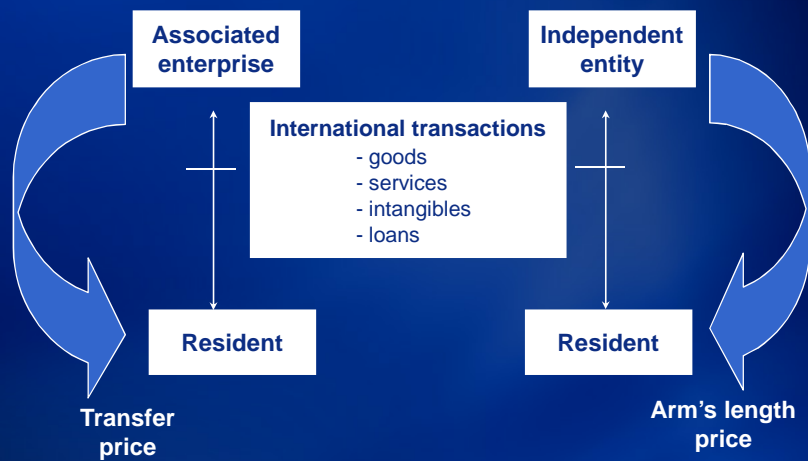


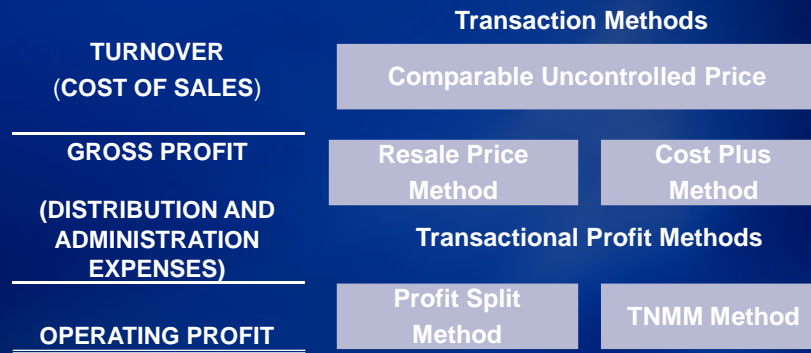
Profit Split Method – Overview and Practical Issues

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Concept of Transfer Pricing



Arm's Length Methodologies



Transactional Profit Methods

- Examine the profits that arise from a particular transaction among associated enterprises
- Applied in exceptional cases where application of traditional transactional methods becomes difficult due to business complexities
- Accepted only if compatible with Article 9 of OECD Model Tax Convention, especially with regards to comparability

Most Appropriate Methods in FY 2006-07*

Place	New Delhi		Mumbai		Bangalore		Total	
	No. of cases	%	No. of cases	%	No. of cases	%	No. of cases	%
TNMM	305	76	467	63	298	82	1070	72
CUP	69	17	177	24	42	11	288	19
CPM	16	4	67	9	12	3	95	6
RPM	12	3	26	3	14	4	52	3
PSM	1	0.2	1	0.1	0	0	2	0.1
Total	403	100	738	100	366	100	1507	100

* Source – Presentation made by Director of Income Tax (TP) in Nov 2008

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Profit Split Method (PSM)

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Definition as per OECD

“ A transactional profit method that identifies the combined profit to be split for the associated enterprises from a controlled transaction and then splits those profits between the associated enterprises based upon 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.”

Indian TP Regulations

“ PSM is applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm’s length price of any one transaction.”

- The combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined
- The relative contribution made by each of the associated enterprises to earning of such combined net profit, is then evaluated on the basis of the FAR and on the basis of reliable external market data
- The combined net profit is then split amongst the enterprises in proportion to their relative contributions
- The profit thus apportioned to the assessee is taken into account to arrive at an ALP

Overview

- ❑ Where transactions are very interrelated, they cannot be evaluated on a separate basis
- ❑ PSM seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits at ALP
- ❑ PSM first identifies the profit to be split from the controlled transaction in which AEs are engaged
- ❑ It then splits those profits between AEs on an economically valid basis that approximates the division of profits at ALP

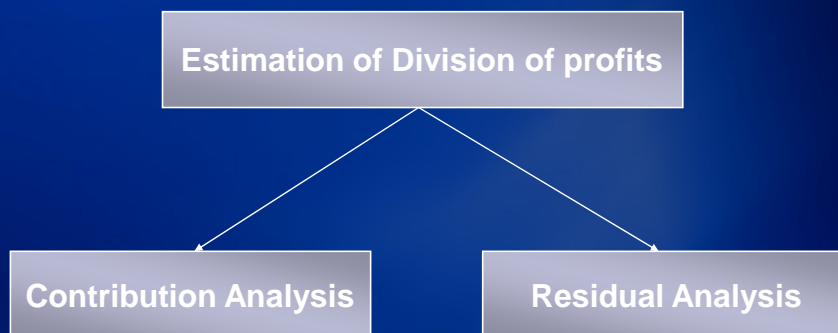
Overview

- ❑ Calculates the combined operating profit resulting from a whole inter-company transaction based on the relative value of each associated enterprise's contribution to the operating profit
- ❑ The contribution made by each party is determined on the basis of a division of functions performed, valued, if possible using external comparable data
- ❑ Applicable for analyzing tangible, intangible or services issues

Can be Used When..

- ❑ Parties are so interdependent that it is not possible to identify closely comparable transactions
- ❑ Based on expected rather than actual profits
- ❑ Requires consolidated Profit & Loss numbers i.e. both parties
- ❑ How would profits be split between unrelated parties?
- ❑ Relies heavily on the judgement of the profit splitter
- ❑ Complex Method

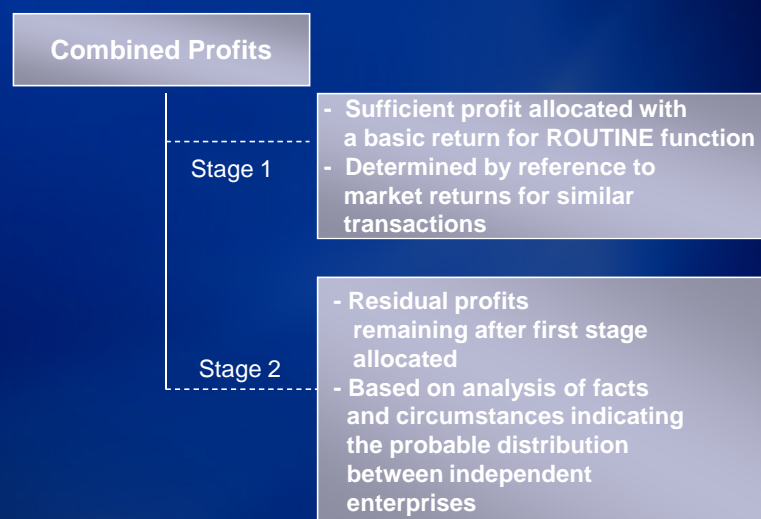
Approaches for estimation of division of profits



Contribution Analysis

- Division of profits based upon relative value of the functions performed
- Generally operating profit used to combine and divide
- Determination of contribution by each related party might be determined comparing the nature and degree of each party's contribution and assigning a percentage based on relative comparison and external market data
e.g. : provision of services, development expenses incurred, capital invested
- Ensures both income and expenses are attributed to relevant associated enterprises consistently

Residual Analysis



Strengths

- Both parties to the transaction are tested
- Two sided approach – Used to achieve division of profits from economies of scale or other joint venture efficiencies
- Allocation based on division of functions
- Flexibility taking into account specific facts and circumstances that are not present in independent enterprises
- Less probability of extreme profit split since both parties to the transaction are evaluated
- May be appropriate in cases where application of method is agreed both by the taxpayer and the tax administration

Weakness

- External data considered to value contribution of enterprises may be less closely connected to those transaction than in case of other methods
- Difficult to identify profit and contribution of each party (require comparables)
- High level of analysis and benchmarking required (very complex)
- Difficult to access information from foreign affiliates
- Difficult to measure combined revenue and costs for all the associated enterprises since this would require stating books and records on a common basis and currencies
- If applied to operating profit, it is difficult to identify appropriate operating expenses associated with transaction and allocate costs

Weakness (Cont.)

- ❑ At present the transfer pricing guidelines do not provide much guidance on determining the combined profit to be split
- ❑ There are issues relating to accounting standards and issues on whether to select net, operating or gross profits
- ❑ The accounts of the parties must be brought onto a common basis in relation to accounting practice and to currency and then combined
- ❑ How to measure the profits depends on the facts of the case and the comparability and functional analysis of the controlled transactions. The choice may also be dependent on the availability of comparable external data

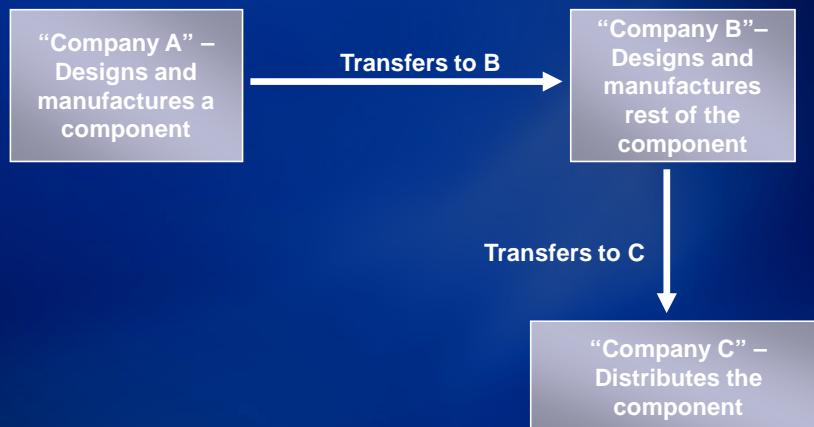
Possible use of methods

Type of Transaction	Possible method
Sale of goods - Tangibles	CUP, CPM, Resale price, Profit split, TNMM
Provision of services	CUP, CPM, TNMM
Financing (loans, deposits, guarantees)	CUP, Profit split, TNMM
Transfer of intangibles (technology, brand, know –how)	CUP, CPM, Profit Split

PSM – Case study

Background

Case for Electronic Component industry*



* Example as provided in the OECD Guidelines

Possible use of Most Appropriate Method (MAP)

- ❑ MAP in this case would be CUP if similar comparable could be found
- ❑ Component transferred from A to B reflects innovative technological advance enjoyed by A in the market
- ❑ Thus, may not be possible to find a reliable CUP to estimate the correct ALP that A could command

Possible Method

- A -- Estimate the profit for A's manufacturing function
+ profit attributable to intangibles
- B -- Estimate the profit for B's manufacturing function
+ profit attributable to intangibles
- C -- Selling price from B to C accepted as ALP

Profit and Loss of A and B

	A		B	
Sales		50		100
Less: Purchases		10		50
Less: Manufacturing cost		15		20
Gross Profit		25		30
Less: R& D	15		10	
Less: Operating expenses	10	25	10	20
Net Profit		0		10

- ❑ *The R&D activity of each company is directed towards technological design relating to the same class of item*
- ❑ *It is established that the relative amounts of R&D expenditure reliably measure the relative value of the companies' contributions*

Calculation of total residual profit

- ❑ It is established that third party comparable manufacturers without innovative intangible property earn a return (excluding purchases) of 10%
- ❑ Thus, determining the routine manufacturing profit of A and B

A's manufacturing cost = 15	Routine return on costs attribute to A = 1.5
B's manufacturing cost = 20	Routine return on costs attribute to B = 2.0
Residual profit	Combined Net profit - Combined manufacturing profit $= 10 - 3.5$ $= 6.5$

Allocation of residual profit

- ❑ Initial allocation rewards manufacturing functions of A and B
- ❑ Residual profit can be split on basis on their share of total R&D costs
- ❑ It can be reliably assumed that respective R&D costs reflects relative contributions

A's R&D cost =15	B's R&D cost =10
A's share $6.5 \times 15 / 25 = 3.9$	B's share $6.5 \times 10 / 25 = 2.6$
<u>Recalculation of profits</u>	
A's Net profits = $1.5 + 3.9 = 5.4$	B's Net profits = $2.0 + 2.6 = 4.6$

Revised P&L for tax purposes

	A		B
Sales	55.4		100
Less: Purchases	10		55.4
Less: Manufacturing cost	15		20
Gross Profit	30.4		24.6
<hr/>			
Less: R& D	15		10
Less: Operating expenses	10	25	10 20
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Net Profit	5.4		4.6
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Learnings

- Allocation of residual split may need considerable refinement in practice in order to identify and quantify the appropriate basis for allocation
- Difference in types of intangibles may need to be taken into account
- Different types of intangibles may have different levels of risk associated with them
- This would lead to different levels of expected returns at arm's length
- Relative levels of current intangibles may not adequately reflect the contribution to the earning of current profits that is attributable to intangible property developed or acquired in past

Residual PSM - Sensitivity

- Projections (Revenue Growth & EBIT)
- Identification of Routine Functions
- Benchmarking of Routine Returns
- Single IP vs. Multiple IPs
- Life and Lag Assumptions
- Discount Rate

Probable issues in the Indian context

- How do you share losses?**
- Start up companies / costs**
- New entrants to PSM**
- Tax and regulatory issues in implementing PSM**
- Custom valuation issues**

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