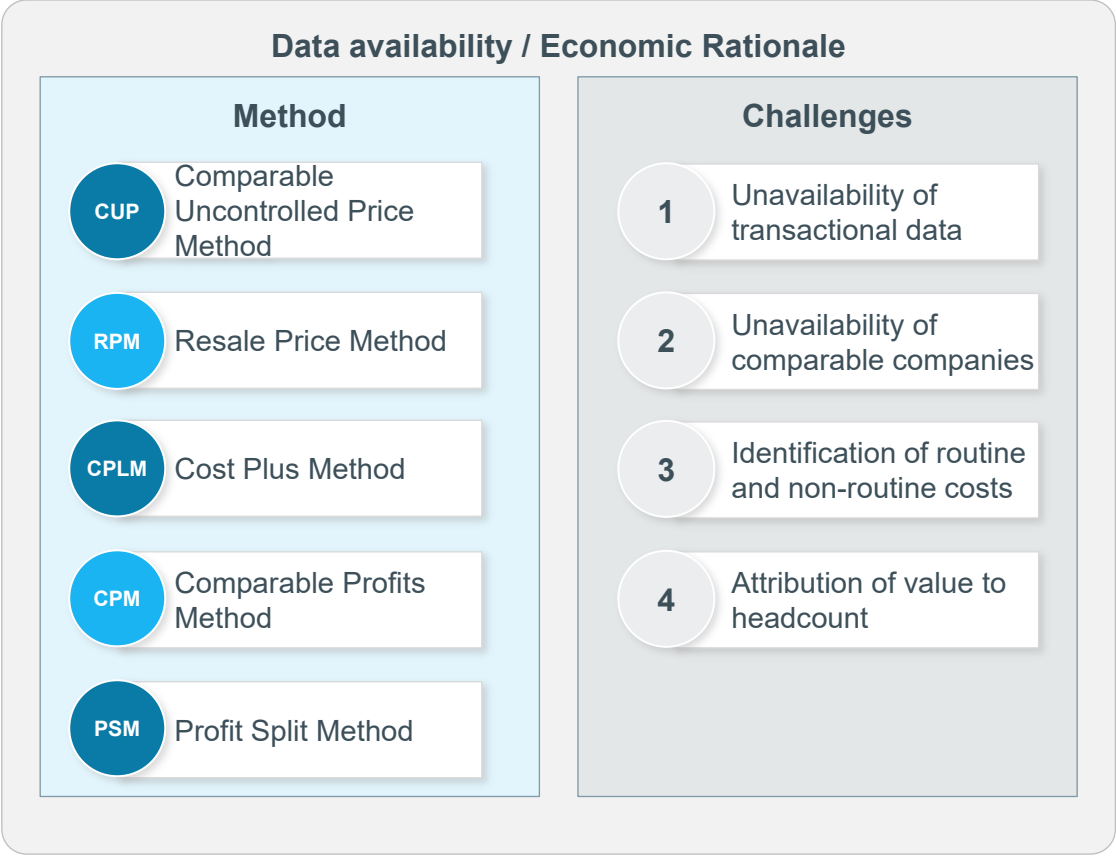# KEYSTONE

[KPI-based] Fractional Profit Allocation Method (KFPAM)

Existing transfer pricing methods face data availability and subjectivity challenges

Data availability / Economic Rationale

Method

CUP — Comparable Uncontrolled Price Method

RPM — Resale Price Method

CPLM — Cost Plus Method

CPM — Comparable Profits Method

PSM — Profit Split Method

Challenges

1. Unavailability of transactional data

2. Unavailability of comparable companies

3. Identification of routine and non-routine costs

4. Attribution of value to headcount

Subjectivity

Method

CPM — Comparable Profits Method

CUP — Comparable Uncontrolled Price Method

RPSM — Residual Profit Split Method

Challenges

1. Selection of comparables and transactions

1. Determination of routine vs. non-routine functions

2. Determination of value drivers/profit splitting metrics

KFPAM proposes data indexed by the market without the need to search for transactional or comparable information
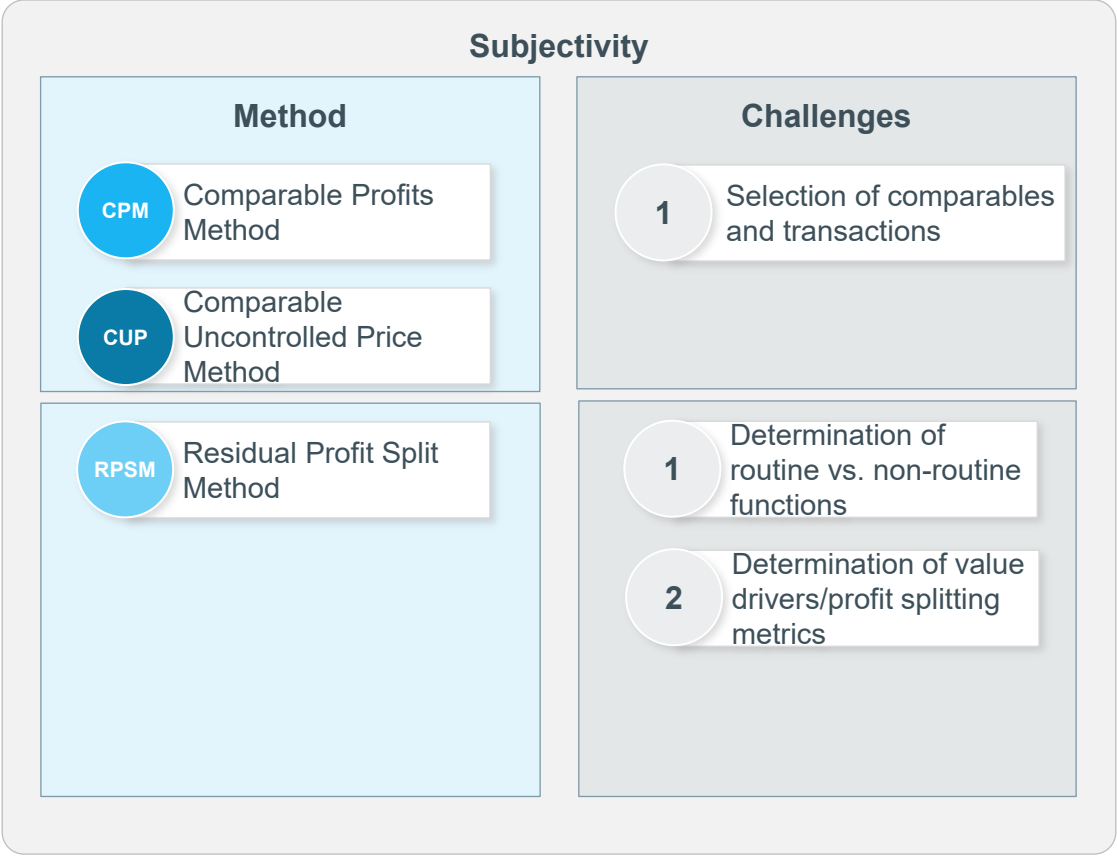
KFPAM proposes empirical evidence derived from internal company practices and management to be used to represent unbiased allocation of profit

KPI-based fractional profit allocation method (KFPAM)

What is the method?

KFAPM is a multi-sided profit allocation method that uses company-tracked and marketplace-benchmarked KPI's of value/performance to determine a more objective and potentially less controversial way of allocating system profits, grounded in the business reality of the company itself

Why is it important?

KFAPM eliminates the need for often subjective assessments and characterizations of functions, assets, and risks analyses by focusing on managerial-level KPI's suitable for a profit split, embedded in data that is generated at points where the company touches the marketplace

How is it used?

The proposed method would utilize managerial-level KPI's, such as total all-in compensation[1] or cost-of-capital, to determine optimal allocation of profit for tax purposes

Application of the traditional transfer pricing methods is often problematic due to numerous challenges in identification of comparable transactions, companies, or proper allocation keys

KFPAM only requires identification of relevant business KPI's

[1] All-in refers to total compensation, including profit-sharing, variable, and long-term compensation   CONFIDENTIAL

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KFPAM utilizes readily available and objective metrics based on company's constant interaction with the marketplace

Step 1: Fundamental Assumptions

1. No "one-size-fits-all" solution

2. Connected to first principles of how the business views itself, how it operates from a non-tax perspective, and how it interacts with third parties

3. Implemented using allocation factors based on readily available and verifiable data

4. Reflective of the company's value chain based on its revealed performance/interaction with markets

Step 2: Identifying KPI Metrics

1. Businesses often already track metrics/KPIs suitable for a profit split, embedded in data generated at points where the company touches the marketplace

2. Some of the most common markets generating such metrics are labor, product/service, and capital markets. These give rise to metrics that may be applicable across a wide range of industries (although not all)

Key Data

Tracked by the business in the ordinary course of business and updated regularly

Derived from/used in actual arm's length interactions with markets

Objective, hard to manipulate, and easy to authenticate to tax authorities

Example KPI Metrics: Objective, hard to manipulate and auditable

Total all-in compensation[1]
- Includes the contributions of people performing all functions at all levels
- Labor markets are efficient – every business optimizes compensation vs. value
- Aligns with OECD DEMPE and KERT concepts

Cost of Capital
- A metric combining equity markets, debt markets and company performance
- Utilized as an internal hurdle rate to make investment decisions
- Continuously tracked against efficient capital markets to serve as a guiding parameter for company decision making

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Visual guide using a decision tree to determine appropriate utilization of the KFPAM method

Alternate route: Given the subjectivity in evaluating economic value using inconsistent data, an alternate method would be to directly utilize the KFPAM method

Is there availability of third-party transactional data or comparable company data to evaluate the covered transaction?

No

Yes

Can routine and non-routine functions reliably identified and isolated?

Utilize the CUP or CPM

No

Yes

Consider application of KFPAM by identifying KPIs that accurately reflect the unobservable value of goods or services provided under the covered transaction

Utilize Residual Profit Split method

Understand current business management metrics

Utilize the identified KPI/s to allocate profit/losses

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KPI-based transfer pricing view

Tax Transfer Pricing (Legal Entity) View:

LE1: (Country X)

LE2: (Country Y)

LE = legal entity
BU = business unit

BU1 | BU2

Tax Transfer Pricing

BU1 | BU2

Functional analysis aims at understanding the functional composition of legal entities.

Managerial KPI-based View:

LE1 | LE2

Managerial Transfer Pricing

[Legal entities are irrelevant, focus on business units]

LE1 | LE2

BU1: (Function: R&D)

BU2: (Function: Manufacturing)

KPI

KPI

External markets

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Examples

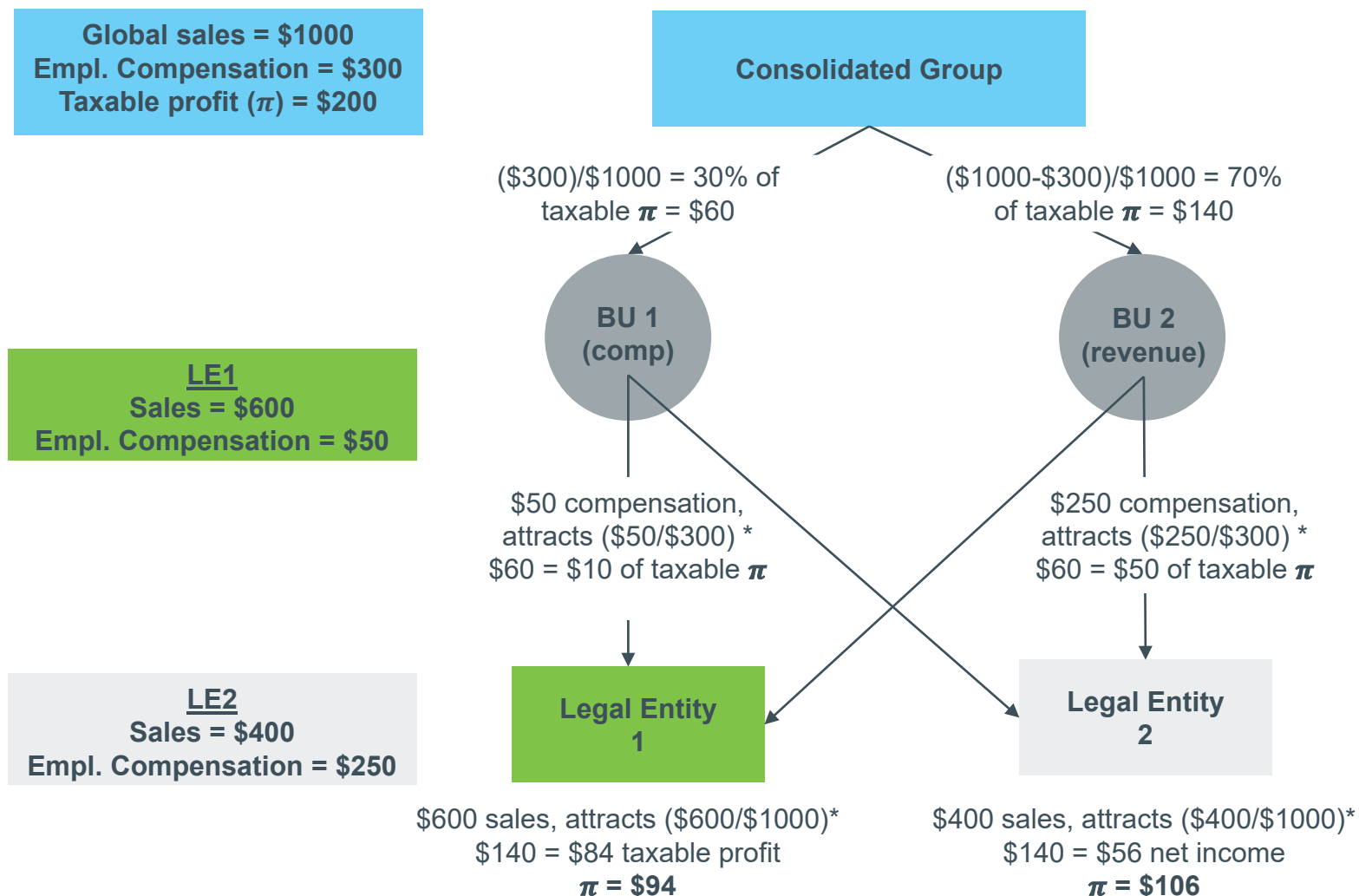# Example 1: Tangible goods – revenue and compensation

Step 1: Use the relative ratio of the MNE's total worldwide employee compensation to total worldwide user and customer revenue to split global profits between BU1 and BU2 shares.

Step 2: Allocate global profits between the legal entities, Legal Entity 1 (LE 1) and Legal Entity 2 (LE 2)

Step 2a: Use the relative ratio of LE 1 aggregate employee compensation to LE 2 aggregate employee compensation to split BU1's of global profits (calculated in step 1) between LE 1's jurisdiction and LE 2's jurisdiction.

Step 2b: Use the relative ratio of LE 1 aggregate user and customer revenue to LE 2 aggregate user and customer revenue to split BU2's share of global profits (calculated in step 1) between LE 1's jurisdiction and LE 2's jurisdiction.

Step 3: Combine LE 1's shares of global profits from both BU1 and BU2 to determine LE 1's overall share of global profits. Similarly, combine LE 2's shares of global profits from BU1 and BU2 to determine LE 2's overall share of global profits.

Global sales = $1000
Empl. Compensation = $300
Taxable profit (π) = $200

LE1
Sales = $600
Empl. Compensation = $50

LE2
Sales = $400
Empl. Compensation = $250

Consolidated Group

($300)/$1000 = 30% of taxable π = $60

($1000-$300)/$1000 = 70% of taxable π = $140

BU 1 (comp)

BU 2 (revenue)

$50 compensation, attracts ($50/$300) * $60 = $10 of taxable π

$250 compensation, attracts ($250/$300) * $60 = $50 of taxable π

Legal Entity 1

Legal Entity 2

$600 sales, attracts ($600/$1000)* $140 = $84 taxable profit
π = $94

$400 sales, attracts ($400/$1000)* $140 = $56 net income
π = $106

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Example 2: Banking – capital and compensation

$1000 residual profit ($\pi$)
$100 capital, 10% cost of capital (=$10)
$15 compensation
Total cost: $10 + $15 = $25

Bank

LE1
Sales = $90
Empl. Compensation = $2
Cost of Capital = $1

LE2
Sales = $240
Empl. Compensation = $3
Cost of Capital = $5

$330

BU 1

$90

$240

$60 capital
(=$6 cost)
$5 compensation
$330 residual π

LE 1 has $10 of **BU 1** capital ($1 cost) and $2 of **BU 1** compensation
Attracts $330 * ($1+$2)/($6+$5) = **$90**

LE 2 has $50 of **BU 1** capital ($5 cost) and $3 of **BU 1** compensation
Attracts $330 * ($5+$3)/($6+$5) = **$240**

Legal Entity 1

$670

BU 2

BU 2 profit allocated to legal entities in parallel (not shown)

$40 capital
(=$4 cost)
$10 compensation
$670 residual π

Legal Entity 2

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