusive Framework on BEPS on 4 June 2018 and prepared for publication by the OECD Secretariat.

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Abbreviations and acronyms

BEPS	Base erosion and profit shifting
CCA	Cost contribution arrangement
CUP	Comparable uncontrolled price
IT	Information technology
MNE	Multinational enterprise
OECD	Organisation for Economic Co-operation and Development
R&D	Research and development
TNMM	Transactional net margin method

Executive summary

The guidance set out in this report responds to the mandate under Action 10 of the BEPS Action Plan, which required the development of:

“... rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: ... (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains;...”

The OECD Transfer Pricing Guidelines have included guidance on the transactional profit split method since their first iteration in 1995. Since the revision to the Guidelines in 2010, the transactional profit split method has been applicable where it is found to be the most appropriate method to the case at hand. This basic premise is unchanged. However, this revised guidance, while not being prescriptive, clarifies and significantly expands the guidance on when a profit split method may be the most appropriate method. It describes presence of one or more of the following indicators as being relevant:

Each party makes unique and valuable contributions;

The business operations are highly integrated such that the contributions of the parties cannot be reliably evaluated in isolation from each other;

The parties share the assumption of economically significant risks, or separately assume closely related risks.

The guidance makes clear that while a lack of comparables is, by itself, insufficient to warrant the use of the profit split method, if, conversely, reliable comparables *are* available it is unlikely that the method will be the most appropriate.

The revised text also expands the guidance on how the profit split method should be applied, including determining the relevant profits to be split, and appropriate profit splitting factors.

Sixteen examples are included in the revised guidance to illustrate the principles discussed in the text, and demonstrate how the method might be applied in practice. These will be included in Annex II to Chapter II of the Guidelines.

Revisions to Section C, Part III Chapter II of the OECD Transfer Pricing Guidelines

The current provisions of Section C of Part III, Chapter II of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations are deleted in their entirety and replaced by the following language.

C.1. General

2.114. The transactional profit split method seeks to establish arm's length outcomes or test reported outcomes for controlled transactions in order to approximate the results that would have been achieved between independent enterprises 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 and the compensation which would have been agreed in comparable transactions between independent enterprises for those contributions. The transactional profit split method is particularly useful when the compensation to the associated enterprises can be more reliably valued by reference to the relative *shares* of their contributions to the profits arising in relation to the transaction(s) than by a more direct estimation of the value of those contributions.

Glossary of the Transfer Pricing Guidelines

The entry for “Profit split method” in the Glossary of the Transfer Pricing Guidelines will be amended to read:

Profit split method

A transactional profit split method that identifies the relevant profits to be split for the associated enterprises from a controlled transaction (or controlled transactions that it is appropriate to aggregate under the principles of Chapter III) and then splits those profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been agreed at arm's length.

2.115. 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) might be arm’s length, but should be used with caution and appropriately documented.

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

2.116. As is noted in paragraph 2.2, 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.

2.117. 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 prescriptive rule for establishing when a particular transfer pricing method is the most appropriate method.

2.118. 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.

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

2.119. 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 price 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.

2.120. 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.

2.121. Another strength of the transactional profit split method is that it can offer flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that may not be 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 (or the separate assumption of closely related economically significant risks), 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.

2.122. A further strength of the transactional profit split method is that all relevant parties to the transaction are directly evaluated as part of the pricing of the transaction, that is, the contributions of each party to the transaction are specifically identified and their relative values measured in order to determine an arm's length compensation for each party in relation to the transaction.

2.123. 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 the detailed information required to apply a transactional profit split method reliably. 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. Given the necessity of applying judgement in determining each of the parameters for the application of the transactional profit split method, it will be particularly important to document how the method has been applied, including the determination of the relevant profits to be split, and how the profit splitting factors were arrived at. See sections C.4 and C.5.

2.124. 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. 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. That said, where there is evidence that independent parties in comparable transactions apply a profit split method among themselves, such evidence should be considered in determining whether a transactional profit split method is the most appropriate method for the controlled transactions. See paragraph 2.129.

C.2.2 Nature of the accurately delineated transaction

2.125. 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 Section D.1, and in particularly Section D.1.2 of Chapter I of these Guidelines.)

2.126. 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 that the transactional profit split may be the most appropriate method could include a high level of integration in the business operations to which the transactions relate and /or 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.

2.127. At the other end of the spectrum, 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, 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.

2.128. A lack of closely comparable, uncontrolled transactions which would otherwise be used to benchmark an arm's length return for the party performing the less complex 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 sufficiently 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.

2.129. 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 transaction

2.130. 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) they represent a key source of actual or potential economic benefits in the business operations. 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 actual 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 in Annex II to Chapter II of these Guidelines.

Glossary of the Transfer Pricing Guidelines

The Glossary of the Transfer Pricing Guidelines will be amended to add a definition of ‘Unique and valuable contributions:’

Unique and valuable contributions

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

Transactions involving unique and valuable intangibles

2.131. 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).

2.132. 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. Example 5 in Annex II to Chapter II provides an illustration. See paragraphs 6.150 to 6.151. 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

2.133. 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. For example, where complementary but discrete activities are undertaken by the entities, it may be the case that it is possible to find reliable comparables since the functions, assets and risks involved in each discrete stage may be comparable to those in uncontrolled arrangements. This needs to be borne in mind in considering which transfer pricing method is the most appropriate in a particular case. Examples 6, 7 and 8 in Annex II to Chapter II illustrate the principles of this section.

2.134. In some cases the parties may perform functions jointly, use 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.¹

2.135. Another example may be where the integration between the parties takes the form of a high degree of inter-dependency. For instance, 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 these kinds of cases, where each party makes such a contribution, and is dependent on the other party (or where the value of the contribution(s) of one party depends to a significant degree on the contribution(s) of the other party), some form of flexible pricing that takes into account, and varies with, the outcome of the risks assumed by each party arising from its dependence on the other party may be observed.

2.136. 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; in particular whether a split of actual profits or of anticipated profits should be used. See section C.4.1.

2.137. 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.

2.138. 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. That is, a high degree of integration may also affect whether contributions by the enterprises are considered to be unique and valuable. For instance, a unique contribution by one party may have a significantly greater value when considered in combination with the particular unique contribution of the other party. Paragraphs 6.93-6.94 discuss this issue in relation to the combination of intangibles. See also Example 9 in Annex II to Chapter II.

¹ See the *Report on the Attribution of Profits to Permanent Establishments* (OECD, 2010).

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

2.139. 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).

2.140. 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 so closely inter-related and/or correlated that the playing out of the risks of each party cannot reliably be isolated. See Example 10 in Annex II to Chapter II.

2.141. The relevance of this 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 their importance to the actual or anticipated relevant profits from the controlled transaction(s), rather than in respect of their importance to any one of the associated enterprises whose business operations may extend beyond those covered by the relevant profits.

2.142. 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, i.e. the actual relevant profits to be split, will reflect the playing out of the risks of each party. Conversely, a profit split of anticipated profits will tend to concentrate the playing out of economically significant risks on one party. That is, the transfer pricing outcome—a sharing of actual or anticipated 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

2.143. 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 2.128.

2.144. 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

2.145. 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

2.146. 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.

2.147. 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 the economically significant risks by the parties, and
- Be capable of being measured in a reliable manner.

2.148. In addition,

- If the transactional profit split method is used to set transfer pricing in controlled transactions at the outset, 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

2.149. 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, in order to approximate the results that would have been achieved between independent enterprises in comparable circumstances. 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 less complex 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

2.150. 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, as a proxy for the division that independent enterprises would have achieved (see section C.5.2). In cases where the relative value of the contributions can be measured, it may not be necessary to estimate the actual market value of each party’s contributions.

Glossary of the Transfer Pricing Guidelines

The entry for “Contribution analysis” in the Glossary of the Transfer Pricing Guidelines will be amended as follows:

Contribution analysis

An analysis used in the profit split method under which the relevant profits from controlled transactions are divided between the associated enterprises based upon the relative value of the contributions made by each of the associated enterprises participating in those transactions, supplemented where possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances.

2.151. It can be difficult to determine the relative value of the contribution that each of the associated enterprises makes to the relevant profits, 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.

C.3.1.2 Residual analysis

2.152. 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, 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 less complex 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.5.

Glossary of the Transfer Pricing Guidelines

The entry for “Residual analysis” in the Glossary of the Transfer Pricing Guidelines will be amended as follows:

Residual Analysis

An analysis used in the profit split method which 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 less complex 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 any residual profit (or loss) remaining after allowing for the profits attributable to the first category of contributions would be based on an analysis of the relative value of the second category of contributions by the parties, supplemented where possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances.

2.153. Example 11 in Annex II to Chapter II illustrates the application of a residual analysis under a transactional profit split method.

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

2.154. The relevant profits to be split under the transactional profit split method are those of the associated enterprises arising as a result of the controlled transactions under review. It is essential to identify the level of aggregation, see paragraphs 3.9-3.12. In determining the relevant 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. Example 12 in Annex II to Chapter II of these Guidelines illustrates the principles of this section.

2.155. 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.

2.156. 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.

2.157. 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

2.158. The determination of the profits to be split, including whether those profits are actual profits or anticipated profits, or some combination thereof, should be aligned with

the accurately delineated transaction. Example 13 in Annex II to Chapter II illustrates the principles of this section.

2.159. 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 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.

2.160. 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. See scenario 1 of Example 13 in Annex II to Chapter II of this guidance.

2.161. In any application of a transactional profit split, care should be exercised to ensure that the method is applied without hindsight. See paragraph 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 be determined on the basis of information known or reasonably foreseeable by the parties at the time the transactions were entered into. This is so notwithstanding the fact that in many cases, the actual calculations can necessarily only be performed some time afterwards, where, for example they apply profit splitting factors determined at the outset to the actual profits. Additionally, it should be remembered that the starting point in the accurate 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

2.162. Most commonly, 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, depending on the accurate delineation of the transaction, 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 (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.

2.163. 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 determines 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 determines 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.

2.164. 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 determines 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.

2.165. Example 14 in Annex II to Chapter II illustrates the principles of this section.

C.5. Splitting the profits

2.166. 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 profit splitting factors. See paragraphs 2.146-2.148 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.

2.167. 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.

2.168. 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 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

2.169. 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 functional analysis and an analysis of the context in which the transactions take place (e.g. the industry and environment) are essential to 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. The determination of appropriate profit splitting factor(s) should reflect the key contributions to value in relation to the transaction. Examples 15 and 16 in Annex II to Chapter II of these Guidelines illustrate the principles of this section.

2.170. 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) which could be calculated on the basis of a single profit splitting factor or a weighting of multiple factors.

2.171. Profit splitting factors based on assets or capital (e.g. operating assets, fixed assets (e.g. production assets, retail assets, IT assets), intangibles), or costs (e.g. relative spending and/or investment in key areas such as research and development, engineering, marketing) may be used where these capture the relative contributions of the parties to the profits being split and they can be measured reliably. 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).

2.172. Other profit splitting factors that could be appropriate in the circumstances of a given case include 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). In other situations it is possible that

headcount or time spent by a certain group of similarly skilled employees with similar responsibilities could be used if there is a strong and relatively consistent correlation between this and the creation of value represented by the relevant profits. The guidance in this section should not be considered as an exhaustive list of potential profit splitting factors. Other profit splitting factors may be acceptable provided they result in arm's length outcomes for all relevant parties.

2.173. 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 I 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)

2.174. 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 2.147-2.148 and 2.166. They will frequently be extracted from the taxpayers' cost accounting or financial accounting.

2.175. 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. 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.

2.176. 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.

2.177. 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.

2.178. 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 economically significant risks and the importance, relevance and measurement of the factors which gave rise to these.

C.5.3 Examples of profit splitting factors

C.5.3.1 Asset-based profit splitting factors

2.179. 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. Example 15 in Annex II to this chapter illustrates the principles of this section.

2.180. 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.”

C.5.3.2 Cost-based profit splitting factors

2.181. 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.

2.182. 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 2.181. 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 profit splitting factor and to determine the factor consistently among the parties.

2.183. 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 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 16 in Annex II to Chapter II of this guidance.

Annex II to Chapter II - Examples to Illustrate the Guidance on the Transactional Profit Split Method

The provisions of Annex II to Chapter II of the Transfer Pricing Guidelines are deleted in their entirety and are replaced by the following language.

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

The adjustments and assumptions about arm's length arrangements in the examples that follow are intended for illustrative purposes only and should not be taken as prescribing adjustments and arm's length arrangements in actual cases or particular industries. They are necessarily presented with limited facts. The identification of the presence of one of the three factors (as identified in paragraphs 2.125 to 2.143) indicating that the transactional profit split method may be the most appropriate transfer pricing method, does not mean that one or both of the other factors may not also be present. For example, in a situation in which unique and valuable contributions are identified as being made by each party to the transaction, the business operations of the parties may also be highly integrated and the parties may also share the assumption of economically significant risks or separate assumption of closely related risks.

While the examples seek to demonstrate the principles of the Sections of the Guidelines to which they refer, those principles must be applied in each case according to the specific facts and circumstances of that case. As such, the examples should not be used to interpret superficially similar cases.

Example 1

1. 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.
2. 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 and performs important enhancement functions. Company S 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.

3. The accurate delineation of the transaction indicates that the contributions made by both Company A and Company S are unique and valuable to the development of the pharmaceutical product.
4. Under these circumstances, the transactional profit split method is likely to be the most appropriate method for determining the compensation for the patent rights licensed by Company A to Company S.

Example 2

5. 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.
6. A Co processes tea by undertaking the following activities: sorting leaf, grading, full or partial fermenting, and 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.
7. 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.
8. B Co owns and has, by its own efforts, developed 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.
9. 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

10. 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.
11. 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.
12. Once the products are manufactured, they are sold to Company B, which develops and executes cutting-edge global marketing activities relating to the new line of products. In particular, Company B is 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.

13. 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. Company B has performed the R&D activities and assumed the risks associated with the development of a sophisticated proprietary algorithm to get feedback from customers on the performance of the 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.
14. The accurate delineation of the transaction indicates that the contributions of Company A and Company B are unique and valuable to the potential success of the new line of products.
15. Under these circumstances, the transactional profit split method is likely to be the most appropriate method for determining the compensation for the products sold by Company A to Company B as both parties make unique and valuable contributions to the transaction.

Example 4

16. The facts in this example are the same as in Example 3, 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. Company B has a mechanism whereby customer feedback on the products it sells is relayed to Company A, but this is a relatively simple process, and does not constitute a unique and valuable contribution. In sum, 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.
17. 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.
18. 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 and that Company B does not make any unique and valuable contributions in relation to the controlled transaction.
19. Under these circumstances, the transactional profit split method may not be the most appropriate method as it is likely that the arm's length compensation for the contribution of Company B can be reliably benchmarked by reference to comparable uncontrolled transactions and the application of a one-sided transfer pricing method or methods.

Example 5

20. WebCo is a member of an MNE group that develops IT solutions for business customers. Recently, WebCo 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.

21. At this stage, WebCo licenses the program to ScaleCo, a company in the same MNE group. ScaleCo is responsible for scaling-up the web crawler and for deciding the crawling strategy. ScaleCo is a specialist in designing add-ons for the web crawler and in customising the product to address gaps in the market. Without these contributions, the system would not be able to meet potential customers' needs.
22. Under the terms of the licence, WebCo will continue developing the underlying base technology and ScaleCo will use these developments to scale up the web crawler..
23. The functional analysis concludes that the economically significant risk in relation to the transaction is the development risk, i.e. the risk that the web crawler being developed is unsuccessful.. In accordance with the risk analysis framework described in Section D.1.2.1 of Chapter I of these Guidelines, it is determined that WebCo and ScaleCo assume the development risk of the software.
24. The accurate delineation of the transaction indicates that WebCo's and ScaleCo's contributions are unique and valuable to the creation and potential success of the web crawler.
25. Under these circumstances, the transactional profit split method is likely to be the most appropriate method for determining the arm's length compensation for the licence between WebCo and ScaleCo.

Example 6

26. 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, in Country B.
27. 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.
28. 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.
29. ASSET Co enters into a contract with Company A and Company B such that both companies will provide the portfolio management services. Company A employs portfolio managers who specialise in Country A equity and Company B employs portfolio managers who specialise in Country B equity. ASSET Co acts as a nominee for Companies A and B. It does not perform any functions in relation to the FUND Co contract, nor has it contributed any assets or assumed any risks.
30. An investment management committee composed of equal numbers of portfolio managers from Company A and Company B decides on the funds' investment management. This committee meets regularly and 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.
31. The functional analysis concludes that the economically significant risk in relation to the transaction relates to retail investors withdrawing their deposits from the FUND Co mirror funds, in particular as a result of poor performance. 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 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.

32. 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) may be available, but would provide no information on how to split the arm's length fee between Company A and Company B.
33. Under these circumstances, the transactional profit split method is found to be the most appropriate method for determining the compensation for Company A and Company B as their operations are highly integrated and interdependent such that it is not possible to use a one-sided method to determine an arm's length outcome for either of their respective contributions. The arm's length fee received by ASSET Co from FUND Co will form the revenue portion of the relevant profits to be split between Company A and Company B. The arm's length compensation to ASSET Co will be zero.

Example 7

34. Company L, a resident of Country L, and Company M, a resident of Country M, are part of an MNE group, LM Corporation. Companies L and M offer international trade facilitation, freight forwarding and customs broking services to unrelated customers. Together, Companies L and M, provide customers with services including receipt of goods in the exporting country, customs clearance in the exporting country, containerisation, organising shipment of the container, delivery of containers to and from the ship, de-containerisation, customs clearance in the importing country, and delivering the goods to their destination. Customers may be importers or exporters and Companies L and M facilitate imports and exports from both countries. Customers typically pay for these services based on a combination of the volume and weight of the goods.
35. The accurate delineation of the transaction determines that Companies L and M perform the same trade facilitation, freight forwarding and customs broking services jointly in a highly integrated manner. Companies L and M are highly dependent on each other for the successful completion of each transaction with a customer. Companies L and M also perform similar marketing and customer relationship functions, depending on the location of the customer. Companies L and M jointly use an integrated goods-tracking IT system. The system was initially purchased jointly by Companies L and M from an unrelated supplier. Companies L and M each make incremental improvements to the system where possible. LM Corporation's value proposition to its customers lies in its competitive pricing, which is made possible by its efficiency and economies of scale and scope, and its seamless integration across international boundaries.
36. Companies L and M jointly perform the same key value-adding functions and jointly use and contribute to the MNE group's most important assets. Although arm's length pricing for their joint activities is readily available, their operations are highly integrated and interdependent such that it is not possible to use a one-sided method to determine an arm's length outcome for either of their respective contributions. In this case, therefore, it is likely that a transactional profit split will be the most appropriate method of determining the arm's length compensation due to Companies L and M.
37. If Companies L and M also share the assumption of the economically significant risks associated with the transactions, a profit split of actual profits is likely to be appropriate.

Example 8

38. Company A is the parent company of M Group, an MNE group engaged in the manufacturing and distribution of electronic devices. Company A has the exclusive right to sell the devices in all territories.
39. Company A decides to subcontract the manufacturing of the electronic devices to Company B, another 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. A 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 unrelated customers.
40. 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 its entire output is acquired by Company A.
41. 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, arm's length compensation for the contributions of Company B can be reliably 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 9

42. ACo, resident in Country A, and BCo, resident in Country B, are members of AB Inc, an MNE Group. ACo owns worldwide patents on Compound A and BCo owns worldwide patents on Enzyme B. Compound A and Enzyme B are both unique. ACo and BCo have each developed their respective compound or enzyme by their own efforts, for different purposes, but each found that they were not able to be used as they had originally intended. As a result, neither Compound A nor Enzyme B has significant value at this time.
43. However, engineers from ACo and BCo working together subsequently determine that the combination of Compound A and Enzyme B creates a unique and valuable drug which is very effective in treating a specific disease and is likely to be highly valuable.
44. ACo and BCo enter into a contract according to which ACo grants BCo the right to use Compound A. BCo will combine both components to develop the new drug and will market it.
45. Under these circumstances, the high level of integration and inter-dependency between the contributions of ACo and BCo affects the value of those contributions such that each contribution is unique and valuable when considered in combination with the other. As a result, the transactional profit split method is found to be the most appropriate method for determining the compensation at which the rights to use Compound A are transferred by ACo to BCo.

Example 10

46. Company A designs, develops and produces a line of high technology industrial products. A new generation of the product line incorporates a key component developed and created by Company B, an associated enterprise of Company A. This key component is highly innovative, incorporating unique and valuable intangibles. This innovation represents the key point of difference in the new generation of products. The success of the new generation of products is heavily dependent upon the performance of the key component made by Company B. The key component is specifically tailored for the new generation of products and cannot be used in any other products.
47. The key component was developed entirely by Company B. The accurate delineation of the transaction determines that Company B performs all the control functions and assumed all the risks in relation to the development of the component, with no involvement by Company A.
48. The accurate delineation of the transaction also finds that Company A performs all the control functions and assumed all the risks in relation to the overall production and sale of the new generation of products. Company A cannot control (and thus does not assume) the risks relating to the performance of the key component.
49. In this example, it is determined that while Company A and Company B each assumes separate economically significant risks, those risks are highly inter-dependent. As a result, it is determined that the transactional profit split method is the most appropriate method.
50. If it is also found that the most appropriate way of applying the transactional profit split method in this case is by splitting revenues or gross profits from Company A's sales of the new generation product, each party would bear the consequences of the playing out of risks relating to their own operating costs.

Example 11

51. The success of an electronics product is linked to the innovative technological design both of its electronic processes and of its major component. That component is designed and manufactured by associated company A; is transferred to associated company B which designs and manufactures the rest of the product; and is distributed by associated company C. Information exists to verify by means of a resale price method that the distribution functions, assets and risks of Company C are being appropriately rewarded by the transfer price of the finished product sold from B to C.
52. The most appropriate method to price the component transferred from A to B may be a CUP, if a sufficiently similar comparable could be found. See paragraph 2.15 of the Guidelines. However, since the component transferred from A to B reflects the innovative technological advance enjoyed by company A in this market, which is found to be a unique and valuable contribution by company A, in this example it proves impossible (after the appropriate functional and comparability analyses have been carried out) to find a reliable CUP to estimate the correct price that A could command at arm's length for its product. Calculating a return on A's manufacturing costs could however provide an estimate of the profit element which would reward A's manufacturing functions, ignoring the profit element attributable to the unique and valuable intangible used therein. A similar calculation could be performed on company B's manufacturing costs, to give an estimate of B's profit derived from its manufacturing functions, ignoring the profit element attributable to its unique and

valuable intangible. Since B's selling price to C is known and is accepted as an arm's length price, the amount of the residual profit accrued by A and B together from the exploitation of their respective unique and valuable intangibles can be determined. At this stage the proportion of this residual profit properly attributable to each enterprise remains undetermined.

53. The residual profit may be split based on an analysis of the facts and circumstances that might indicate how the additional reward would have been allocated at arm's length. The R&D activity of each company is directed towards technological design relating to the same class of item, and it is established for the purposes of this example that the relative amounts of R&D expenditure reliably measure the relative value of the companies' contributions. See paragraph 2.145 of the Guidelines. This means that each company's unique and valuable contribution may reliably be measured by their relative expenditure on research and development, so that, if A's R&D expenditure is 15 and B's 10, giving a combined R&D expenditure of 25, the residual could be split 15/25 for A and 10/25 for B.
54. Some figures may assist in following the example:

a) Profit & Loss of A and B

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

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

55. It is established, for both jurisdictions, that third-party comparable manufacturers without unique and valuable intangibles earn a return on manufacturing costs (excluding purchases) of 10% (ratio of net profit to the direct and indirect costs of manufacturing).² A's manufacturing costs are 15, and so the return on costs would attribute to A a manufacturing profit of 1.5. B's equivalent costs are 20, and so the return on costs would attribute to B a manufacturing profit of 2.0. The residual profit is therefore 6.5, arrived at by deducting from the relevant net profit of 10 the combined manufacturing profit of 3.5.

² This 10% return does not technically correspond to a cost plus mark-up in its strictest sense because it yields net profit rather than gross profit. But neither does the 10% return correspond to a TNMM margin in its strictest sense, since the cost base does not include operating expenses. The net return on manufacturing costs is being used as a convenient and practical first stage of the profit split method, because it simplifies the determination of the amount of residual net profit attributable to the unique and valuable intangibles contributed by A and B.

c) Allocate residual profit

56. The initial allocation of profit (1.5 to A and 2.0 to B) rewards the manufacturing functions of A and B, but does not recognise the value of their respective unique and valuable contributions that have resulted in a technologically advanced product. Since in this case it is determined that the relative share of total R&D costs incurred by A and B in relation to the product is a reliable proxy for the value of their respective unique and valuable contributions, the residual can be split between A and B on that basis. The residual is 6.5 which may be allocated 15/25 to A and 10/25 to B, resulting in a share of 3.9 and 2.6 respectively, as below:

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

$$\text{B's share } 6.5 \times 10/25 = 2.6$$

d) Recalculate Profits

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

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

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

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

Note

58. The example is intended to exemplify in a simple manner the mechanisms of a residual profit split and should not be interpreted as providing general guidance as to how the arm's length principle should apply in identifying arm's length comparables and determining an appropriate split. It is important that the principles that it seeks to illustrate are applied in each case taking into account the specific facts and circumstances of the case. In particular, it should be noted that the allocation of the residual profit may need considerable refinement in practice in order to identify and quantify the appropriate basis for the split. Where R&D expenditure is used, differences in the types of R&D conducted may need to be taken into account, e.g. because different types of R&D may have different levels of risk associated with them, which would lead to different levels of expected returns at arm's length. Relative levels of current R&D expenditure also may not adequately reflect the contribution to the earning of current profits that is attributable to intangible property developed or acquired in the past. See section C.5.3.2 of Chapter II of these Guidelines.

Example 12

59. Company A, resident in Country A, Company B, resident in Country B, and Company C, resident in Country C, are members of an MNE group. Companies A and B undertake the design and manufacturing of products and their activities in this regard are highly integrated. Additionally, Company A and Company B are responsible for the marketing and distribution of the products to unrelated customers in Country A and in Country B, respectively. Company C is responsible for the benchmarkable marketing and distribution of products purchased from Company A and Company B to unrelated customers in Country C.
60. Company A and Company B enter into an agreement to buy and sell pieces, moulds and components to manufacture the different models of the products. 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 unique and valuable know-how and other intangibles in their respective design and manufacturing processes. In contrast, the accurate delineation of the transaction shows that Company C does not make any unique and valuable contribution. Instead, Company C performs benchmarkable marketing and distribution functions.
61. Design and manufacturing are identified as the key value drivers for the MNE group and the functional analysis shows the economically significant risks are the strategic and operational risks relating to the design and manufacturing functions. 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 and other inputs. The manufacturing and design activities of Company A and Company B are highly interdependent and the entities both perform relevant control functions in relation to the economically significant risks. 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 and Company B share the assumption of the risks relating to design and manufacturing. Both Companies A and B make unique and valuable contributions to the manufacturing and design processes.
62. Under these circumstances, the transactional profit split method is likely to be the most appropriate method for determining the compensation for Companies A and B in relation to their intra-group transactions. However, a one-sided transfer pricing method such as a resale price method or a TNMM is likely to be the most appropriate to determine an arm's length return for Company C.
63. In applying the transactional profit split method, the sales of products in Countries A, B and C should be taken into account in determining the relevant profits to be split. In the case of Country C, this will be calculated by reference to the sales revenue of Company C, less the arm's length return to Company C (as established above) for its contributions.
64. Under a residual approach to the transactional profit split method, the first step of the process would be to determine an arm's length return for the less complex, benchmarkable contributions of each of the parties (i.e. Companies A and B). These amounts are then deducted from the pool of relevant profits to identify the residual profits to be split. Under the second step of the residual analysis, the residual profits would then be split between Company A and Company B on the basis of their relative contributions to those residual profits.

Example 13

65. Company A, resident in Country A, is the parent company of Retail Group, an 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.
66. To expand the business into the Country B 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 has extensive experience in retail fashion distribution and has a strong track record in building brand recognition and loyalty in Country B through its in-house team which develops and implements innovative marketing strategies and activities.
67. The accurate delineation of the transaction indicates that the contributions of both companies are unique and valuable to the Retail Group's business in Country B.
68. In the scenarios presented below, the transactional profit split is found to be the most appropriate method for determining the compensation for the rights granted by Company A to Company B on the basis that both parties to the transaction are making unique and valuable contributions.

Scenario 1

69. 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.
70. 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 and D.2.6.4 of these Guidelines).
71. 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

72. 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
73. Under these circumstances, the transactional profit split method applies to 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 14

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

Scenario 1

75. Assume A and B are two associated enterprises situated in two different tax jurisdictions. Both manufacture the same widgets and incur expenditure that results in the creation of a unique and valuable intangible which they can mutually use. For the purpose of this example, it is assumed that the nature of this particular unique and valuable intangible is such that the value of A and B's respective unique and valuable contributions in the year in question is proportional to A and B's relative expenditure on the intangible in that year. (It should be noted that this assumption will not always be true in practice.) Assume A and B exclusively sell products to third parties. Assume that it is determined that the most appropriate method to be used is a residual profit split method; that the manufacturing activities of A and B are less complex, non-unique transactions that should be allocated an initial return of 10% of the Cost of Goods Sold; and that the residual profit should be split in proportion to A's and B's expenditure in relation to the unique and valuable intangible. The following figures are for illustration only:

	A	B	Combined A + B
Sales	100	300	400
Cost Of Goods Sold	60	170	230
Gross Profit	40	130	170
Overhead expenses	3	6	9
Other operating expenses	2	4	6
Expenditure in relation to the unique and valuable intangible	30	40	70
Operating Profit	5	80	85

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

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

Step two: determining the residual profit to be split

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

Combined Operating Profit		85
Profit already allocated (initial returns for manufacturing transactions)		23
Residual profit to be split in proportion to A's and B's expenditure in relation to the unique and valuable intangible		62
Residual profit allocated to A:	$62 * 30/70$	26.57
Residual profit allocated to B:	$62 * 40/70$	35.43
Total profits allocated to A:	6 (initial return) + 26.57 (residual)	32.57
Total profits allocated to B:	17 (initial return) + 35.43 (residual)	52.43
Total		85

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

	A	B	Combined A + B
Sales	100	300	400
Cost Of Goods Sold	60	170	230
Gross Profit	40	130	170
Other operating expenses	2	4	6
Expenditure in relation to the unique and valuable intangible	30	40	70
Operating Profit before overhead expenses	8	86	94
Overhead expenses	3	6	9
Operating Profit	5	80	85

Combined Operating Profit before overhead expenses		94
Profit already allocated (initial returns for manufacturing transactions)		23
Residual profit before overhead expenses to be split in proportion to A's and B's expenditure in relation to the unique and valuable intangible		71
Residual profit allocated to A:	$71 * 30/70$	30.43
Residual profit allocated to B:	$71 * 40/70$	40.57
Total profits allocated to A:	6 (initial return) + 30.43 (residual) – 3 (overhead expenses)	33.43
Total profits allocated to B:	17 (initial return) + 40.57 (residual) – 6 (overhead expenses)	51.57
Total		85

76. As shown in the above example, excluding some specific items from the determination of the relevant profits to be split implies that each party remains responsible for its own expenses in relation to it. As a consequence, the decision whether or not to exclude some specific items must be consistent with the accurate delineation of the transaction.

Scenario 2

77. As another example, in some cases it may be appropriate to back out a category of expenses to the extent that the profit splitting factor(s) used in the residual profit split analysis relies on those expenses. For example, in cases where relative expenditure contributing to the development of a unique and valuable intangible is determined to be the most appropriate profit splitting factor, residual profits can be based on operating

profits before that expenditure. After determining the split of residual profits, each associated enterprise then subtracts its own expenditure. This can be illustrated as follows. Assume the facts are the same as in Scenario 1 to this example at paragraph 2.74 above and assume the overhead expenses are not excluded from the determination of the residual profit to be split.

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

78. Same as at Scenario 1, Step 1 above.

Step two: determining the residual profit to be split

a) *In case it is determined as the operating profit after expenditure in relation to the unique and valuable intangible:*

Same as at Scenario 1, Step 2, case a)

b) *In case it is determined as the operating profit before expenditure in relation to the unique and valuable intangible:*

	A	B	Combined A + B
Sales	100	300	400
Cost Of Goods Sold	60	170	230
Gross Profit	40	130	170
Overhead expenses	3	6	9
Other operating expenses	2	4	6
Operating profit before expenditure in relation to the unique and valuable intangible	35	120	155
Expenditure in relation to the unique and valuable intangible	30	40	70
Operating Profit	5	80	85

Relevant Operating Profit before Expenditure in relation to the unique and valuable intangible	155
Profit already allocated (initial returns for manufacturing transactions)	23
Residual profit before Expenditure in relation to the unique and valuable intangible to be split in proportion to A's and B's expenditure in relation to the unique and valuable intangible	132

Residual profit allocated to A:	$132 * 30/70$	56.57
Residual profit allocated to B:	$132 * 40/70$	75.43

Total profits allocated to A:	6 (initial return) + 56.57 (residual) – 30 (expenditure in relation to the unique and valuable intangible)	32.57
Total profits allocated to B:	17 (initial return) + 75.43 (residual) – 40 (expenditure in relation to the unique and valuable intangible)	52.43
Total		85

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

79. This example illustrates the fact that, when the profit splitting factor used to split the residual profit relies on a category of expenses incurred during the period, it is irrelevant whether the residual profit to be split is determined before the expenses are deducted by each party, or whether the residual profit to be split is determined after the expenses are deducted. The outcome can however be different in the case where the splitting factor is based on the accumulated expenditure of the prior as well as current years.

Example 15

80. Company A, resident in Country A, and Company B, resident in Country B, are members of an MNE group. Both companies undertake the design and manufacturing of products and their activities in this regard are highly integrated. Additionally, Company A and Company B are responsible for the marketing and distribution of the products to unrelated customers in Country A and in Country B, respectively.
81. Company A and Company B enter into an agreement to buy and sell pieces, moulds and different components to manufacture various different models of products. 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 unique and valuable know-how and other intangibles in their respective design and manufacturing processes.
82. The functional analysis shows the economically significant risks are the strategic and operational risks in relation to the design and manufacturing functions and 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 and other inputs. The manufacturing and design activities of Company A and Company B are highly interdependent and the entities both perform relevant control functions in relation to the economically significant risks. 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 and Company B share the assumption of the risks relating to design and manufacturing. Both Companies A and B make unique and valuable contributions to the design and manufacturing processes.
83. Under these circumstances, the transactional profit split method is likely to be the most appropriate method for determining the compensation for Companies A and B in relation to their intra-group transactions
84. In the absence of comparable uncontrolled transactions or direct evidence of how independent parties would have split the profits in comparable circumstances, the profit split can be applied based on the relative value of the 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.

Example 16

85. Company A, Company B and Company C, members of the same MNE group, jointly agree to share the "greenfield" development of a new product. In this regard, none of the entities brings existing contributions of value such as pre-existing intangibles to the project. Each associated enterprise will be responsible for developing and manufacturing one of the three key components of the product.

86. In this case, assume that the transactional profit split is found to be the most appropriate method for determining the profits of the three companies from the sale of the new product. The functional analysis concludes that the relative contributions of the parties may be measured by reference to the relative expenses incurred by each company in the development of the components as there is a direct correlation between these relative expenses and the relative value contributed by each company. Accordingly, the relevant profits (losses) in relation to the sales of the new product can be split based on the relative development costs incurred by each of the parties.
87. In this example, the splitting of profits based on relative development costs will yield results similar to those which would have resulted under an analogous cost contribution arrangement, since parties performing activities with similar economic characteristics should receive similar expected returns, irrespective of whether the contractual arrangement in a particular case is termed as a CCA or not (see paragraph 8.4).

Revised Guidance on the Application of the Transactional Profit Split Method

INCLUSIVE FRAMEWORK ON BEPS: ACTIONS 10