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Profit split method – untapped potential for transfer pricing analysis

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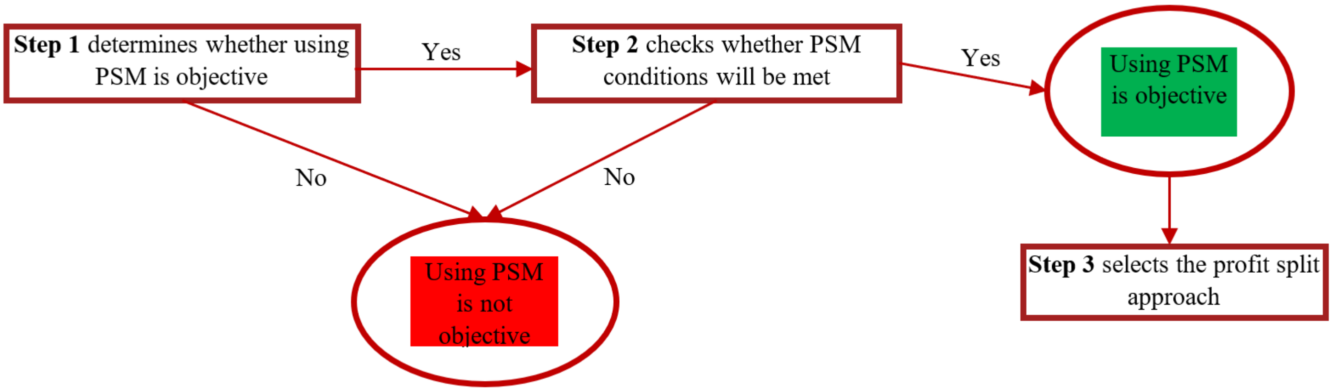
The Cabinet of Ministers' Rule No. 677[1] has been amended with effect from 18 February 2021 on ways of applying the profit split method ("PSM") in analysing transactions between related parties. This article offers a flowchart to help taxpayers evaluate the possibility of using PSM for economic validation of prices applied in their transactions, with a practical example of profit split.

What is PSM and when it can be used

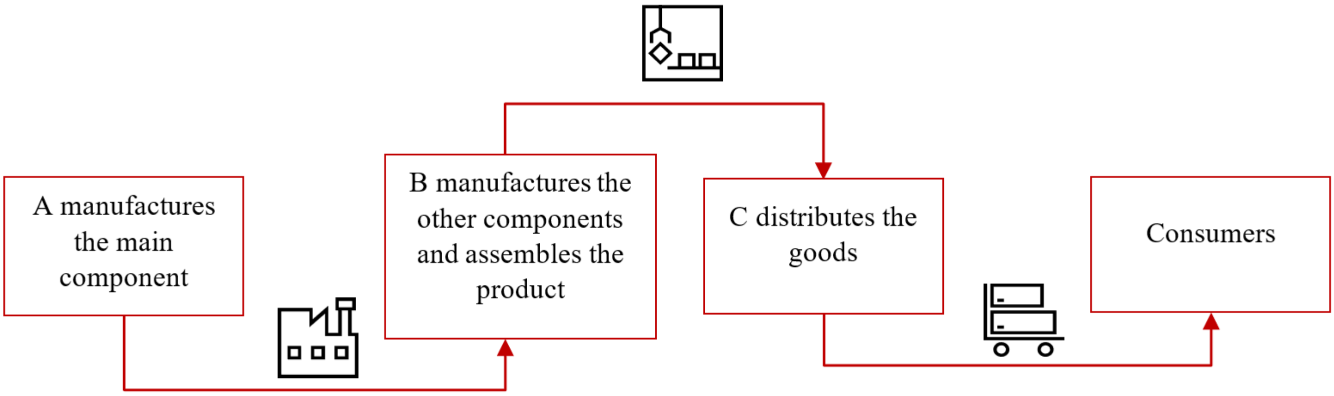
PSM is a transfer pricing method that provides for calculating the outcome of a controlled transaction (profit or loss) to be apportioned between the related parties before the controlled transaction begins and then splitting it according to economically sound factors. The flowchart below allows the taxpayer to evaluate the scope for using PSM to analyse a controlled transaction:



	Decision-making aspects
Step 1	PSM can be used if – - both parties make a unique and valuable contribution to the transaction, representing the main source of the economic benefit from which profit is derived; - the parties' contribution cannot be credibly separated or valued; and - economically significant and closely interlinked risks are assumed by both parties together or by each one independently.
Step 2	If Step 1 finds that the transaction essentially permits the use of PSM then we need to establish whether all the conditions will be satisfied: - Profit factors and splitting factors must be selected in line with the functional analysis; - The process of determining the profit for splitting and the selected splitting factors[2] must be quantitatively measurable; - PSM must be used to arrive at an arm's length price before the transaction begins (the *ex-ante* approach); - The profit split and the splitting factors must be consistent throughout the transaction period; and - The profit must be split at the level of operating profit (EBIT) or gross profit.
Step 3	If the two preceding steps are successfully completed and the use of PSM is considered objective, the following types of profit split are used: - Contribution analysis – the profit is split according to the relative value of the parties' contributions; - Residual analysis – the profit is split into two categories: 1. The first includes any profit for which a reliable external benchmark is available; 2. The second includes the residual profit which arises from the parties making a unique and valuable contribution that cannot be allocated under the traditional analysis principles and is allocated to the parties according to their relative contribution.

As the complexity of related-party transactions increases, the use of PSM is becoming increasingly relevant, particularly in enterprise groups using a highly integrated business model with several participants each making a significant contribution. PSM will also be especially useful in the digital business, where the traditional transfer pricing methods cannot be used considering the unique contribution of the parties.

Below is a practical example of using PSM to analyse a controlled transaction that involves companies A, B and C in a multinational group manufacturing and distributing electrical goods:



Analysis of the A–B transaction shows that both parties make a significant and unique contribution to the combined result of the transaction, so PSM should be used. In the B–C transaction, however, the resale price method can be objectively used for transfer pricing analysis.

To illustrate, the table below provides the financial data of A and B relevant to the transaction:

	A	B
Revenue	50	100
Acquisition cost	(10)	(50)
Production cost	(15)	(20)
Gross profit	25	30
R&D cost	(15)	(10)
Operating costs	(10)	(10)
Operating profit (EBIT)	0	10

The outcome of the transaction is split according to the residual analysis.

1) Category 1 profit calculation – for the production function

A market data analysis shows that manufacturers that do not have a unique and valuable intangible asset apply a 10% markup on their production cost in comparable circumstances.

Thus –

- A’s markup is 1.5 (10% of 15),
- B gets a markup of 2 (10% of 20), and
- the profit from production allocated to both parties is 3.5 (1.5 + 2).

2) Category 2 residual profit calculation – for the R&D function

Since the parties’ combined operating profit (EBIT) is 10 (0 + 10), the residual profit is 6.5 (10 – 3.5), which should be allocated to R&D according to their contribution if their combined R&D cost is 25 (15 + 10).

Thus –

- A’s residual profit is 3.9 (6.5 x 15/25);

- B’s residual profit is 2.6 (6,2 x 10/25).

Accordingly, the profit between the parties was recalculated and the combined operating profit (EBIT) was split according to their functions and relative contribution:

- A (1.5 + 3.9 = 5.4)
- B (2 + 2.6 = 4.6)

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1 Rules for applying provisions of the Corporate Income Tax Act

2 The profit splitting factors must be independent from the taxpayer’s transfer pricing policy, must be based on objective data that is not concerned with amounts paid between related parties, and must be verifiable and based on market data. Examples of economically sound factors include the value of assets or capital, operating expenses, cost of goods sold, R&D cost, sales volume, and salaries of employees performing key value-adding functions.