
Are you curious about the transfer pricing method commonly applied by tax courts to determine arm’s length profit allocations from controlled transactions within complex value chains? Let us present the “Nulon example,” the only example of the profit-split method (PSM) in the U.S. Regs. It offers valuable insights into the IRS and tax courts’ application of this method. As a primer, this article provides a foundation for understanding our more comprehensive third Tax Notes International PSM series article, “The Profit-Split Method: A Commentary on the Nulon Example.”

Intangible property, often called “intangibles,” differentiate an MNE’s value and success and are integral to complex value chains. Consequently, the PSM has increasingly been favored by tax courts in the U.S. and various OECD jurisdictions for deliberations, particularly for allocating profits from valuable nonroutine intangibles, as demonstrated by the Nulon example. This example illustrates the application of the residual PSM (RPSM) in distributing residual profits among related parties. Additionally, understanding the nuances of the RPSM’s implementation in the U.S. Regs is invaluable for MNEs operating under jurisdictions adhering to the OECD Transfer Pricing Guidelines. The RPSM is pivotal in landmark transfer pricing cases across OECD countries, including Australia, India, Germany, Japan, and the Netherlands.

Background

XYZ is a U.S.-based corporation with a successful portfolio of law enforcement products developed, manufactured, and marketed nationwide. XYZ-U.S. innovated and secured a patent for the chemical

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1 Treas. Reg. § 1.482-6(c)(3)(iii).
3 For a discussion on evaluating whether the profit-split method is the best method, see Guy Sanschagrin and Doug Schwerdt, “Introducing the Profit-Split Method: ‘To Apply or Not to Apply, This Is a BEPS Question,’” Tax Notes Int’l, 27 March 2023, p. 1803.
5 While the term “XYZ-U.S.” does not explicitly appear in the U.S. Reg. § 1.482-6(c)(3)(iii) Nulon example, it is used herein to specifically denote the U.S. operations of XYZ, based on the regulatory description of XYZ as a “U.S. corporation that develops, manufactures, and markets a line of products for police use in the United States.” This designation clarifies the distinction between XYZ’s U.S.-based activities and its European operations, facilitating clearer discussions of their distinct roles and markets across different regions.
composition of Nulon, a material used in bulletproof protective clothing and headgear. Since launching, Nulon has captured a significant share of the U.S. bulletproof materials sector. XYZ-U.S. granted its subsidiary, XYZ-Europe, a license to manufacture and market Nulon throughout Europe. XYZ-Europe’s research unit adapted Nulon to meet stringent military specifications and launched a high-intensity marketing campaign targeting the European defense industry. XYZ-U.S. did not incur expenses related to licensing Nulon or XYZ-Europe’s marketing efforts. XYZ-Europe successfully manufactured and sold Nulon throughout Europe under one of its brand names. XYZ-Europe’s Nulon sales soared to $500 million, with $300 million in expenses, yielding $200 million in pre-royalty profit.

The IRS district director selected the RPSM to determine the arm’s length royalty XYZ-Europe should pay XYZ-U.S. for the Nulon technology. This method was presumably selected because XYZ-U.S. and XYZ-Europe contributed valuable nonroutine intangibles to XYZ-Europe’s Nulon Military\(^6\) sales. The RPSM first allocates routine returns and then splits the residual profit based on each party’s relative nonroutine and valuable contributions.

**RPSM Step 1: Allocate Income to Routine Contributions**

- In this initial step, routine contributions (e.g., manufacturing, services, distribution, etc.) are provided market returns, typically established through benchmarking studies. The IRS established a 10 percent routine return on XYZ-Europe’s $200 million operating assets\(^7\) (i.e., a $20 million return for XYZ-Europe’s routine contribution) based on benchmarking European companies with similar functions.

- The IRS determined that XYZ-U.S. incurred no direct expenses for the licensing or marketing of Nulon in Europe. Consequently, XYZ-U.S. was not allocated a routine return in Step 1.

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\(^6\) The phrase “Nulon Military,” not in the U.S. Regs Nulon example, is used to differentiate XYZ-Europe’s Nulon products and markets from those of XYZ-U.S., which sells the original Nulon technology products to the police sector.

\(^7\) The IRS’s application of a 10% return to XYZ-Europe’s net pre-royalty profit rather than to the value of its operating assets suggests a focus on operational profitability. While the term "operating assets" typically implies an asset-based approach, such as Return on Assets (ROA), its usage here indicates a nuanced interpretation aligned with a "net pre-royalty profit margin." The U.S. Regs’ mention of "operating assets" could be seen as contextualizing the profitability assessment within XYZ-Europe’s operational framework, albeit with a potentially inaccurate use of the term or an intention to convey the expected profit margin from the use of these assets.
**RPSM Step 2: Allocate Residual Profit (or Loss)**

- The remaining $180 million residual profit was attributed to “Nulon Military” intangibles, notably the Nulon technology (including XYZ-Europe’s modifications) and the “high-intensity” European marketing campaign.\(^8\)

- Step 2 of the RPSM allocates the residual profit (or loss) based on each entity’s relative nonroutine and valuable contributions.

- The IRS used a ratio of the capitalized values of XYZ-U.S.’s Nulon R&D expenses and XYZ-Europe’s Nulon R&D and marketing expenses. The values were then compared to their respective sales (worldwide for XYZ-U.S. and European for XYZ-Europe)\(^9\) to determine the economic ownership shares in the intangible assets. This approach ensures that the allocation of the residual profit corresponds proportionally to each entity’s investment in the intangibles that generate sales.

- XYZ-U.S. conducted the original R&D to develop the base Nulon technology, while XYZ-Europe adapted it for military use and marketed it in Europe. The capitalized costs of these investments determined the economic ownership shares of the Nulon military-grade intangible assets between the two entities.

- XYZ-U.S.’s Nulon R&D expenditures were 20 percent of worldwide sales, while XYZ-Europe’s adapted R&D and marketing expenditures were 40 percent of European sales.\(^{10}\) The total R&D and marketing expenditures were 60 percent of XYZ-Europe’s sales, with XYZ-U.S. owning one-third (20/60) and XYZ-Europe owning two-thirds (40/60) of the Nulon Military intangibles.

- Applying the one-third/two-thirds split to XYZ-Europe’s $180 million residual profit results in a $60 million royalty payment to XYZ-U.S. This royalty payment represents 12 percent of XYZ-Europe’s $500 million Nulon Military sales.

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\(^8\) Presumably, the “high intensity” marketing campaign is a focused marketing program targeting European military organizations.

\(^9\) According to U.S. Reg. § 1.482-6(c)(3)(iii), XYZ’s operations involving Nulon are divided between the U.S., targeting police use, and Europe, where XYZ-Europe adapts and markets it for defense applications. While R&D expenses influence worldwide protective product sales, suggesting a broad application, the term “worldwide” should not be automatically assumed to represent the aggregate of U.S. and European sales alone. This term rather reflects the global impact of R&D activities, potentially including other regions not explicitly detailed in the example.

\(^{10}\) For XYZ-U.S., this was based on its worldwide product sales because XYZ-U.S.’s R&D expenses supported the worldwide protective product sales. XYZ-Europe’s ownership share was based on its European Nulon Military sales.
Important Takeaways

- The Nulon example illustrates a step-by-step framework for applying the RPSM.

- MNEs should select profit-split factors that reliably represent the relative value of each entity’s nonroutine contributions and are consistently measurable. Appropriate factors can include capitalized development costs of intangible assets\(^{11}\), headcount involved in the development, enhancement, maintenance, protection, and exploitation (DEMPE) of these assets, operating expenses of DEMPE functions, or amortization of intangible assets\(^{12}\), among others.

- When selecting profit-split factors, MNEs should consider the specific risks undertaken by each entity, such as market, operational, or regulatory risks, which can significantly impact profit outcomes.

- As exemplified in the Nulon case, profit-split factors, such as R&D and “high-intensity” marketing costs, reflect the economic activities that drive value creation.

- XYZ-Europe’s “high-intensity marketing campaign” exemplifies strategic marketing efforts that yield valuable nonroutine contributions in the form of brand and market position intangibles, meriting residual profit. Such campaigns also highlight marketing’s critical role in value creation and the management of associated market and regulatory risks.

- The Nulon example stresses the importance of detailed records of intangible asset development expenditures when applying the RPSM. These records are crucial for determining each entity’s relative contribution and allocating the residual profit.

The Nulon example provides guidance on applying the RPSM to allocate profits involving intangibles owned by two or more related parties. The complexity of the RPSM has led many MNEs and transfer pricing practitioners to refrain from its use. However, tax courts increasingly favor the RPSM for transactions involving valuable nonroutine contributions by related parties. Given the global proliferation

\(^{11}\) Include all capitalized costs in the financial statements related to the development of intangible assets. These costs are a direct financial measure of each entity’s investment in the development activities. However, it is important to note that capitalization rules may vary across jurisdictions, potentially leading to inconsistencies in the measurement of these costs.

\(^{12}\) The amortization expense associated with intangible assets, which is a financial metric regularly reported in financial statements, provides an indication of their value and contribution over time. Nevertheless, amortization policies and useful life estimates can differ among entities, which may affect the comparability of this factor across the MNE group.
of intangibles, MNEs should consider using the RPSM to determine arm’s length profit allocation among entities that utilize intangible property within their value chains.

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