Day 2, Session 3

Transactional Profit Methods

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Agenda

I. Arm's length principle and transactional profit methods

II. Selection of the most appropriate transactional profit method
   a) Transactional Net Margin Method (TNMM)
   b) Profit Split Method (PSM)

III. Applying the most appropriate transactional profit method
   a) Transactional Net Margin Method (TNMM)
   b) Profit Split Method (PSM)

Section I

Arm's Length Principle and Transactional Profit Methods

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Evolution of Transactional Profit Methods

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1979
- CUP, RPM and CPM and other Methods
- Transactional profit methods under "other methods"
- Preference to traditional transaction methods

1984-1987
- Detailing regarding allocation of costs
- Discussions on reliability of allocation mechanisms

1995
- Abolishing the hierarchy between traditional transaction methods and transactional profit methods
- Use of comparability adjustments to mitigate issues in comparability
- Multiple year data
- Periodical adjustments
- Arm's length range

Trend: Increase in use of transactional profit methods

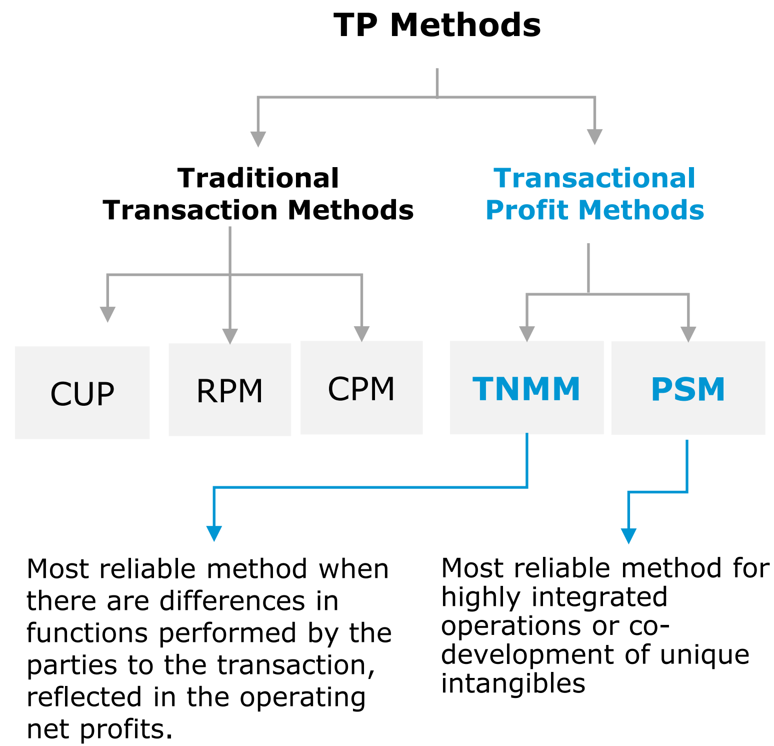
2010
- Emphasis on "most appropriate method"
- Nine-step process to comparability analysis

2017
- In the context of BEPS (2015)
- Revised guidance on application of transactional profit split method
- Guidance on hard to value intangible (HTVI)

2022
- Acknowledgement on the continued validity of the arm's length principle would
- However, reservations on its efficiency for specialized transactions including intangibles (Para 1.15)

General Application

- Only the Transactional Net Margin Method (TNMM) and Profit Split Method (PSM) have sufficient legal basis to satisfy Article 9 of the OECD Model in applying transactional profit methods *(OECD Guidelines 2022, Para 2.62)*
- "Profits" as a measure of arm's length nature of controlled transactions
- The selection process should take account:
  - Strengths and weaknesses of all TP methods
  - Appropriateness of the TP method based on function, risk and asset analysis
  - Reliability of comparable information
  - Degree of comparability and ability to apply comparability adjustments to eliminate material differences



Section II

Selection of Transactional Profit Methods

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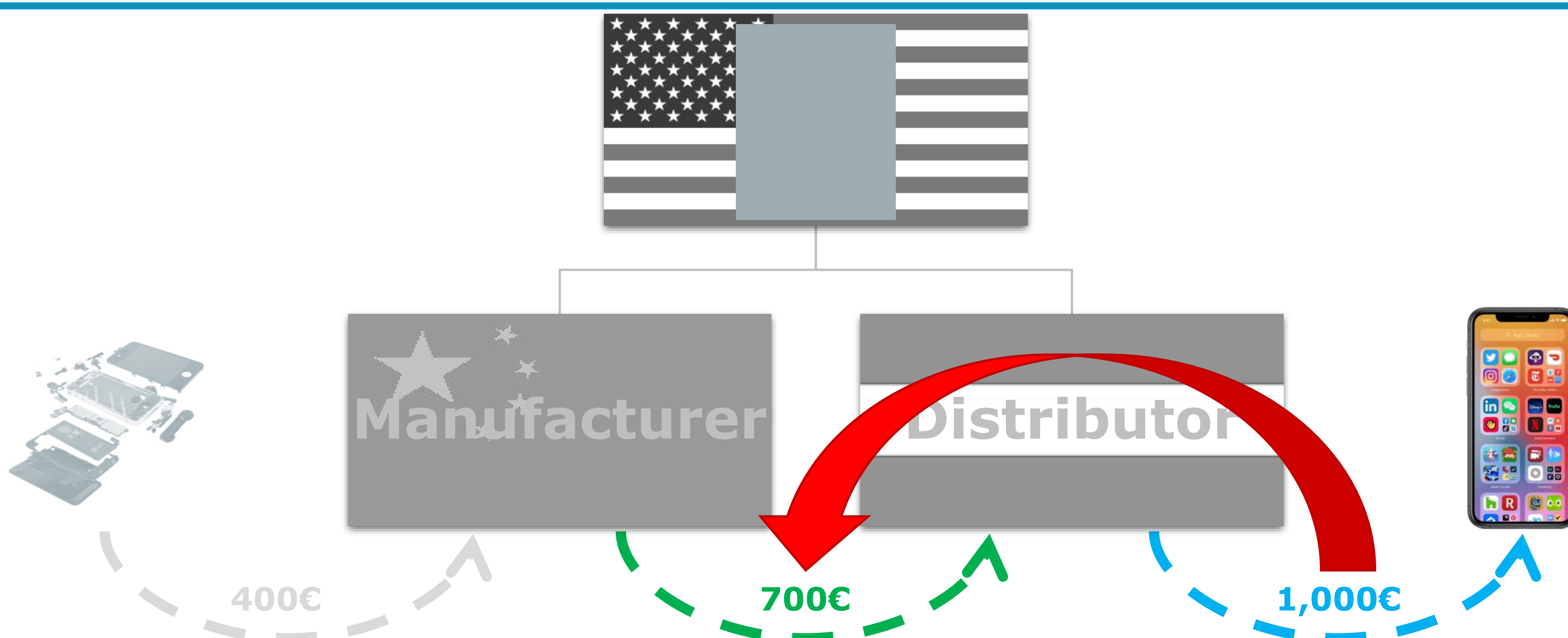
TNMM - Concepts

- *The transactional net margin method examines the net profit margin relative to an appropriated base (…) that a taxpayer realizes from a controlled transaction. (Para 2.64, OECD TP Guidelines, 2022)*
- Transfer prices tested with reference to profit earned by comparable companies
- Does not follow comparability standards as stringently as traditional transaction methods; but particularly dependent on functions performed, risks assumed and assets employed
- Tested party: Least complex entity, with minimal ownership of intangible property; narrowly identifiable business activities for which information on comparable can be reliably identified.

Where is used in practice?

- Distribution of finished goods (where RPM cannot be adequately applied)
- Manufacturing of finished goods (where C+ cannot be adequately applied)
- Provision of services (where C+ cannot be adequately applied)
- Intermediary buy/sell activities (tradeCo, logistics, …)
- Supplementary/corroborative analysis in connection with other transfer pricing methods

TNMM –Distributor



Profit *Manufacturer*
700€ - 400€ = **300€**

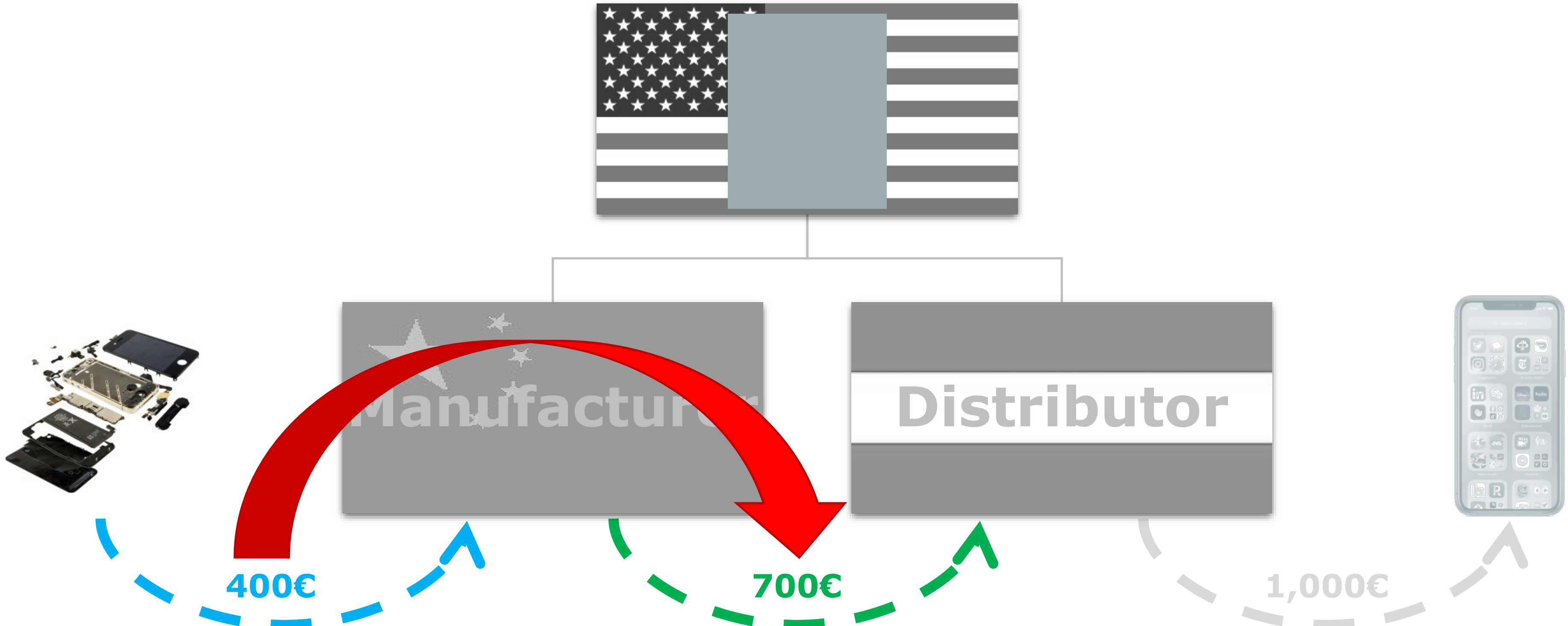
Profit *Distributor*
1,000€ - 700€ = **300€**

TNMM - Distributor

What is the net profit margin (ROS) that unrelated parties in similar circumstances would have agreed upon for a comparable transaction?

P&L Distributor	EUR	Net Profit Margin
Operating revenues	1,000	
- Cost of Goods Sold	(700)	
Gross profit/loss (EBITDA)	**300**	
Other operating expenses ▪ Selling, general and administrative expenses ▪ Depreciation ▪ Amortization ▪ Impairment losses	(200)	
Operating profit/loss (EBIT)	**100**	**10%**
± Interest income/expenses	(20)	
± Other income/expenses	(30)	
Net profit/loss (before taxes)	**50**	
Taxes (20%)	(10)	
Net profit/loss (after taxes)	**40**	

TNMM - Manufacturer



Profit *Manufacturer*
700€ - 400€ = **300€**

Profit *Distributor*
1,000€ - 700€ = **300€**

Profit *Group*: 300€ + 300€ = **600€**

TNMM - Manufacturer

What is the net mark-up (ROTC) that unrelated parties in similar circumstances would have agreed upon for a comparable transaction?

P&L Manufacturer	EUR	Gross Mark-up
Operating revenues	700	
- Cost of Goods Sold	(400)	
Gross profit/loss (EBITDA)	**300**	
Other operating expenses ▪ Selling, general and administrative expenses ▪ Depreciation ▪ Amortization ▪ Impairment losses	(200)	
Operating profit/loss (EBIT)	**100**	**17%**
± Interest income/expenses	(20)	
± Other income/expenses	(30)	
Net profit/loss (before taxes)	**50**	
Taxes (20%)	(10)	
Net profit/loss (after taxes)	**40**	

TNMM – Key Considerations

Pros.	Cons.
▪ Simple one-sided method ▪ In practice, the most used ▪ Less comparability required than in CUP, RPM and CPM ▪ Commonly used by European tax authorities, Asian and North American tax authorities	▪ Net margin may be impacted by non-transfer pricing issues ▪ Not appropriate for early-stage activities (start-up entities) ▪ Method to be used if the other methods are not applicable

- Profit Level Indicators (PLI)
  - Operating Margin (OM)
  - Return on Total Costs or Net cost Plus (ROTC or NCP)
  - Return on Assets (ROA), Return on Capital Employed (ROCE)
  - Berry Ratio (BR)
- Comparability Adjustments:
  - Working capital - Accounts receivable, Accounts Payable, inventory, conditions of the sale, currency risk, accounting practices, utilization risks, capacity risks.
  - Not accepted in all countries, required in some others

PSM - Concepts

- *The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions*. *(OECD TP Guidelines 2022, Para 2.114)*
- When?
  - 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.
- Steps:

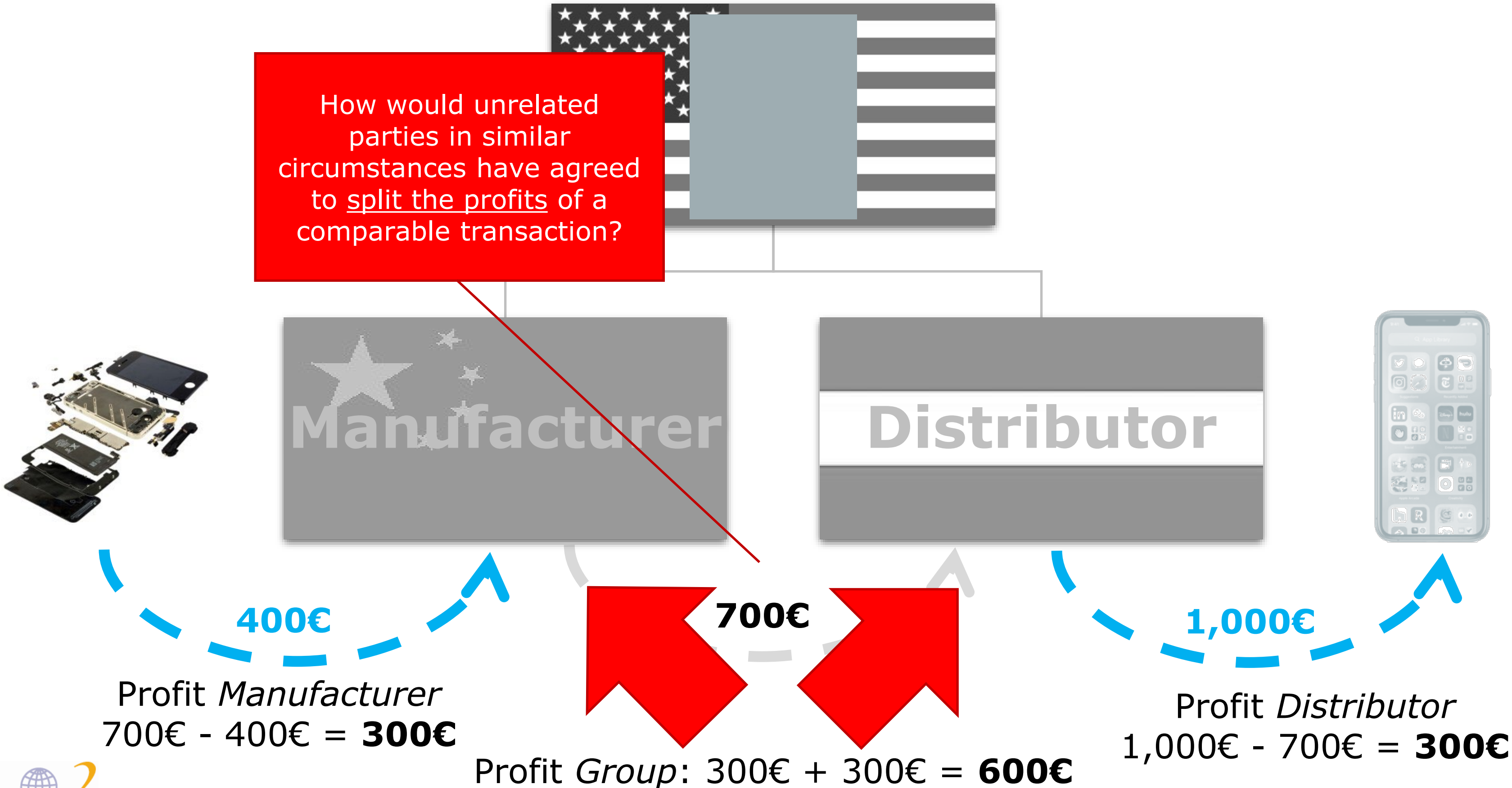
  1. Identification of profits (losses) to be split (relevant to the controlled transactions)

  2. 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

PSM - Concepts

- Consistent with the functional, risks and asset analysis of the controlled transaction
- Capable of being measured in a reliable manner.
- Profit splitting factors agreed in advance of the transaction and remain consistent
- *Contribution analysis:* Based on nature and contribution of each party
- *Residual analysis*: When one/ some of the parties are less complex in participating
  (1) Routine profits: Determine profits using relative easily benchmarked
  (2) Non-routine profits: Allocate profits based on reliable key
- Essential to accurately delineate the transactions and determine the aggregation of the relevant transactions
- Role of common accounting practices (revenue recognition) of the parties to the profit split, including impact of differences in currencies
- Profits relevant to the controlled transaction, relevant geographical market, relevant product lines, business segments
- DEMPE functions for licensing structures
- RACI Model for contribution analysis - role of value chain and process mapping.
- Budgeted PSM vs. Actual PSM

PSM – Manufacturing and Distribution



PSM – Key Considerations

Pros.	Cons.
▪ Adapted when both parties in the related-party transaction have significant intangible assets (or make "unique and valuable contributions" to jointly operate the same value chain) ▪ Adapted when impossible to identify which entity/part of the company generated profits (e.g. global trading operations) ▪ Provide for flexibility overtime when operational footprint evolves and relative contributions adjust accordingly	▪ Complex economic analysis ▪ Not adapted to all economic models ▪ Relies on assumptions ▪ Difficult to implement from a system perspective and also from a VAT/custom duty perspective (need to adjust prices, retroactive fillings)

Section III

Applying the most approriate Transactional Profit Method

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TNMM - Application

- OpCo receives shared and central management support services from HoldCo for which it pays management fees on the basis of full costs engaged by HoldCo in providing these services plus a mark-up of 7%
- The arm's length nature of the transfer pricing policy applied in the framework of this transaction was tested via a benchmarking analysis
- As such, a search for external comparable companies in the pan-European region engaged in similar functions to that of HoldCo Ltd. was performed using the AMADEUS database. The results of the analysis is provided below

Range of MTC achieved by comparables	2021-2023
Maximum	13.4%
Upper quartile	**8.1%**
Median	**6.9%**
Lower quartile	**3.0%**
Minimum	1.7%

HoldCo financial statements	2022
Sales / Total Management Fees (A)	1,650,500
Total operating expenses / Allocable Costs (B)	1,580,015
EBIT (C)	110,485
EBIT as % Revenue (D=C/A)	6.5%
EBIT as % of Costs (Mark Up on Total Costs) (E=C/B)	**7.0%**

PSM (Comparable + Contribution) - Application

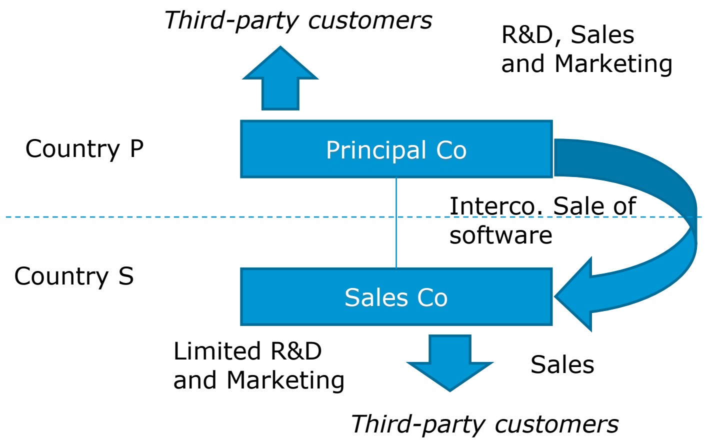
UK manufacturer of handbags → French related distributor → Customer

	Manufacturer	Distributor	Price = 200
1st step *Determination of the group's consolidated profit related to the manufacturing and distribution of products*	**Manufacturing costs = 30**	**Distribution costs = 10**	
	Consolidated profit = 200-30-10 = 160		
2nd step *Allocation of the consolidated profit between both companies, according to an appropriate allocation key taking into account, for example, typical fees paid between third-parties for same type of activity)*	**Allocation key = 75%/25%** **- For the manufacturer: 75 % of marketing investments** **- For the distributor: 25 % of marketing investments**		
	Allocation of profit: **- For the manufacturer: 160 x 75 % = 120** **- For the distributor: 160 x 25 % = 40**		

Comparable Profit Split:

Allocation based on comparable allocation between independents (contracts, economic surveys, …)

PSM (Residual) - Application



Details (in Billion EUR)	P Co	S Co	Group X
Revenue (A)	60	70	130
from intra-group sales	*40*	*0*	
from local sales to end customers	*20*	*70*	
Cost of Goods Sold (COGS) (B)	20	40	60
Op-expenses (C)	20	20	40
PBT (D=(A-B-C))	20	10	30
Profit margin (E = (D/A))	33%	14%	23%

Principal company *(Principal Co.)* is located in country P and part of MNE X

- *Principal Co.* ***develops "standardised" anti-virus software*** for license and sale to third-party customers in Country P.
- *Principal Co.* ***sells*** the software to its subsidiary *Sales Co.* for distribution in Country S
- *Principal Co.* is legal owner of intangibles related to ***R&D and marketing*** for software development and sales, respectively.

Software Distributor *(Sales Co.)* is located in Country S, part of MNE X

- *Sales Co.* imports software CDs from Principal Co. for ***distribution*** to local customers in Country S.
- *Sales Co.* undertakes limited ***R&D and marketing*** functions and entitled to residual profits.

PSM (Residual) - Application

Co (A)	Functions (B)	FS Profit reported (C)	Routine profits (D)	Residual profits (E)	Profits from ALP (D)+(E)=(F)
P Co	Software development R&D	20	8	10	**18** (8+10)
S Co	Distribution Marketing	10	7	5	**12** (7+5)
Total		30	15	(30-15) = 15	30

Routine profits - TNMM Benchmarked

- P Co software dev. 20% X Costs (40) = 8
  - 20% TNMM OP/OC PLI
- S Co distribution 10% X Sales (70) = 7
  - 10% TNMM OP/OR PLI

Residual profits – ratio of 2:1

- P Co R&D = 67% X 15 = 10
- S Co Marketing = 33% X 15 = 5
- Residual profits based on an allocation key
- Allocation key aligned with independent enterprises

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