February 15, 2019

Functional Cost Diagnostic Model

Advance Pricing and Mutual Agreement Program

1. Introduction and Overview

This memorandum provides instructions and guidance on applying the Excel model APMA has developed to facilitate its review of the taxpayer's APA request. In general, the model organizes the collection of financial data relevant to the proposed covered transactions, especially data on costs incurred by the respective controlled taxpayers in the proposed covered group.[1] APMA is requesting that the taxpayer complete this model so that APMA can better understand the controlled taxpayers' contributions to the proposed covered transactions, including the respective contributions each controlled taxpayer makes to the exercise of control over the economically significant risks surrounding the proposed covered transactions. Based upon its past direct experience with the taxpayer's prior APAs and its general understanding of the taxpayer's business operations, APMA believes it is necessary to consider whether the arm's length values of the respective contributions to the proposed covered transactions might be more reliably measured by comparing them to one another than by benchmarking returns for the functions a single taxpayer in the proposed covered group performs, the assets it employs, and the risks it assumes.

The model focuses on the identification, organization, and analysis of "functional" costs, i.e., costs incurred by a controlled taxpayer in the proposed covered group that relate to one or more business operations within the scope of the proposed covered transactions. Such business operations would typically be presented in the covered issue diagram in the APA request.[2]

As explained below, the taxpayer is instructed to identify functional costs and present them in the model for APMA's review. The taxpayer is also asked to analyze the economic value of the contribution associated with the activity for which the functional costs are incurred. It is anticipated that many of the functional costs that will be entered into the model will be incurred by the controlled taxpayers in performing "routine" functions. As such, the economic value of these contributions is measurable by reference to benchmarks obtained from comparable uncontrolled transactions. One feature of the

[1] *See* Rev. Proc. 2015-41, Section 1.04, for the definition of "covered group" and related terms.
[2] *See* Rev. Proc. 2015-41, Exhibit 11 of the Appendix.

model is that it automatically computes arm's length compensation for these activities based on the user's benchmarks and selected profit level indicators.

The taxpayer is also requested to consider which controlled taxpayer(s) in the proposed covered group incur functional costs having an economic value that would not be measured reliably by referring to benchmarks obtained from comparable uncontrolled transactions and that are expected, ex ante, to last beyond a single accounting period. The model does not specify what functional costs incurred by the controlled taxpayers in the proposed covered group may meet this description. They will necessarily be specific to the business operations of the proposed covered group and the scope of the proposed covered transactions. For guidance on what factors the taxpayer should consider in order to identify these functional costs, APMA would direct the taxpayer to the OECD Guidelines, including, but not limited to, the general provisions of Chapter I; the discussion of "profit splitting factors" in Chapter II, Section C.5.1; and Chapter VI.[3]

The model handles these functional costs differently from how it handles benchmarkable functional costs. The model accumulates these costs and capitalizes them according to standard formulas and techniques and based upon assumptions entered by the taxpayer into the model (such as about the useful life of a "unique and valuable" contribution).

Another functionality of the model is that it produces a pro forma split of residual profits (losses) based upon the relative stocks of accumulated and capitalized functional costs the taxpayer has identified. In conjunction with the granular financial data entered into the model for each of the controlled taxpayers in the proposed covered group and, among other items from the APA request, the taxpayer's covered issue diagram, this pro forma residual analysis will provide APMA with a more comprehensive understanding of the taxpayer's views of the value drivers of its business operations and how those views compare with the distribution of capitalized functional costs incurred throughout the proposed covered group, which, in entering its data into the model, the taxpayer might have identified as being concentrated solely in one controlled taxpayer.

The fact that the model computes a pro forma residual profit (loss) split does not imply APMA has thereby concluded already that the transactional profit split method – or, more specifically, the residual profit split method ("RPSM") – is the "most appropriate method" for the taxpayer's proposed covered transactions under the OECD Guidelines. APMA will make that determination based upon its review of the facts it obtains through due diligence, including discussions with the taxpayer about the application of this diagnostic model, and the standards set forth in the OECD Guidelines.

Please direct any questions about the model to the APMA team assigned to your case or to the APMA assistant director with responsibility for the country with whom your APA would be negotiated.

[3] OECD (2017), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris and OECD (2018), Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS: Action 10, OECD/G20 Base Erosion and Profit Shifting project, OECD, Paris.

2. Using the Model

A typical application of the model proceeds through the following steps: Setup, Financials, Functional Costs, and Benchmarks. Note the general use of color in the model: dark-green areas contain instruction text; light-green cells are intended for user input; grey cells are for model computations; and orange cells highlight model results.[4]

2.1. Setup

When first opening the model, the new file shows only the *Setup* worksheet with other tabs hidden. The first step is to complete the *General Information* section. In the specified cells, enter the financial period and years of historical costs. The latter refers to the number of data years before the first analysis year. The number of years should be at least the sum of lead time and useful life of any functional costs under review. As this may not be changed, we advise using a value greater than the anticipated number of historical data years.[5] After setup the model will lock the cells in this section. The user should prepare a new file if any of the general parameters need to be changed.

After completing this information select *Initialize Model*, which will create and reveal additional worksheets.

Next, under *Function Specification*, enter the functions performed by each party, scrolling down to reveal the sections for all the parties. The functions must be defined such that one function is associated with one potential comparable benchmark. A function may not be tested with two benchmarks. For example, if R&D and manufacturing are provided with different benchmarked returns then they must be specified as separate functions. Any individual function may be associated with benchmarked activities, non-benchmarked activities, or a mix of both activities. The model will require separate financial statement data and cost center data for each function specified in this section.

When finished select *Add Data Tabs* to complete the setup and be taken to the next section.

2.2. Financials

The model creates one financial data worksheet for each party and function (*Fin P1F1*, *Fin P1F2*, *etc.*) as well as one worksheet for the combined financials of the parties (*Combined Fin*).[6] The model relies on the functional financial statement data and cost center data (described in the next section) to compute benchmarked returns for each party and function. The combined financials are used to compute residual profits and, if applicable, the pro forma split of profits.

Be mindful of the following when preparing and entering the financial statement data:

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[4] All model computations are performed within the worksheets with traceable formulas.
[5] See further discussion of historical costs in the next section and definitions at the end of the document.
[6] For familiarity we adopted the financial data template used in the APMA CPM/TNMM model. Minor changes to this template include a new line for equity, which may be used in computing benchmarked returns for a finance function using an ROE.

- The combined financials should include all profits that relate to the combined contributions of the parties or, in the context of this model, to functions performed by more than one party.
- Construct financial statements for each function by allocating revenues, costs, and balance sheet items[7] to the function.
- Here are examples of common situations:
    a. A U.S. manufacturer selling to its non-U.S. affiliate would identify the revenues and costs arising from its production of goods for the non-U.S. market only.
    b. If the non-U.S. affiliate purchases products from sources other than the U.S. manufacturer, then it may be necessary to identify and segregate the profits relating only to products purchased from its U.S. manufacturer.
    c. If the U.S. manufacturer and its non-U.S. affiliate both make contributions to revenues generated by a third affiliate (in the same non-U.S. jurisdiction or in a different jurisdiction), then it may be necessary to identify and include these other results in the analysis.[8]
- During due diligence, be prepared to provide support for the financial data and the procedures used to construct the data. Ideally present each party's results in a consolidating financial statement format with each function in a separate column; ensure that the consolidated results (after eliminations) tie to audited figures for the party.

When finished return to the *Financials* title tab. Select *Completed Financial Tabs* to be taken to the next section.

2.3. Functional Costs

In addition to the financial statement worksheet, the model also creates one functional cost worksheet for each party and function (*FC P1F1*, *FC P1F2*, etc.). This section entails a systematic analysis of the expenses incurred by each function. In each functional worksheet, provide a listing of the cost centers and enter the costs incurred by year. Also specify, for each cost center, if it is categorized as COGS or SG&A and if it is provided a benchmarked return. If not benchmarked, then specify the lead time and useful life in years.

In this manner the costs are accumulated as *Benchmarked COGS*, *Benchmarked SG&A*, or *Development Costs*. The first two types are deemed to be performed by comparable companies and provided a targeted return. The third type is capitalized and amortized, using the values entered for lead time and useful life, and accumulated as *Capitalized Contributions* (to residual profit).

[7] E.g., balance sheet items for the ROA or for capital-intensity adjustments.
[8] A party's contributions to profits generated in another jurisdiction may be fully routine or benchmarkable.

Be mindful of the following when entering and analyzing the functional costs:

- As discussed earlier, the model focuses on the identification, organization, and analysis of costs incurred that relate to one or more business operations within the scope of the proposed covered transactions. Identify these costs with specificity, considering the relevant OECD Guidelines which include, but are not limited to, the general provisions of Chapter I; the discussion of "profit splitting factors" in Chapter II, Section C.5.1; and Chapter VI.

- The characterization of costs follows the principles of residual analysis which divides profits into two categories. It is anticipated that many of the functional costs will be incurred as a part of routine or reliably benchmarked activities. These typically reflect less complex contributions.

- Costs that cannot be reliably benchmarked are deemed unique and valuable contributions. Specifically, such contributions (i) are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) represent a key source of actual or potential economic benefits in business operations.

- Certain functional costs may relate to income not included in the combined financials. If only a portion of the costs are applicable, then modify the *Applicable Share* from the default (100%) to the applicable value by year.

- Include all historical expenditures that generate income during the period of review. For each cost center, establish when economic benefits start and end to determine lead time and useful life. Specific examples:

    a. If the expenditure relates only to revenue generated in one accounting year (i.e., from the date of expense to the same date in the subsequent year) apply a lead time of "0" years and a useful life of "1" year.

    b. If the expenditure relates to revenues generated in one accounting year and in subsequent years, apply a lead time of "0" years and a useful life greater than one year.

    c. If the expenditure relates to revenues generated only in future accounting periods, apply a lead time greater than "0" years and the appropriate useful life in years. Fractional years are acceptable for both lead time and useful life.

- During due diligence, be prepared to provide support for the economic judgements and assumptions applied in this step. Ensure that the total functional costs under analysis tie to amounts in the function's income statements.

When finished return to the *Functional Costs* title tab. As an optional step, select *Create Amortization Tables* to generate the capitalization and amortization computations in table format. These tables are for illustrative purposes only. Be aware that one table and worksheet will be created for each non-

benchmarked cost center in all the functional cost worksheets. We advise that you save the model before performing this optional step.

Select *Completed Functional Tabs* in the title tab to be taken to the next section.

2.4. Benchmarks

The model creates one benchmark worksheet for each party (*BM P1* and *BM P2* in a two-party model). For each party's benchmarked functions, specify the *Indicator* (i.e., net profit indicator) that was selected in the TNMM analysis. Specify the *Return* as a targeted point, i.e., from the established range of TNMM results.[9]

As with the other sections of the model, be prepared to provide support for any TNMM analyses performed outside of the model. Include the tested-party financials in the model as the financial data for the function.

When finished return to the *Benchmarks* title tab. Select *Completed Benchmark Tabs* to be taken to the summary of results.

3. Computations

The *Computations* worksheet provides a summary of the model results. This worksheet does not require user input. Starting from the combined income statement, the model computes benchmarked profits for each party and the combined residual profit. If more than one party makes unique and valuable contributions, the model computes a pro forma split of the residual profit based on the accumulated or capitalized costs representing the parties' respective contributions to residual profit.

Note that the model does not split profits based on combined operating profits, i.e., profits after all relevant expenses. This would have the parties share in the consequences of risks assumed by only one of the parties. If the shared risks do not extend to certain costs (e.g., the R&D costs of one party, or the marketing costs of another party), it would be appropriate to split a gross level of profits. The model assumes separate risks in the manner described and uses operating profit before development costs as the profit to be split. From the resulting share, each party then deducts its respective costs.

4. Definitions

Following are explanations of terminology used in this document and in the model.

Lead Time. In the model, the time in years between the date of an investment and the date economic benefits are first realized.

[9] The model performs computations based on a targeted point rather than a range. If applying a range, we suggest that the user input different points and record the results outside of the model.

Useful Life. The time in years during which an investment generates returns or losses after the date economic benefits are first realized.

Applicable Share. The share of any functional cost of a party that contributes to combined income.

Applicable Costs. The product of any functional cost a party and the applicable share.