The Profit Split Method: When and How to Apply this Method

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Objectives

Share practical experience with respect to the use and implementation of the Profit Split Method (PSM), notably through case studies.
Contents

- **Context**
- **Methodological Insights**
- **Case Studies**
  - Pricing of Products / Services
    - Case Study #1: Using Residual Profit Split Method to Set Prices of Products / Services
  - IP Pricing
    - Case Study #2: Brand Fee for an Industrial Company
    - Case Study #3: Franchise Fee for a Company
    - Case Study #4: Comparable Profit Split
  - Split Factor
    - Case Study #5: Using Investments to Determine the Split Factor
    - Case Study #6: Financial Services—Use of Compensation Data to Determine the Split Factor
  - Transfer Pricing beyond Tax
    - Case Study #7: Transfer Pricing vs. Operational Objectives
Context
“[PSM] It is often not an easy method to apply. I am under no illusion that a profit split is a panacea, but nevertheless there may be value in providing enhanced guidance on how profit splits can be used with precision in appropriate cases, notwithstanding the practical challenges.”

—Andrew Hickman, Head of Transfer Pricing Unit, OECD, 2014
PSM May Increasingly Apply in Certain Situations

Situations in which the PSM may apply (OECD*)

- “Plain Vanilla” Profit Split cases
  - Co-Entrepreneurs
  - Fragmented transactions and business models

- New business models, notably the digital economy

- Complex transactions
  - Unique & valuable Intangible
  - Integration & sharing of risk
  - Hard To Value Intangible and articulation of *ex ante/ex post* approaches

Overall, there seems to be some fear/hesitation from the business community* related to current OECD work on PSM

- Uncontrolled proliferation of PSM in non-BEPS situations
- Unreasonable use of PSM by tax authorities resulting in tax reassessments and double taxation
- PSM not necessarily in line with the arm’s length principle
- PSM not practical to apply

Methodological Insights
Where We Come From?
Fifteen Years of One-Sided Transfer Pricing

Routine Local Functions
Industry Information
Critical Success Factors
Group Value Chain
Roles and Responsibilities
Contribution Analysis
Low Risks
Benchmark
Within the IQ Range
Arm’s-Length Pricing System
Economic Analysis
Intangibles Mapping
Strategic and Non-Strategic Risks
Where We Do *Not* Want to Head To

A universal application of PSM in virtually all cases based on arbitrary/simplistic formulas = Global Formulary Apportionment
Methodological Insights
Selection of PSM
PSM Should Apply Only in Specific Circumstances

- Both parties to a transaction make **unique and valuable** contributions (e.g., contribute unique intangibles) to the transaction

- Operations are **highly integrated** and a one-sided method would not be appropriate

- There are important differences between related-party transactions and third-party transactions attributable, for example, to **economies of scale or scope**

- **Pricing of complex transaction**
The VCA Analytical Framework Is a Starting Point

The Analytical Framework Based On Value Chain Analysis

**STEPS**

**STEP 1. Value Chain Analysis**

- Value Driver #1
- Value Driver #2
- Value Driver #3
- Value Driver #4
- Value Driver #5

**STEP 2. Functions**

- Each person is a proxy for group-wide headcount involved in the activity

**Risks**

- Strategic
- Operational

**Assets (Intangibles)**

- Technology related intangibles
- Marketing intangibles

**STEP 3. Legal Entities**

- Define roles of the entities in the joint value creation and responsibilities in respect of the different value drivers and related risks
Preparing a VCA Does Not Imply Using the PSM

- **Value Chain Analysis** is a tool for a qualitative assessment of steps in a company’s value creation and can serve as a framework for identifying bargaining positions of entities involved therein
  - It helps the selection and application of the most appropriate transfer pricing methods for the case at hand, including the Profit Split Method when appropriate

- When the **Profit Split Method** is applicable, it should find its origin and justification in the Value Chain Analysis
  - Application of the Profit Split Method should rely on solid economic analyses (analysis of external long-term relationships, investment-based models, game theory, compensation-based models, surveys, etc.)
Methodological Insights
Application of PSM – the example of the Residual Profit Split Method (RPSM)
The RPSM Involves 4 Steps

**Step 1: Determination of “benchmarkable” profits**

**Discussion topic:**
- Local remuneration should be appropriately determined – does TNMM grasp all the value derived from local operations?
The RPSM Involves 4 Steps

Step 2: The case of more than one intangible

Discussion topics:

- In the case of two identified intangibles, one option could be to isolate and value one intangible outside the RPSM (example shown)
- Another option consists in valuing the two intangibles as part of the same RPSM model
The RPSM Involves 4 Steps

Step 3: Residual = Technology IP Value?

Discussion topics:

- The assumption under typical RPSM models is that residual profits should remunerate exclusively the intangible(s)

- Should synergies and economies of scale be embedded in the intangible(s’ value?)
The RPSM Involves 4 Steps

Step 4: Residual = Split between owner and contributors?

Discussion topics:

- Identification of entities which “contribute” to intangibles value
- Split factor should rely on solid economic analyses (analysis of external long-term relationships, investment-based models, game theory, compensation-based models, surveys, etc.)
Case Studies
7 Case Studies

- Pricing of Products / Services
  - **Case Study #1**: Using RPSM to Set Prices of Products / Services

- IP Pricing
  - **Case Study #2**: Brand Fee for an Industrial Company
  - **Case Study #3**: Franchise Fee for a Company
  - **Case Study #4**: Comparable Profit Split

- Split Factor
  - **Case Study #5**: Using Investments to Determine the Split Factor
  - **Case Study #6**: Financial Services—Use of Compensation Data to Determine the Split Factor

- Transfer Pricing beyond Tax
  - **Case Study #7**: Transfer Pricing vs. Operational Objectives
Case Study #1

Using RPSM to set Prices of Products / Services
Scenario

- Affiliates A and B are engineering companies. They sell projects to clients which include products and services
- Affiliate A and Affiliate B are involved in the project
- Affiliate B contracts with the client and book sales
- Affiliate A provides products and services to Affiliate B
- Both Affiliates perform key functions (engineering, and project management) and other functions (manufacturing, project execution)
- Objective is first to agree a budgeted price for the products and services Affiliate A will sell to Affiliate B
1st Step: Determine expected profits of A and B in relation to Project X

Key Issues

- What are the relevant segmented costs?
- How do we set the transfer price on a budget basis?
2nd Step: Determine expected remuneration for the simple functions from functionally comparable and independent companies

Residual profit (or loss) = the difference between total profits and the profits attributed to functions deserving a routine remuneration.

\[
\text{Residual Profits} = 30
\]

\[
\text{Project price to client} = 250
\]
Case Study #1
Using RPSM to set Prices of Products/Services

**3rd Step:** Determine transfer price on the basis of an arm’s length expected split of profits

The residual profit (or loss) is allocated between the related parties based on the “residual capital” associated with for example investments to develop, enhance and maintain the value of key activities (design, procurement and project management).

![Diagram showing the allocation of profits and costs]

- **Functional capital = 160**
  - Comparable ROCE = 12.5%
  - Functional profit = 20

- **Residual capital = 80**
  - Costs 100
  - 20

- **Residual capital = 40**
  - Functional profit = 20
  - 10

- **Functional capital = 100**
  - Comparable ROCE = 20%
  - Costs 80

**Transfer Price = 110**

**Project sales price to client = 250**

**Issues to consider**

- What if actual costs deviate from expected costs?
- How can one deal with adjustments?
Case Study #2

Brand Fee for an Industrial Company
Case Study #2
B2B Brand in Industrial Manufacturing MNE

- Manufacturing company supplying a wide range of industrial companies across the globe

- **Objectives of Project:** Determine the relevance of implementing a brand royalty fee from the Group’s parent company, as well as the amount of such royalty fee

- **Project’s Steps:**
  - Assess whether the MNE’s brand is a valuable intangible asset
  - Determine the functions that contribute to the brand, the underlying related risks and the past and current funding of brand related investments
  - Determine the arm’s length royalty fee (and more broadly the arm’s length terms and conditions between the licensor and the licensee)
Following Value Chain Analysis, 3 Critical Success Factors / value drivers were identified

1. Technology / technological know-how
2. Global size and dense local sales network
3. Brand and related intangibles

Attributes of brand and related intangibles

- Brand acts as a guarantee of highest quality, reliability and operational excellence
- Outstanding reputation and culture based on strong corporate values help to attract and retain most skilled workforce
- Uniform appearance and associated reputation increases cross-selling opportunities
The functions performed centrally and locally contributing to the brand and related intangibles were identified through ~20 interviews performed with management and operational personnel.

These functions related to the brand (and related intangibles) are:

- Central Marketing functions
- Central Procurement and Operational Management functions
- Central HR functions
- Other central functions
- Local Marketing functions
The Company wants to realign its intangibles structuring

### Before

<table>
<thead>
<tr>
<th>Brand and Related Intangibles</th>
<th>Functions (perform/control)</th>
<th>Funding (provide)</th>
<th>Risks (control/bear)</th>
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<tr>
<td>Development</td>
<td>C (mark, proc, HR, other)</td>
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<td>Exploitation</td>
<td>L (mark)</td>
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- Costs supporting intangibles are recharged to all OpCos of the Group
- No intangible value is recognized at central level

### After

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<td>Protection</td>
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<td>Exploitation</td>
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- Costs supporting intangibles are no longer recharged to all OpCos of the Group but kept at central level
- Intangible value is gradually recognized at central level

Determination of arm’s length terms and conditions of brand license considering the specificities of the case at hand: Profit Split Method was deemed most suited (4 step-analysis)
Case Study #2
B2B Brand in Industrial Manufacturing MNE

STEP 1

1. Determine remuneration for all "benchmarkable" activities / assets
e.g., using PLI's of comparable companies

SALES

ROUTINE COSTS

TECHNOLOGY RELATED INVESTMENTS

BRAND RELATED INVESTMENTS

CONSOLIDATED PROFITS

BENCHMARKABLE PROFITS
Case Study #2
B2B Brand in Industrial Manufacturing MNE

STEP 2

Use of CUPs to isolate arm’s length remuneration for technology in business
Case Study #2
B2B Brand in Industrial Manufacturing MNE

STEP 3

Derive total value associated to the MNE’s brand and related IP.
Use of past and current investments to determine split of residual profits allowed taking into account past and current local and central contributions.
Case Study #3

Franchise Fee for a Company
Case Study #3
Franchise Fee for a Company

Franchise Intangible
- Brand
- Other related intangibles (know-how, operational excellence, etc.)

Financial Model Intangible
- Unique to the Industry in which the Company operates
- Unique to the Company

Base profit
- Local manufacturing services and distribution functions
Based on the Residual Profit Split Method, one single Franchise Fee flow was determined to be paid by Affiliates to Parent Co.

The arm’s length “Franchise fee” = central management support cost + 5% +

basic brand fee per BU +

50% of the residual profits/losses plus associated central high value added management cost

The Franchise fee to be paid by each local Affiliate is fluctuating depending on the residual profits or losses on the specific market.

The remuneration mechanism applied by the Group in relation to the invoicing of the Franchise fee implies that central functions assume significant parts of the risks inherent in the Group’s business model.
Case Study #4

Comparable Profit Split
Case Study #4
Comparable Profit Split

Key Features

 License agreement relating to the use of a molecule for example (only one intangible)
 Objective: determine an arm’s length royalty rate
 The licensor and/or the licensee have access to third party licensing agreements and the relevant financials
 The CUP or CUT method can not be applied since these agreements do not relate to products with similar profit potential

Conditions Relating to the Use of Those Agreements

 Financial data on these agreements suggest that the licensor’s share of the profits does not fluctuate too drastically (a maximum ratio of 1 to 3)
 There is no statistical relationship between the portion of the profits attributable to the licensor and the profits themselves

USE THE PROFIT SPLIT METHOD TO DETERMINE ARM’S LENGTH ROYALTY RATES
Key Features

- Internal comparable licensing agreements
- Application of internal CUP method may not yield arm’s length results
- Licensing rates from internal CUP are used to calculate the underlying split of total consolidated profits between licensor and licensee
- This split factor can then be applied to the consolidated profits from tested transaction
- This analysis needs to be performed over multiple years
Case Study #4
Comparable Profit Split

- Assume company A licenses out a comparable patent to B, a third party which pays a 5% royalty

The 5% royalty results in a split of profits between licensee and licensor

- The intra-group royalty can be set using the same split of profits
Case Study #5
Using Investments to Determine the Split Factor
Underlying economic logic: Relative value of the investments is a reliable indicator for the contribution of each party to the creation of the intangibles.

The cost capitalization approach is a 3-step process:
- Identify the relevant IP creating investments
- Capitalize the investments using appropriate assumptions on gestation lag and economic lifetime
- Determine the split factor in % used to split the residual profits between the different contributors
Case Study #5
Using Investments to Determine the Split Factor

- **Main inputs needed**
  1. Investments in intangibles
  2. **Gestation lag**—time between the investment is made and revenue generation
  3. **Economic lifetime**—the period of time during which the intangible generates revenues

- **Different assumptions** for gestation lags ("GL") and economic lifetimes ("EL") will imply different relative values of 1 Euro invested over the entire investment cycle (= GL+EL) of an intangible

- **The EL plays a significant role**
  - EL of 1 year: No buildup of economic capital over time
  - Unlimited EL: Intangible does not amortize over time
Case Study #5
Using Investments to Determine the Split Factor

Theoretical numerical example

- **Four contributors (A, B, C and D) have invested in intangible development**
- **Different GLs and ELs, e.g.,**
  - A invested and still invests in a unique, valuable IT tool → **GL: 2 years and EL: 5 years**
  - B is responsible for the identification of best practice processes → **GL: 1 year and EL: 2 years**
  - C invested in and developed the Group brand in the past but not from 2015 → **GL: 0 years and EL: 3 years**
  - D starting to invest in the brand in 2015 → **GL: 0 years and EL: 3 years**

**1st Step:** Cost capitalization approach—Past, current and anticipated IP creating investments of the four contributors:

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<tbody>
<tr>
<td>A</td>
<td>20,0</td>
<td>21,0</td>
<td>22,1</td>
<td>23,2</td>
<td>24,3</td>
<td>25,5</td>
<td>26,8</td>
<td>28,1</td>
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<td>31,0</td>
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<td>B</td>
<td>10,0</td>
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<td>11,3</td>
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<td>C</td>
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<td>44,0</td>
<td>48,4</td>
<td>53,2</td>
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<td>64,4</td>
<td>70,9</td>
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<td>D</td>
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<td></td>
<td></td>
<td>77,9</td>
<td>85,7</td>
<td>94,3</td>
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2\textsuperscript{nd} Step: Capitalization of the respective investments for each contributor

- Example: Capitalization of the investments performed by A
  [Reminder: A’s intangible building investments from Step 1]

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<td>26.8</td>
<td>28.1</td>
<td>29.5</td>
<td>31.0</td>
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- Capitalization of A’s investments (GL: 2 years and EL: 5 years) to derive economic capital of A:

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<tbody>
<tr>
<td>Beginning balance (= last year's ending balance) [a]</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>20.0</td>
<td>37.0</td>
<td>50.9</td>
<td>61.4</td>
<td>68.5</td>
<td>71.9</td>
<td>75.5</td>
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<tr>
<td>Lagged investment (2 years) [b]</td>
<td>0.0</td>
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<td>20.0</td>
<td>21.0</td>
<td>22.1</td>
<td>23.2</td>
<td>24.3</td>
<td>25.5</td>
<td>26.8</td>
<td>28.1</td>
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<tr>
<td>Amortization* (amortized over 5 years) [c]</td>
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<td>0.0</td>
<td>0.0</td>
<td>4.0</td>
<td>8.2</td>
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<td>22.1</td>
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<tr>
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<td>0.0</td>
<td>20.0</td>
<td>37.0</td>
<td>50.9</td>
<td>61.4</td>
<td>68.5</td>
<td>71.9</td>
<td>75.5</td>
<td>79.3</td>
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Gestation lag = 2 years, i.e. investment made in 2008 is capitalized in year 2010

Based on EL of 5 years: one 5\textsuperscript{th} of lagged investment of n-1 = 20.0/5

\[
\begin{align*}
\text{= } & 20.0/5 + 21.0/5 + 0/5 + 0/5 + 0/5 \\
\text{= } & 20.0/5 + 21.0/5 + 22.1/5 + 0/5 + 0/5 \\
\end{align*}
\]

\(\text{→ The total amortization [c] is calculated as the sum of the annual amortizations of the lagged investments over the last 5 years (=EL)}\)

Note:
For simplification purposes, investments were assumed to take place / be fully effective at the end of the year, i.e., amortization of lagged investment in year \(n\) starts in year \(n+1\). Also, please note that time value of money was not reflected in this example.
Case Study #5
Using Investments to Determine the Split Factor

The tables below illustrate the capitalization for the other three contributors B, C and D taking into account their respective GL and EL Notes:

For simplification purposes, investments were assumed to take place / be fully effective at the end of the year, i.e., amortization of lagged investment in year \( n \) starts in year \( n+1 \). Also, please note that time value of money was not reflected in this example.

The amortization of each contributor (line [c] in respective capitalization table) corresponds to the economic costs which are used within the Residual Profit Split model to replace the statutory/accounting costs.

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</table>

\[ \text{= 40,0/3 + 44,0/3 + 48,4/3} \]
\[ \text{= 44,0/3 + 48,4/3 + 53,2/3} \]
\[ \rightarrow \text{The total amortization [c] is calculated as the sum of the annual amortizations of the lagged investments over the last 3 years (=EL)} \]

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Beginning balance (= last year's ending balance) [a]</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>77,9</td>
</tr>
<tr>
<td>Lagged investment (0 years) [b]</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>77,9</td>
<td>85,7</td>
<td>94,3</td>
</tr>
<tr>
<td>Amortization* (amortized over 3 years) [c]</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>26,0</td>
<td>54,6</td>
</tr>
<tr>
<td>Economic capital ending balance [x] = [a]+[b]-[c]</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>77,9</td>
<td>137,7</td>
<td>177,5</td>
</tr>
</tbody>
</table>

Since C stopped investing in intangible in 2014 (due to restructuring) and given the EL of 3 years, it has no economic capital in 2017 anymore.
Case Study #5
Using Investments to Determine the Split Factor

3rd Step: Determining the split factors for each intangible contributor

The split factors are derived based on the relative share of economic capital per contributor:

<table>
<thead>
<tr>
<th>Economic capital per IP contributor (see Step 2)</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>A [v]</td>
<td>0,0</td>
<td>0,0</td>
<td>20,0</td>
<td>37,0</td>
<td>50,9</td>
<td>61,4</td>
<td>68,5</td>
<td>71,9</td>
<td>75,5</td>
<td>79,3</td>
</tr>
<tr>
<td>B [w]</td>
<td>0,0</td>
<td>10,0</td>
<td>15,2</td>
<td>15,5</td>
<td>15,8</td>
<td>16,1</td>
<td>16,5</td>
<td>16,8</td>
<td>17,1</td>
<td>17,5</td>
</tr>
<tr>
<td>C [x]</td>
<td>40,0</td>
<td>70,7</td>
<td>91,1</td>
<td>100,2</td>
<td>110,2</td>
<td>121,2</td>
<td>133,3</td>
<td>68,7</td>
<td>23,6</td>
<td>0,0</td>
</tr>
<tr>
<td>D [y]</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>77,9</td>
<td>137,7</td>
</tr>
<tr>
<td>Total economic capital [z]</td>
<td>40,0</td>
<td>80,7</td>
<td>126,3</td>
<td>152,7</td>
<td>176,9</td>
<td>198,7</td>
<td>218,2</td>
<td>235,3</td>
<td>253,9</td>
<td>274,2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A = [v] / [z]</td>
<td>0%</td>
<td>0%</td>
<td>16%</td>
<td>24%</td>
<td>29%</td>
<td>31%</td>
<td>31%</td>
<td>31%</td>
<td>30%</td>
<td>29%</td>
</tr>
<tr>
<td>B = [w] / [z]</td>
<td>0%</td>
<td>12%</td>
<td>12%</td>
<td>10%</td>
<td>9%</td>
<td>8%</td>
<td>8%</td>
<td>7%</td>
<td>7%</td>
<td>6%</td>
</tr>
<tr>
<td>C = [x] / [z]</td>
<td>100%</td>
<td>88%</td>
<td>72%</td>
<td>66%</td>
<td>62%</td>
<td>61%</td>
<td>61%</td>
<td>29%</td>
<td>9%</td>
<td>0%</td>
</tr>
<tr>
<td>D = [y] / [z]</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>33%</td>
<td>54%</td>
</tr>
</tbody>
</table>

In 2015:
- 31% of residual profits should go to A
- 7% of residual profits should go to B
- 29% of residual profits should go to C
- 33% of residual profits should go to D

Please note that the split factors need to be applied to residual profits derived from properly segmented profit and loss statements.
Case Study #6

Financial Services—Use of Compensation Data as the Split Factor
Value chain and functional assets and risks analyses show that key activities for this investment management MNE are fund design, distribution of funds and portfolio management. Functions deserving a routine remuneration include administrative and support functions.

### Revenues

- **Routine Remuneration**

### Consolidated Profit of the Group

- **Step 1**
  - Remuneration Attributable to Simple Functions

- **Step 2**
  - Residual Profit allocation by function and by entity

### Method

- **TNMM+CUP**
- **Profit Split Method**
Starting point: A careful consideration of the group value chain and value drivers

When splitting the residual profit, ability to define an economically robust split factor is essential to apply this method.
Case Study #6
Financial Services—Use of Compensation Data as the Split Factor

- Determination of split factor was based on the use of compensation data

- Split factor determination involves 4 steps:
  1. Reviewing the functional organizational chart and discussing with management to understand key functions
  2. Identifying compensation data, issues may include:
     ✓ Total vs. variable compensation
     ✓ Period for the analysis (relevant years)
  3. Performing adjustments, examples may include:
     ✓ Labor related benefits (e.g., health insurance, etc.)
     ✓ Cost of living adjustments
     ✓ Foreign exchange rates
  4. Determining split factor based on compensation data

- Other discussion items
  – Confidentiality
  – Impact of regulated compensations
  – Labor market vs. industry dynamics
Case Study #7

Transfer Pricing vs. Operational Objectives
Transfer Pricing is an enabler for the growth of MNEs and has implications beyond tax with operational and financial upside
Case Study #7
Transfer Pricing vs. Operational Objectives

- A leading Project Based MNE

- Key functions: Design, Procurement and Project management

- All entities managed as profit centers

- Management teams of individual entities incentivized on their own profitability
Case Study #7
Transfer Pricing vs. Operational Objectives

- Price of products / services based on PSM
- Based on budget

Pros and Cons
- From an Incentives/Performance Management perspective
  => Is such a TP system favoring smooth cooperation within Group entities?
- From a Tax/Transfer pricing
More than ever before, robust economic analysis is essential for tax payers to mitigate transfer pricing related risks and seize related opportunities.
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