

European Business Initiative on Taxation (EBIT)

**Submission to the OECD –
Practical Examples of Profit Split Solutions**

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Submission to the OECD – Practical Examples of Profit Split Solutions

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Dear Marlies,

EBIT is pleased to send you four practical examples of profit split solutions from our day-to-day experience in the context of the OECD's work on BEPS Action 10, as agreed during our meeting in Paris on 7 October 2014.

EBIT trusts that the below examples are helpful for you and the OECD in finalising your work in this area. We are always happy to discuss with the OECD and we remain fully committed to a constructive dialogue.

Yours sincerely,

The European Business Initiative on Taxation – December 2014

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EXAMPLE 1 - RESIDUAL PROFIT SPLIT¹ POLICY FOR INTEGRATED TRADING ACTIVITIES

A Company headquartered in Country A with branches in Countries B, C and D is engaged in the European market for trading and marketing in both physical commodities and derivatives. As an “Investment Services Provider” it provides customized risk management and hedging solutions for hedging energy price fluctuations such as spot/forward, physical and derivative products and options. The company’s business activities are regulated.

The Functional Analysis concluded that two broad types of functions were identified as being Key Entrepreneurial Risk Taking (“KERT”) in nature, namely the Trading and the Sales Trading functions. Those two functions are dependent on each other and could not exist without each other. It is therefore very difficult to determine what the value is of each of them on a standalone basis. Trading Support, Sales Trading Support and Support have all been classified as non-KERT functions. Some of the Functions are performed in several jurisdictions requiring a Split of income.

In relation to Risks, pricing, market / trading volume, counterparty, foreign exchange and liquidity risks have all been considered as being Key Risks. As with the functions, many of these risks are borne in all three Countries. With due regard to the OECD Report on Profit Attribution to Permanent Establishments, KERT functions have been identified as the functions that give rise to and/or manage these Key Risks.

Having regard to the Functional Analysis and the KERT functions in the context of the highly integrated Trading and Sales Trading functions, a Profit Split based approach was considered as the most appropriate and is necessary where the significant functions and risks are borne in multiple jurisdictions. From a risk management perspective, it is also essential that Traders and Sale Traders share their P&L since each of them manage different risks (in a nutshell, the Traders run the market risk, while the Sales Traders run the counterparty risk). Other methods could create a bias that would create distortion or higher risks.

Where the KERT functions are performed in just one jurisdiction, referred to as a “natural home” trading model, it was determined as not being necessary to perform any reallocation of profits under a profit split method as the income and profits is already recognised in the correct jurisdiction. Hence, revenues and profits are booked and remain in their initial jurisdiction.

The more basic, non-integrated functions, the Sales Support, the Sales Trading Support and the Support services, are remunerated on a Cost Plus basis (at the Operating Profit level, i.e. applying a Net Cost Plus remuneration method or “NCP”).

Such an approach represents a suitable application of the Arm’s Length Principle with a suitable, stable profit level received by the support teams for their value-adding, but non-KERT, functions. The residual profit after the payment for all of the Support functions (including Trading Support and Sales Trading Support) are split between the KERT functions/locations in an appropriate manner.

High-level description of the Step-by-Step approach for the application of the residual profit method:

- ✓ Step 1: Determine the split of total NBI (Net Banking Income) between Trading and Sales Trading

¹ Residual Profit Split Method. This method involves two steps. First, operating income is allocated to each party in the controlled transactions to provide a market return for their routine contributions to the relevant business activity. Second, any residual profit is divided among the controlled taxpayers based on the relative value of their contributions of any valuable intangible property to the relevant business activity. This method is best suited for analyzing the transfer of highly profitable intangibles.

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- ✓ Step 2: Determine the NBI per Trading Desk and location
- ✓ Step 3: Calculate business contribution to be paid by FX desk to the other trading desks
- ✓ Step 4: Split the Sales Trading NBI (per Step 1) between State A, B and C, based on relative value of total compensation
- ✓ The profit attribution of NBI to Sales Trading will be split between A, B and C based on the relative value of total compensation within the Sales Trading department.
- ✓ At the end of Step 4, an arm's length allocation of NBI between A, B and C has been achieved.
- ✓ Step 5: Determine total costs related to Trading Support and Sales Trading Support based on Net Cost Plus approach
- ✓ Step 6: Allocate Trading Support and Sales Trading Support costs between relevant desks
- ✓ Step 7: Determine total costs related to Support costs based on Net Cost Plus Approach
- ✓ Step 8: Allocate Support costs between the relevant Trading Desks.

EXAMPLE 2 - PROFIT SPLIT FOR EXPLOITATION OF IP

A Company headquartered in Country A ("Company A") is a manufacturer and distributor of branded goods. The brands cover a large portfolio of different products bearing different trademarks with associated proprietary rights including logos, designs, as well as trade manufacturing patents, and know how (altogether referred to as "IP").

Company A is the legal owner of the worldwide rights pertaining to the brands. Brands are a key feature of the products and are a valuable asset contributing to the profit of the group, but require significant marketing investment to maintain and develop its value.

Company A has granted a long term exclusive license to its subsidiary located in country B ("Company B") to manufacture and distribute all branded products in all territories except in country A. This license is remunerated via a royalty fee. Company B uses the licensed IP to manufacture and distribute the products in 20 countries by either selling directly the products to third party distributors, or via sub licensing the IP to affiliates.

The significant people functions contributing to the maintenance and development of the IP (i.e. Development, Enhancement, Maintenance, Protection and Exploitation of the IP (the "DEMPE" functions) have been determined to include Research & development (new technology development, new product development), raw material supply strategy, brand portfolios management, dealership development strategy, product pricing strategy, trade marketing strategy.

The functional analysis of Company A and Company B shows that the DEMPE functions pertaining to the licensed IP in all countries, except country A, are shared between Company A and Company B. Company A is mostly in charge of the Product development and IP protection, whereas Company B performs all other functions and bears all the funding required for the exploitation of the IP. The routine functions include manufacturing, sales support, logistics, finance, HR, legal. Those functions are performed either by Company B or subcontracted by Company B to other subsidiaries within the group and remunerated with a Cost Plus methodology.

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The significant people functions of Company B (DEMPE) are performed by employees of Company B located in country B. Company B deploys significant and highly qualified staff to lead, control and manage the activities of the sub-contractors. Its governance model is tightly controlled from Company B by its personnel in country B.

Hence the residual profit split was selected as the most appropriate transfer pricing method for the purpose of determining an arms 'length royalty rate between Company A and Company B.

The various steps of the residual profit split can be described as follows:

1. Determination of the combined profit to be split (i.e. aggregated profit realized by Company B in all 20 countries generated by the sales of licensed products)
2. Deduction of a routine profit in each country (cost + based on benchmarking analysis using Amadeus) to determine each country's residual profit
3. Computation of the split factor:
 - a. Identification of Activities that are contributing to the equity of the licensed brands
 - b. Costs incurred by Company A and Company B for each of these activities
 - c. Average of costs over the last 5 years
 - d. % of each company average costs vs total will represent the split factor (the split factor is computed every year and may thus fluctuate based on costs incurred by respective Companies)
4. The split factor is applied to residual profit in each country
5. The amount of profit attributed to Company A under the split factor is translated into a royalty percentage of net sales in each country
6. The median of the interquartile range of the 20 royalty rates in each country is used as the arm's length royalty rate
7. Company B pays a royalty to Company A using the median rate applied to combined sales in all licensed countries.

EXAMPLE 3 - COMPARABLE PROFIT SPLIT² POLICY FOR DIVERTED LNG CARGOES

The affiliated Companies A and B are respectively located in State A (U.S.) and in State B (Europe) and are part of the Liquefied Natural Gas (LNG) business unit. Both companies are responsible for a portfolio of assets including long-term supply contracts, re-gasification capacities and charter contracts.

Company A sells natural LNG to gas distribution companies, electric power generators, and gas marketing companies mainly in State A. Company B developed a portfolio of mid-term LNG sales contracts with customers primarily located outside State A and B (mainly Asia).

Company B entered into a long term supply Contract (referred to "Commercial Arrangement") with an external supplier for the purchase of a certain amount of cargoes of LNG per year. The Commercial Arrangement is indexed to INDEX and assumes a primary discharge port is obtained in the Terminals A in the U.S. Company A and B entered into an

² Comparable Profit Split Method. Transfer prices are based on the division of combined operating profit between uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity. Under this method, the uncontrolled parties' percentage shares of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity between the related parties.

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interco-contract for the annual sale and purchase of $\frac{3}{4}$ of the cargoes acquired via the Commercial Arrangement for delivery to Terminal A. The Commercial Arrangement and interco-contract have similar clauses except the number of cargoes. In both, it is provided that in case of diversion of cargoes the incremental margin would be shared between the seller and the buyer.

Further to significant economic changes in the U.S. market, the parties to the agreement entered into an amendment in order to divert cargoes under the supply terms to a third party purchaser. Under the terms of the amendment, Company A resells the diverted cargo to Company B for resale to an external customer located in Asia under a mid-term contract concluded with Company B.

As Company B entered into a long-term supply agreement with an unrelated supplier, whose functions and risks directly relate to the diverted cargoes and are similar to the transaction undertaken by related parties, the comparable profit split was considered as the most appropriate method to determine an arm's length remuneration for the related transaction.

The clause in the Commercial Arrangement entered into between the third party supplier and Company B according to which the diversion rights is foreseen include the following condition: *“to any terminal in zones XYZ, any upside margin shall be shared equally 50/50 between Seller and Buyer”*.

Therefore, it was determined between unrelated parties, that for opportunities to divert cargoes out of the Supply Agreement, a 50/50 upside profit split is reasonable. It should be added, this upside profit split was applied to the same cargoes in the related transaction. This split is a common practice in the LNG market due to the fact that both parties have an interest in the diversion and both need the agreement of the other to execute it. So the bargaining power is balanced and lead to a split.

The price Company A purchases the LNG cargo from Company B is directly tied to the third party supply contract's pricing formula. This intercompany price is then effectively discounted by 25 percent of the total upside profit sharing i.e. Third Party Supplier (50 percent), Company B (25 percent) and Company A (25 percent).

EXAMPLE 4 - RESIDUAL PROFIT SPLIT FOR INTEGRATED PRODUCTION AND SALES ACTIVITIES WITHIN A COMPANY WITH BRANCHES IN 7 COUNTRIES

A Company operates an integrated organisation of production and sales operations comprised of 10 different business units in 7 European countries. The Company operates with branches.

The functions performed by the production units are routine functions related to manufacturing processes and logistics operations. The production units perform work under tolling structures. The economic risk they bear is low. Management of the production units is highly integrated with the sales units' management.

From a functional and risk perspective, the activities of the sales units can be distinguished in routine and non-routine operations.

For simplification, activities performed by non-managerial staff are seen as routine operations or operations of a “standard nature” related to sales and distribution activities towards customers and administrative support functions.

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Non routine operations are all activities which are less recurring by nature, including decisions on investments/divestments, guidelines on HSSE, product pricing, key customers management, production planning, marketing strategy etc.

The Company operates with integrated cross-border management structures. This management structure has the effect that there is only one “entrepreneur” for each business unit assuming cross-border responsibility for the manufacturing and the sales. However staff performing the entrepreneurial functions for a specific business unit are not necessarily located in just one jurisdiction.

The functional analysis concluded that the businesses are highly integrated and interdependent across the various branches. Under such circumstances the residual profit split method is an appropriate transfer pricing method to determine the profits of each of the business units in each of the branches.

The residual profit split method operates as follows:

1. Remuneration for the routine manufacturing activities:
The Transactional Net Margin Method (TNMM) with a mark-up on costs as profit level indicator is considered to be an appropriate transfer pricing method to reward the local routine manufacturing activities.
2. Remuneration for the routine sales and distribution activities:
The TNMM with a return on sales as profit level indicator is considered to be an appropriate transfer pricing method to reward the local routine sales and distribution activities.
The sales margins are per business unit and per branch.
3. Attribution of the residual profit:
After having determined the routine functions remuneration, the residual profit per business unit is calculated by deducting the business unit’s routine functions remuneration from the business unit’s overall result. The residual profit is the remuneration for the non-routine integrated management activities. The residual profit per business unit is split over the various branches using the following allocations keys; number of “Significant People Functions” (33%); value of fixed assets (33%); value of sales (34%).

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