

LB&I International Practice Service Process Unit – Overview

IPS Level	Number	Title	UIL Code	Number
Shelf	N/A	Business Outbound	–	–
Volume	1	Income Shifting (Business Outbound)	Level 1 UIL	9411
Part	1.7	Other transfer pricing issues	Level 2 UIL	9411.07
Chapter	N/A	N/A	Level 3 UIL	N/A
Sub-Chapter	N/A	N/A	–	–

Unit Name	Residual Profit Split Method - Outbound
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Introduction

Residual Profit Split Method - Outbound

- All transactions between controlled taxpayers must meet the arm's length standard of IRC 482; in other words, the pricing of such transactions must reflect the pricing that would have occurred if the parties had been uncontrolled taxpayers engaged in the same transactions under the same circumstances. One of several possible transfer pricing methods for determining if a transaction meets the arm's length standard is the profit split method, and one specific application of the profit split method is called the residual profit split method ("RPSM").
- The RPSM, like any other transfer pricing method, may only be used if, based on the facts and circumstances, it is the best method. A transfer pricing method will be considered the best method only if it provides the most reliable measure of an arm's length result. Two primary factors are considered when identifying the best method: the degree of comparability between the controlled transaction and any uncontrolled comparables, and the quality of data and assumptions. For more information on the best method, please see Practice Unit "Overview of IRC Section 482," DCN: ISO/9411.07_01(2013).

Introduction (cont'd)

Residual Profit Split Method - Outbound

- The RPSM is generally used when both controlled taxpayers in the controlled transaction make significant nonroutine contributions (i.e., significant contributions for which it is not possible to identify a market return).
- Some examples of when to use RPSM include:
 - A tangible goods sale, if the seller uses nonroutine manufacturing intangibles to make the goods, and another controlled party purchases and resells the goods using its nonroutine marketing intangibles.
 - A licensing transaction, in which one controlled party licenses nonroutine manufacturing intangibles to a second controlled party, who then manufactures goods using those manufacturing intangibles and sells the goods using its own nonroutine marketing intangibles.
 - Commercial sales of a software product, if two controlled parties each contribute nonroutine software intangibles to manufacture the product, and the controlled parties share the revenue from the sales.
- The split of operating profit between the two controlled parties is determined under the RPSM. One can then determine the arm's length transactional price or value that results in that split of operating profit (e.g., arm's length price for the tangible goods sale, arm's length payment for the license, arm's length split of third-party sales revenue).

Introduction (cont'd)

Residual Profit Split Method - Outbound

- The RPSM is a profit-based method that uses information about both of the controlled taxpayers.
- Under profit-based methods, the arm's length price is determined by benchmarking the operating profits earned by one or both of the controlled parties against the operating profits earned by comparable companies performing similar functions and incurring similar risks. In contrast, transaction-based methods, such as the comparable uncontrolled price method, cost plus method and the resale price method, assess whether an arm's length price is paid by comparing the prices or gross margins from controlled transactions to information from uncontrolled transactions.
- Transaction- and profit-based methods that use information that pertains to only benchmark the profits of one controlled party (e.g., that party's operating profit or gross margin) may not be reliably used when both controlled parties, in the context of the controlled transaction, make significant nonroutine contributions (i.e., contributions for which it is not possible to identify a market return). Thus, in such situations the most reliable method could be the RPSM, which considers the functions and assets, and profitability of both controlled parties. The RPSM generally applies when both controlled parties make contributions in the controlled transaction that are nonroutine.
- The RPSM, when determined to be the best method, divides the operating profit from the relevant business activity between the two controlled taxpayers (the two parties) in two conceptual stages. First, each party is rewarded for routine contributions. Second, residual profit or loss (i.e., the profit or loss after the reward for the routine activities is paid out) is allocated between the parties in proportion to the relative value of the parties' nonroutine contributions. When there is a residual profit, it is shared by the parties as a reward for their nonroutine contributions. When there is a residual loss, it is shared by the parties as a sharing of the risk that comes from developing and making nonroutine contributions.

Introduction (cont'd)

Residual Profit Split Method - Outbound

- This unit will explain how to determine if the RPSM is the best method, and, if so, how to apply the RPSM to a transaction between a US Parent (“USP”) and its controlled foreign corporation (“CFC”) in which intangible property is employed. The relevant regulations for the RPSM are outlined in Treas. Reg. 1.482-6. Please note that the RPSM is also discussed in Treas. Reg. 1.482-7 (Cost Sharing Arrangements) and -9 (Services), but those sections will not be the subject of the current unit. While the RPSM is applicable to both inbound and outbound controlled transactions, this unit will be covering the outbound scenario. For the inbound transactions, please see Practice Unit “Residual Profit Split Method-Inbound” DCN: ISI/PUO/P_6.9_04(2014).



CONSULTATION: Consultation with an economist, an engineer, TPP and/or Income Shifting IPN may be necessary. It is important to consult with the appropriate personnel as early as possible. In addition, LB&I Counsel should consult with ACC(INTL) Branch 6 if there are any uncertain legal issues with the RPSM

Process Overview

Residual Profit Split Method - Outbound

- This unit outlines the four steps in the application of the RPSM:
 - Identify routine and nonroutine contributions made by the parties. If there are no nonroutine contributions, then the RPSM should not be used.
 - Assuming that there are nonroutine contributions, determine if the RPSM is the best method for assessing whether the compensation paid is consistent with the arm's length standard.
 - Assuming that the RPSM is the best method, allocate income to the parties based on routine contributions.
 - Allocate the residual profit/loss to the parties based on nonroutine contributions.

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TREATY IMPLICATION: If an adjustment is pursued and gives rise to double taxation, the taxpayer may have access to double tax relief under the articles on Associated Enterprises and the Mutual Agreement Procedure ("MAP") of a relevant treaty. Providing the taxpayer with information on competent authority and keeping the statutes in both countries open is MANDATORY (See IRM 4.60.2.1 which mentions Pattern Letter 1853). If competent authority relief is sought by the taxpayer, make sure you consult with Advance Pricing and Mutual Agreement Program ("APMA").

Summary of Process Steps

Residual Profit Split Method - Outbound

Process Steps

To determine whether the RPSM is the best method to evaluate a controlled transaction between USP and CFC, and to apply the RPSM to that transaction, the following steps should be taken:

Step 1	Identify the routine and nonroutine contributions made by the parties.
Step 2	Determine if the RPSM is the best method.
Step 3	Allocate income to the parties based on routine contributions.
Step 4	Allocate the residual profit or loss to the parties based on nonroutine contributions.

Step 1: Identify the Routine and Non Routine Contributions

Residual Profit Split Method - Outbound

Step 1

Identify the routine and nonroutine contributions made by the parties.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ The identification of the routine and nonroutine contributions has two purposes: (1) determining whether the RPSM is the best method; and (2) application of the RPSM. – <u>Routine contributions</u> are contributions of the same or a similar kind made by uncontrolled taxpayers involved in a similar business activity for which it is possible to identify market returns. Examples include contributions of tangible property, services and intangibles sufficiently similar to those owned by uncontrolled taxpayers engaged in similar activities where the value of the contribution can be reliably established. 	<ul style="list-style-type: none"> ▪ Transfer Pricing Documentation ▪ Transfer Pricing Roadmap ▪ SEC Reports (Annual Report 10K) ▪ IRM Exhibit 4.61.3-4 – Functional Analysis Questionnaire ▪ Interviews ▪ Tour of Taxpayer's Operations ▪ Intercompany Agreements ▪ Practice Unit, "Comparability Analysis for Tangible Goods Transactions – Outbound," DCN: ISO/PUO/V_1_01(2014):. ▪ Capital IQ ▪ Industry Reports 	

Step 1: Identify the Routine and Non Routine Contributions (cont'd)

Residual Profit Split Method - Outbound
Step 1
Identify the routine and nonroutine contributions made by the parties.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> - <u>Nonroutine contributions</u> are contributions that are not accounted for as routine contributions. In general, nonroutine contributions include contributions of valuable intangible property that are not similar to that owned by uncontrolled taxpayers. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-6(c)(3)(i)(A) – <i>Allocate income to routine contributions</i> (definition of routine) ▪ Treas. Reg. 1.482-6(c)(3)(i)(B)(1) – Nonroutine contributions generally 	

Step 1: Identify the Routine and Non Routine Contributions (cont'd)

Residual Profit Split Method - Outbound

Step 1

Identify the routine and nonroutine contributions made by the parties.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ In determining the routine and nonroutine contributions, it is vital to take into account the functions performed, risks assumed, and resources employed by both USP and CFC. 	<ul style="list-style-type: none"> ▪ Transfer Pricing Documentation ▪ Transfer Pricing Roadmap ▪ SEC Reports (Annual Report 10K) ▪ Taxpayer's Internet Site ▪ IRM Exhibit 4.61.3-4 – Functional Analysis Questionnaire ▪ Interviews ▪ Tour of Taxpayer's Operations ▪ Intercompany Agreements ▪ Practice Unit, "Comparability Analysis for Tangible Goods Transactions – Outbound," DCN: ISO/PUO/V_1_01(2014) 	

Step 1: Identify the Routine and Non Routine Contributions (cont'd)

Residual Profit Split Method - Outbound
Step 1
Identify the routine and nonroutine contributions made by the parties.

Considerations	Resources	6103 Protected Resources
 <p>DECISION POINT: If there are no nonroutine contributions, or if only one controlled taxpayer is making nonroutine contributions, then the RPSM should not be used.</p>	<ul style="list-style-type: none"> ▪ Capital IQ ▪ Industry Reports ▪ Treas. Reg. 1.482-6(c)(3)(i)(A) – <i>Allocate income to routine contributions</i> (definition of routine) ▪ Treas. Reg. 1.482-6(c)(3)(i)(B)(1) – Nonroutine contributions generally 	

Step 2: Determine if the RPSM is the Best Method

Residual Profit Split Method - Outbound

Step 2

Determine if the RPSM is the best method.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ The RPSM can be used only if it is the best method. It is the best method only if it provides the most reliable measure of an arm's length result considering: the degree of comparability between the controlled transaction and any uncontrolled comparables, and the quality of data and assumptions. The RPSM, as applied in practice, generally uses internal data to allocate residual profit to USP and CFC based on their nonroutine contributions, which reduces this method's reliability (see Step 4). However, the RPSM can still be the best method if the data necessary to apply other methods are incomplete or unreliable. 	<ul style="list-style-type: none"> ▪ Transfer Pricing Documentation ▪ Transfer Pricing Roadmap ▪ IRM Exhibit 4.61.3-4 – Functional Analysis Questionnaire ▪ SEC Reports ▪ Forms 5471, 8858, 8865 ▪ Capital IQ ▪ Treas. Reg. 1.482-1(c) – Best method rule ▪ Treas. Reg. 1.482-6 – Profit split method ▪ Treas. Reg. 1.482-6(c)(3) – Residual profit split 	

Step 2: Determine if the RPSM is the Best Method (cont'd)

Residual Profit Split Method - Outbound
Step 2
Determine if the RPSM is the best method.

Considerations	Resources	6103 Protected Resources
 CAUTION: Generally, the RPSM is used when both controlled parties have made significant nonroutine contributions. If only one party makes significant nonroutine contributions, then another transfer pricing method may be more reliable and the best method.	<ul style="list-style-type: none"> Practice Unit, “Comparability Analysis for Tangible Goods Transactions – Outbound,” DCN: ISO/PUO/V_1_01(2014) 	

Step 2: Determine if the RPSM is the Best Method (cont'd)

Residual Profit Split Method - Outbound

Step 2

Determine if the RPSM is the best method.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ In determining the best method, the following questions should be included in one's inquiry: <ul style="list-style-type: none"> - Is there complete and accurate data to apply other methods? - Are market benchmarks available to allocate residual profit to USP and CFC based on their nonroutine contributions or must internal data be used for that purpose (see Step 4)? 	<ul style="list-style-type: none"> ▪ Transfer Pricing Documentation ▪ Transfer Pricing Roadmap ▪ IRM Exhibit 4.61.3-4 – Functional Analysis Questionnaire ▪ SEC Reports ▪ Forms 5471, 8858, 8865 ▪ Capital IQ ▪ Taxpayer's Trial Balance and General Ledger ▪ CAS ▪ Practice Unit, "Overview of IRC Section 482," DCN: ISO/9411.07_01(2013) ▪ Practice Unit, "Comparability Analysis for Tangible Goods Transactions – Outbound," DCN: ISO/PUO/V_1_01(2014) 	

Step 2: Determine if the RPSM is the Best Method (cont'd)

Residual Profit Split Method - Outbound
Step 2
Determine if the RPSM is the best method.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ If the RPSM appears to be the best method, the following additional questions should be asked: <ul style="list-style-type: none"> - Has the relevant business activity (defined in Step 3) that includes the controlled transaction been correctly identified? - Does the relevant business activity include significant business activity that does not involve the controlled transaction at issue? If so, the reliability of the RPSM may be reduced. - Are costs, income or assets allocated in a reasonable manner to the relevant business activity, and how reliable is that allocation? 	<ul style="list-style-type: none"> ▪ Transfer Pricing Documentation ▪ Transfer Pricing Roadmap ▪ IRM Exhibit 4.61.3-4 – Functional Analysis Questionnaire ▪ SEC Reports ▪ Forms 5471, 8858, 8865 ▪ Capital IQ ▪ Taxpayer's Trial Balance and General Ledger ▪ CAS ▪ Practice Unit, "Overview of IRC Section 482," DCN: ISO/9411.07_01(2013) ▪ Practice Unit, "Comparability Analysis for Tangible Goods Transactions – Outbound," DCN: ISO/PUO/V_1_01(2014) 	

Step 3: Allocate Income to the Parties Based on Routine Contributions

Residual Profit Split Method - Outbound
Step 3
Allocate income to the parties based on routine contributions.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Determine the combined operating profit/loss from the relevant business activity, which is the most narrowly identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions. Once determined, such combined operating profit/loss is allocated between the controlled taxpayers following a two step approach: <ol style="list-style-type: none"> 1. Allocate income to routine contributions (Step 3) 2. Allocate residual profit or loss based on nonroutine contributions (Step 4) 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-6(c)(3)(i) – <i>Residual profit split</i> ▪ Transfer Pricing Documentation ▪ Transfer Pricing Roadmap ▪ SEC Reports (Annual Report 10K) ▪ Taxpayer’s Internet Site ▪ Treas. Reg. 1.482-6(c)(3)(i)(A) – Allocate income to routine contributions (definition of routine) ▪ IRM Exhibit 4.61.3-4 – Functional Analysis Questionnaire ▪ Interviews 	

Step 3: Allocate Income to the Parties Based on Routine Contributions (cont'd)

Residual Profit Split Method - Outbound

Step 3

Allocate income to the parties based on routine contributions.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ First step: Allocate to each controlled taxpayer a market return for its routine contributions to the relevant business activity. ▪ Positive income is generally allocated to routine contributions, even if the business has an overall operating loss (in which case a loss would be allocated to USP and CFC in Step 4 based on their nonroutine contributions). 	<ul style="list-style-type: none"> ▪ Tour of Taxpayer's Operations ▪ Intercompany Agreements ▪ Practice Unit, "Comparability Analysis for Tangible Goods Transactions – Outbound," DCN: ISO/PUO/V_1_01(2014) ▪ Capital IQ ▪ Industry Reports 	

Step 3: Allocate Income to the Parties Based on Routine Contributions (cont'd)

Residual Profit Split Method - Outbound

Step 3

Allocate income to the parties based on routine contributions.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Routine contributions are identified by the functions performed, risks assumed and resources employed by each controlled taxpayer in the relevant business activity. ▪ Routine contributions are contributions of the same or similar kind to those made by uncontrolled taxpayers involved in the same business activities for which it is possible to identify market returns. For example, routine contributions ordinarily include contributions of tangible property, services and intangible property that are generally owned by uncontrolled taxpayers engaged in similar activities. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-6(c)(3)(i) – Residual profit split ▪ Treas. Reg. 1.482-6(c)(3)(i)(A) – <i>Allocate income to routine contributions</i> (definition of routine) ▪ IRM Exhibit 4.61.3-4 – Functional Analysis Questionnaire ▪ Interviews ▪ Tour of Taxpayer's Operations ▪ Intercompany Agreements ▪ Practice Unit, "Comparability Analysis for Tangible Goods Transactions – Outbound," DCN: ISO/PUO/V_1_01(2014) ▪ Practice Unit, "CPM Simple Distributor Outbound," DCN: ISO/9411/05_02(2014) ▪ Industry Reports 	

Step 3: Allocate Income to the Parties Based on Routine Contributions (cont'd)

Residual Profit Split Method - Outbound

Step 3

Allocate income to the parties based on routine contributions.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Market rates of return for routine contributions are those achieved by uncontrolled taxpayers engaged in similar activities as the controlled taxpayer. Factors to consider when analyzing the uncontrolled taxpayers: <ul style="list-style-type: none"> - Degree of comparability between the controlled transaction or taxpayer and the uncontrolled comparables selected. - Quality of the data and assumptions <ul style="list-style-type: none"> ▪ Completeness and accuracy of data ▪ Reliability of assumptions ▪ Sensitivity of results to deficiencies in data and assumptions 	<ul style="list-style-type: none"> ▪ Capital IQ ▪ SEC Reports (Annual Report 10K) ▪ Industry Reports ▪ Treas. Reg. 1.482-1(c)(2)(i), <i>Comparability</i> ▪ Treas. Reg. 1.482-1(d)(3) – <i>Factors for Determining Comparability</i> ▪ Treas. Reg. 1.482-6(c)(3)(ii)(A) and (B) – Comparability and reliability considerations ▪ Practice Unit, “Comparability Analysis for Tangible Goods Transactions – Outbound,” DCN: ISO/PUO/V_1_01(2014) ▪ Treas. Reg. 1.482-1(c)(2)(ii)(A) – <i>Completeness and accuracy of data</i> 	

Step 3: Allocate Income to the Parties Based on Routine Contributions (cont'd)

Residual Profit Split Method - Outbound

Step 3

Allocate income to the parties based on routine contributions.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Market rates of return are measured as operating profit achieved per some unit of asset or function. Examples are operating profit divided by operating assets (return on capital employed), operating profit divided by sales (operating margin), or gross profit divided by operating expenses (Berry ratio, which is equivalent to one, plus operating profit divided by operating expenses). 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-1(c)(2)(ii)(B) – <i>Reliability of Assumptions</i> ▪ Treas. Reg. 1.482-1(c)(2)(ii)(C) – <i>Sensitivity of results to deficiencies in data and assumptions</i> ▪ Treas. Reg. 1.482-6(c)(3)(ii)(C) – <i>Data and assumptions</i> ▪ Treas. Reg. 1.482-5(b)(4) – <i>Profit level indicators</i> 	

Step 3: Allocate Income to the Parties Based on Routine Contributions (cont'd)

Residual Profit Split Method - Outbound
Step 3
Allocate income to the parties based on routine contributions.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> Income allocated to USP's and/or CFC's routine contributions is the product of such contributions (as measured, for example, by operating assets, sales or operating expenses) and the market rate of return. 	<ul style="list-style-type: none"> Capital IQ SEC Reports (Annual Report 10K) Industry Reports 	

Step 3: Allocate Income to the Parties Based on Routine Contributions (cont'd)

Residual Profit Split Method - Outbound
Step 3
Allocate income to the parties based on routine contributions.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ In some cases, only one of the controlled taxpayers will have routine contributions. <p> CAUTION: Please note that when determining the market rates of return for routine contributions, generally another transfer pricing method consistent with the methods listed in Treas. Reg. 1.482-3, -4, -5 and -9 will be utilized.</p> <p> CONSULTATION: Consultation with an economist, TPP, and/or Income Shifting IPN may be required to determine if the comparables selected are truly comparable in establishing a market rate of return. An economist can also assist with reviewing or calculating any adjustments necessary to make the comparable data more reliable. In addition, LB&I Counsel should consult with ACC(INTL) Branch 6 if there are any uncertain legal issues.</p>		

Step 4: Allocate Residual Profit or Loss to the Parties Based on Non Routine Contributions

Residual Profit Split Method - Outbound

Step 4

Allocate residual profit or loss to the parties based on nonroutine contributions

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ After income from routine contributions has been allocated to each controlled taxpayer, the remainder of operating profit or loss is allocated to the taxpayers based on their respective nonroutine contributions. ▪ Nonroutine contributions normally consist of intangible assets and/or services provided using intangible assets. <ul style="list-style-type: none"> - Not all intangible assets, and not all services provided using intangible assets, are nonroutine contributions; some can be valued by market data from uncontrolled transactions and are thus considered routine. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-6(c)(3)(i)(B) – <i>Allocate residual profit</i> ▪ Transfer Pricing Documentation (principal and background documents) ▪ Valuation Studies ▪ IRM 4.61.3.5.1 – Functional Analysis ▪ Market studies ▪ Taxpayer’s Records pertaining to Intangible Development Costs 	

Step 4: Allocate Residual Profit or Loss to the Parties Based on Non Routine Contributions (cont'd)

Residual Profit Split Method - Outbound
Step 4
Allocate residual profit or loss to the parties based on nonroutine contributions

Considerations	Resources	6103 Protected Resources
 <p>CONSULTATION: If there is a question about which controlled party owns particular nonroutine contributions, consult with an economist, TPP, and/or Income Shifting IPN. In addition, LB&I Counsel should consult with ACC(INTL) Branch 6 if there are any uncertain legal issues.</p>		

Step 4: Allocate Residual Profit or Loss to the Parties Based on Non Routine Contributions (cont'd)

Residual Profit Split Method - Outbound

Step 4

Allocate residual profit or loss to the parties based on nonroutine contributions

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Residual profit is allocated in proportion to the relative value of USP's and CFC's nonroutine contributions. The relative value of the nonroutine contributions of USP and CFC may be measured by: 1) external market benchmarks; 2) internal data (capitalized costs of developing intangibles), or 3) internal data (actual recent expenditures). 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-6(c)(3)(i)(B) – <i>Allocate residual profit</i> ▪ Transfer Pricing Documentation (principal and background documents) ▪ Valuation Studies ▪ IRM 4.61.3.5.1 – Functional Analysis 	

Step 4: Allocate Residual Profit or Loss to the Parties Based on Non Routine Contributions (cont'd)

Residual Profit Split Method - Outbound

Step 4

Allocate residual profit or loss to the parties based on nonroutine contributions

Considerations	Resources	6103 Protected Resources
<p><u>1) External Market Benchmarks</u></p> <ul style="list-style-type: none"> ▪ Ideally, market data would be used to determine the relative value of USP's and CFC's nonroutine contributions. While such market data has been observed in some industries, such data generally is not available. – Market data would not be available to give the absolute values of USP's and CFC's nonroutine contributions (since the existence of such data would mean the contributions are routine). 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-6(c)(3)(i)(B) – <i>Allocate residual profit</i> (Relative value of intangible contributions) ▪ Market studies ▪ Engineer/Economist/CAS ▪ Taxpayer's Records pertaining to Intangible Development Costs 	

Step 4: Allocate Residual Profit or Loss to the Parties Based on Non Routine Contributions (cont'd)

Residual Profit Split Method - Outbound

Step 4

Allocate residual profit or loss to the parties based on nonroutine contributions

Considerations	Resources	6103 Protected Resources
<p><u>2) Internal Data</u></p> <ul style="list-style-type: none"> ▪ Because external market benchmarks are generally not available to determine relative value, the regulations allow the relative value of nonroutine intangibles to be estimated based on comparing USP's and CFC's capitalized cost of developing the intangibles less an appropriate amount of amortization based on the useful life of each intangible. – Reliability is reduced if internal development cost data is used instead of reliable market benchmarks. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-6(c)(3)(i)(B) – <i>Allocate residual profit</i> ▪ Transfer Pricing Documentation (principal and background documents) ▪ Valuation Studies ▪ IRM 4.61.3.5.1 – Functional Analysis 	

Step 4: Allocate Residual Profit or Loss to the Parties Based on Non Routine Contributions (cont'd)

Residual Profit Split Method - Outbound

Step 4

Allocate residual profit or loss to the parties based on nonroutine contributions

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> - A reason for this reduced reliability is that development costs may not be good estimates for even relative market values, because various investments in developing intangibles might turn out well or poorly. In particular, if early, risky investment by one taxpayer turns out well and leads to less risky follow-up investment by a second taxpayer, the value of the first taxpayer's contribution in proportion to its cost may be greater than the value of the second taxpayer's contribution in proportion to its cost. - Another reason for this reduced reliability is that it may be difficult to reliably allocate such costs to the relevant business activity and to reliably estimate useful lives. 	<ul style="list-style-type: none"> ▪ Market studies ▪ Engineer/Economist/CAS ▪ Taxpayer's Records pertaining to Intangible Development Costs 	

Step 4: Allocate Residual Profit or Loss to the Parties Based on Non Routine Contributions (cont'd)

Residual Profit Split Method - Outbound
Step 4
Allocate residual profit or loss to the parties based on nonroutine contributions

Considerations	Resources	6103 Protected Resources
<p><u>3) Actual Expenditures</u></p> <ul style="list-style-type: none"> ▪ In some cases, USP's and CFC's intangible development expenditures are relatively constant over time, and the useful lives of the intangibles are approximately the same. In such cases, the amount of USP's and CFC's actual expenditures in recent years may be used to estimate the relative value of their nonroutine intangible property contributions. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-6(c)(3)(i)(B) – <i>Allocate residual profit</i> ▪ Transfer Pricing Documentation (principal and background documents) ▪ Valuation Studies ▪ IRM 4.61.3.5.1 – Functional Analysis ▪ Market studies 	

Step 4: Allocate Residual Profit or Loss to the Parties Based on Non Routine Contributions (cont'd)

Residual Profit Split Method - Outbound
Step 4
Allocate residual profit or loss to the parties based on nonroutine contributions

Considerations	Resources	6103 Protected Resources
 CAUTION: Where the allocation of profits is based on costs rather than market benchmarks, the RPSM is generally unsuitable where only one party has incurred intangible development costs.	<ul style="list-style-type: none"> ▪ Engineer/Economist/CAS ▪ Taxpayer's Records pertaining to Intangible Development Costs 	

Examples of the Process

Residual Profit Split Method - Outbound

Description

Factual Background - Example from Treas. Reg. 1.482-6(c)(3)(iii)

Functions of USP

- USP is a U.S. corporation that develops, manufactures and markets a product called Nulon in the U.S.
- USP obtains patent protection for Nulon in both the US and European markets.
- USP licenses the rights to manufacture and market Nulon in Europe to CFC, a wholly-owned European subsidiary.
- For Year 1, USP has no direct expenses associated with the license of Nulon to CFC and incurs no expenses related to the manufacturing and marketing of Nulon in Europe.

Examples of the Process (cont'd)

Residual Profit Split Method - Outbound

Description

Factual Background - Example from Treas. Reg. 1.482-6(c)(3)(iii) (cont'd)

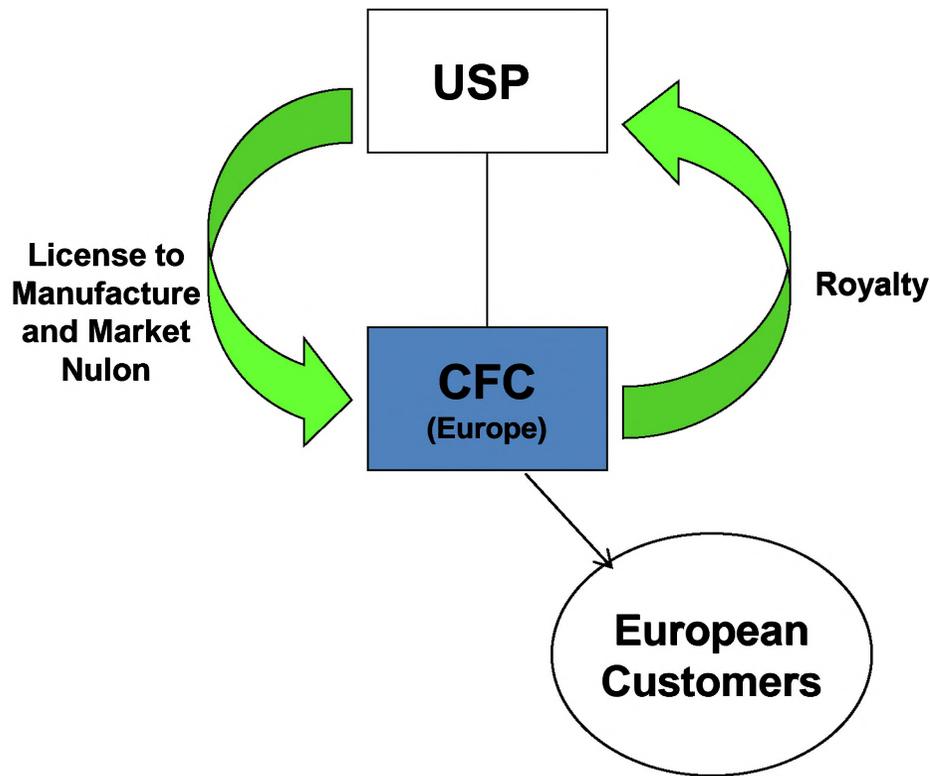
Functions of CFC

- CFC is a well-established company that manufactures and markets products in Europe.
- CFC has a well-developed marketing network that employs brand names that it develops.
- CFC has a research unit that adapts Nulon for the European market.
- CFC develops a high-intensity marketing campaign for Nulon directed at customers in Europe.
- CFC manufactures and sells the adapted version of Nulon in Europe through its marketing network under one of its brand names.
- For Year 1, CFC's Nulon sales and pre-royalty expenses are \$500 million and \$300 million, respectively, resulting in net pre-royalty profit of \$200 million related to the Nulon business. The operating assets employed in CFC's Nulon business are \$200 million.

Examples of the Process (cont'd)

Residual Profit Split Method - Outbound

Description



	USP	CFC
European sales	\$0	\$500M
European Year 1 pre-royalty expenses	\$0	\$300M
European pre-royalty profit	\$0	\$200M
European operating assets	\$0	\$200M

Examples of the Process (cont'd)

Residual Profit Split Method - Outbound

Description

STEP 1: Identify the routine and non routine contributions made by the parties:

USP

- USP provides only nonroutine contributions through the development and patent of Nulon for the US and European markets.

CFC

- CFC provides nonroutine contributions through adapting Nulon for the European market, selling Nulon under one of its brand names, and developing a high-intensity marketing campaign for Nulon in the European market. CFC also provides routine contributions through the use of its operating assets for manufacturing and sales.

Examples of the Process (cont'd)

Residual Profit Split Method - Outbound

Description

STEP 2: Determine if the RPSM is the best method:

- Both USP and CFC make nonroutine contributions.
- It is not possible to identify market returns for these contributions.
- Given the facts and circumstances, the Service determines under the best method rule that a residual profit split will provide the most reliable measure of an arm's length result.

Examples of the Process (cont'd)

Residual Profit Split Method - Outbound

Description

STEP 3: Allocate income to the parties based on routine contributions.

- In the first stage of the RPSM, profits are allocated to CFC's routine manufacturing and distribution contributions, in this case use of CFC's operating assets.
- Based on an examination of a sample of European companies performing functions similar to those of CFC, the Service determines that an average market return on CFC's operating assets in the Nulon business is 10 percent.
- CFC has operating assets of \$200 million.
- This results in a market return of \$20 million (10% X \$200 million) for CFC's Nulon manufacturing and distribution.
- Because USP made no routine contributions in the sale of Nulon in Europe, no profit is allocated to USP in this step.

Examples of the Process (cont'd)

Residual Profit Split Method - Outbound

Description

STEP 4: Allocate residual profit or loss to the parties based on nonroutine contributions:

- Of the total \$200 million of profit, the residual profit is \$180 million (\$200 million minus \$20 million (the return on routine contributions calculated in Step 3)). The residual profit of \$180 million is attributable to the valuable intangibles related to Nulon, (i.e., the European brand name for Nulon, the high-intensity marketing campaign, and the Nulon formula (including CFC's modifications)).
- To estimate the relative values of these intangibles, the Service (1) computes USP's ratio of capitalized and unamortized R&D and marketing expenditures as of Year 1, divided by the sales to which such expenditures relate, (2) computes that same ratio for CFC, and (3) compares those two results.

Examples of the Process (cont'd)

Residual Profit Split Method - Outbound

Description

STEP 4: Allocate residual profit or loss to the parties based on nonroutine contributions (cont'd):

USP's Nonroutine Contribution

- Using information on the average useful life of its investments in the Nulon technology, the Service capitalizes and amortizes USP's R&D expenses to determine the capitalized and unamortized amount as of Year 1.
- Because USP's R&D supports worldwide sales, it is necessary to allocate USP's expenses among the worldwide business activities to which they relate. The Service determines that it is reasonable to allocate such expenses based on worldwide product sales.
- This analysis indicates that USP's capitalized and unamortized R&D expenditures have a value of \$0.20 per dollar of Nulon worldwide sales in Year 1.

Examples of the Process (cont'd)

Residual Profit Split Method - Outbound

Description

STEP 4: Allocate residual profit or loss to the parties based on nonroutine contributions (cont'd):

CFC's Nonroutine Contribution

- Using information on the average useful life of CFC's investments in marketing and R&D, the Service capitalizes and amortizes CFC's expenditures to determine the capitalized and unamortized amount as of Year 1.
- CFC's expenditures on Nulon R&D and marketing support only CFC's European sales.
- The Service determines that CFC's capitalized and unamortized investments in marketing and R&D have a value in Year 1 of \$0.40 per dollar of CFC's Nulon sales.

Examples of the Process (cont'd)

Residual Profit Split Method - Outbound

Description

STEP 4: Allocate residual profit or loss to the parties based on nonroutine contributions (cont'd):

Arm's Length Royalty payable to USP

- Thus, USP and CFC together contributed \$0.60 in capitalized and unamortized intangible development expenses for each dollar of CFC's Nulon sales for the taxable year, of which USP contributed one-third (or \$0.20 per dollar of sales).
- Based on the analysis, the Service determines that an arm's length royalty for the Nulon license payable by CFC to USP for Year 1 is \$60 million, i.e., one-third of CFC's \$180 million in residual Nulon profit.



CAUTION: Economic consultation might be useful in bringing in additional economic considerations not presented in this example.

Training and Additional Resources

Residual Profit Split Method - Outbound		
Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none">▪ 2012 (TPO) CPE CENTRA – Overview and Introduction to IRC 482▪ 2012 (TPO) CPE CENTRA – High Value Services	
Issue Toolkits	<ul style="list-style-type: none">▪ IRM 4.61.3-4 – Functional Analysis Questionnaire▪ Transfer Pricing Roadmap▪ IRM 4.61.3 Development of IRC section 482 Cases	
Podcasts / Videos	<ul style="list-style-type: none">▪ 2011 (TPO) CPE CENTRA – Intangible Migration, Economic Analysis, Risk and Comparability, and Audit Techniques.	

Training and Additional Resources (cont'd)

Residual Profit Split Method - Outbound		
Type of Resource	Description(s) and/or Instructions for Accessing	References
Databases / Research Tools	<ul style="list-style-type: none">▪ Capital IQ	
Reference Materials – Treaties	<ul style="list-style-type: none">▪ <i>Bittker & Lokken Fed. Tax'n Inc. Est and Gift</i> Chapter 79: Reallocation of Income and Deductions▪ OECD Transfer Pricing Guidelines	
Other Training Materials	<ul style="list-style-type: none">▪ 2012 (TPO) Economist Phase V Training – Legal Matters	

Glossary of Terms and Acronyms

Term/Acronym	Definition
APMA	Advance Pricing and Mutual Agreement Program
CAS	Computer Audit Specialist
CFC	Controlled Foreign Corporation
CPE	Certified Professional Education
DCN	Document Control Number
FY	Fiscal Year
IBC	International Business Compliance
IDC	Intangible Development Cost
IDR	Information Document Request
IPN	International Practice Network
IPS	International Practice Service
IRC	Internal Revenue Code
IRM	Internal Revenue Manual
ISI	Income Shifting Inbound
ISO	Income Shifting Outbound

Glossary of Terms and Acronyms (cont'd)

Term/Acronym	Definition
MAP	Mutual Agreement Procedure
PBB	Process Building Block
PUO	Process Unit Overview
RPSM	Residual Profit Split Method
SEC	Securities & Exchange Commission
UIL	Uniform Issue List
USP	United States Parent

Index of Related Issues

Issue	Associated UIL(s)	References
Comparability	▪ 9411	▪ Practice Unit, “Comparability Analysis for Tangible Goods Transactions- Outbound,” DCN: ISO/PUO/V_1_01(2014)
Functional Analysis	▪ 9411	▪ Practice Unit, “Comparability Analysis for Tangible Goods Transactions - Outbound,” DCN: ISO/PUO/V_1_01(2014)
Transfer Pricing Documentation	▪ 9411	▪ Practice Unit, “Review of Transfer Pricing Documentation by Outbound Taxpayers,” DCN: ISO/PUO/P_1.7_02(2014)
Competent Authority	▪ 9411	▪ Practice Unit, “Competent Authority Revenue Procedure 2015-40: U.S. Initiated Adjustment(s),” DCN: ISO/PUO/P_1.7_03(2015)
Comparable Profits Method	▪ 9411	▪ Practice Unit, “CPM Simple Distributor Outbound,” DCN: ISO/9411.05_01(2014)
Commensurate with Income Principle	▪ 9411	▪ Practice Unit, “Commensurate with Income Principle,” DCN: ISO/CU/V_1_04(2014)

Index of Related Issues (cont'd)

Issue	Associated UIL(s)	References
Distinguishing between Sale, License and other Transfers of Intangibles to CFC's by US Transferors	▪ 9411.02	▪ Practice Unit, "Distinguishing between Sale, License and other Transfers of Intangibles to CFC's by U.S. Transferors," DCN: ISO/9411.02_02(2013)
License of Intangible property from US Parent to Foreign Subsidiary	▪ 9411.02	▪ Practice Unit, "License of Intangible property from U.S. Parent to a Foreign Subsidiary," DCN: ISO/9411.02_03(2013)
Risk Shifting to Controlled Foreign Corporations	▪ 9411.04	▪ Practice Unit, "Risk Shifting to Controlled Foreign Corporations," DCN: ISO/9411.04_01(2013)
Controlled Transactions	▪ 9411.07	▪ Practice Unit, "Controlled Transactions for IRC 482 -Outbound," DCN: ISO/CU/V_1_02(2014)
Overview of Section 482	▪ 9411.07	▪ Practice Unit, "Overview of IRC Section 482," DCN: ISO/9411.07_01(2013)
Rev. Proc. 99-32	▪ 9411.07	▪ Practice Unit, "Revenue Procedure 99-32 Outbound Guidance," DCN: ISO/9411.07_03(2013)
Residual Profit Split Method-Inbound	• 9422.09	▪ Practice Unit, "Residual Profit Split Method-Inbound," DCN: ISI/PUO/P_6.9_04(2014)