Release of BEPS discussion draft: Revised guidance on profit splits

July 20, 2016

In brief

On 4 July 2016, the OECD published a discussion draft setting out proposed revisions to the guidance on the transactional profit split method, as set out in the Base Erosion and Profit Shifting (BEPS) Actions 8-10 ("Aligning Transfer Pricing Outcomes with Value Creation"), 2015 Final Report, together with a number of questions. The questions are intended to elicit responses to be taken into account by Working Party No. 6 in considering revisions to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The OECD has asked for comments by 5 September 2016 and intends to hold a public consultation on the proposed guidance 11 and 12 October 2016.

The views and proposals included in the discussion draft do not represent the consensus view of all parties involved, but do provide a useful overview of the current thinking and areas that ultimately will be addressed following the consultations.

The discussion draft reflects the progress made by the OECD since its initial draft on the profit split method, issued on 16 December 2014. In particular, the new discussion draft 'clarifies' the situations for which the profit split method might be warranted, as well as those situations that can better be approached by means of a one-sided transfer pricing method. These clarifications are proposed in the context of aligning transfer pricing outcomes with value creation, the overarching theme of the BEPS project. The discussion draft's key theme is that a profit split method is appropriately applied only where the relevant activities are highly integrated or reflect unique and valuable contributions by both parties to the intercompany transaction, and should not be employed solely because a one-sided method may be difficult to apply under the particular circumstances.

In detail

Profit split method as most appropriate method

The discussion draft states that application of the profit split method as the most appropriate method depends on the existence of a specific commercial relationship between the parties to the transaction. As a result, its application would need to be supported by the features derived from the functional analysis.

The discussion draft posits that the profit split method should not be applied simply because other transfer pricing methods are difficult to apply in the circumstances (for instance, as a result of scarce or unavailable comparable data). Rather, the application of a profit split method should reflect a relationship where the parties to the transaction either share the same economically significant risks or separately assume closely related risks associated with the business opportunity and thus consequently should share in the resulting profits or losses.

Through this approach, the discussion draft would limit the situations in which the profit

split method can be applied, in order to safeguard against the inappropriate use of that method. Inappropriately applying the profit split method would result in economic outcomes that are fundamentally different from the outcome supported by the accurate delineation of the transaction, according to the discussion draft.

In case one of the parties to the transaction assumes only limited risks and comparable data are scarce, a more reliable arm's-length outcome is likely to be reached by using the comparable data but with a comparability adjustment or by interpreting the "inexact" data by means of statistical tools (e.g., to exclude less comparable data points), through the application of an arm's length range or the use of more than one method to determine an appropriate arm's length result.

Appropriate application — The foregoing implies that situations in which a profit split can appropriately be applied are those characterised by the sharing of risks by parties to a transaction accompanied by a high degree of integration of functions or the making of unique and valuable contributions by each of the parties.

The discussion draft expounds on how those situations can be recognised:

- **Highly integrated operations** — Although the discussion draft recognises that most business operations by an MNE group are integrated to some degree, a high degree of integration means that the way in which one party to the transaction performs functions, uses assets, and assumes risks is interlinked with and cannot reliably be evaluated in isolation from the way in which another party to the transaction performs functions, uses assets, and assumes risks.

  This is likely to occur in case of 'parallel integration' in the 'value chain' rather than 'sequential integration,' as in the latter case it will often be possible to find reliable comparables for each stage or element in the value chain. Finding reliable comparables is less likely for parallel integration where multiple parties to the transaction are involved in the same stage of the value chain (e.g., contribution of intangibles, sharing of functions in jointly developing products, and exploiting the marketing of those products together).

- **Unique and valuable contributions** — In another situation, multiple parties to the transaction make unique and valuable contributions, such as unique and valuable intangibles.

  Unique and valuable contributions will occur in cases where (1) the contributions are not comparable to contributions made by uncontrolled parties in comparable circumstances and (2) their use in business operations represents a key source of actual or potential economic benefits.

  These two cases are somewhat linked as comparables for such contributions are seldom available and provide unique sources of economic advantage.

Group synergies — The discussion draft also explains that group synergies do not fall within the scope of situations for which a profit split method would be the most appropriate. Rather, the sharing of benefits (or negative costs) resulting from such synergies can be achieved through the use of appropriate allocation keys similar to the way in which allocation keys can be used to apportion costs of shared services. There thus is no need to combine the total profits of the parties and use the profit split method on account of group synergies alone.

Value chain analysis

The discussion draft recognises the concept of a 'value chain analysis' as a means to identify when it may be appropriate to apply a profit split method.

Items for analysis — A value chain analysis should consider where and how value is created in the business by:

- Considering economically significant functions, assets and risks, which party or parties perform the functions, contribute the assets and assume the risk as well as whether and how the functions, assets and risks of the parties may be interdependent or otherwise interlinked; and
- Considering how the economic circumstances may create opportunities to capture profits in excess of what the market otherwise would allow (e.g., those associated with a first mover advantage, unique intangibles, or other unique contributions).

The value chain analysis therefore should also consider whether the value creation is sustainable and whether market advantages are protected due to barriers to entry to potential competitors or the impact of valuable intangibles. This analysis thus is a tool to accurately delineate the transaction and does not by itself indicate that the profit split method is the most appropriate method, even

when the analysis would show that there are multiple factors and parties that contribute to the creation of value.

Analysis factors — The discussion draft thus draws a clear distinction between the profit split method as such and the value chain analysis, which it labels as a broad-based analysis of the taxpayer's circumstances. The value chain analysis therefore would provide useful insights into:

- The key value drivers to the transaction, including how associated enterprises differentiate themselves in the market;
- The nature of the contributions of assets, functions, and risks by the associated enterprises to the key value drivers, including considerations of which contributions are unique and valuable;
- Which parties can protect and retain value through performance of important functions in relation to the development, enhancement, maintenance, protection, and exploitation of intangibles;
- Which parties assume economically significant risks or perform control functions relating to the economically significant risks associated with value creation; and
- How parties operate in combination in the value chain and share functions and assets in parallel integration.

The discussion draft equally recognises that the value chain analysis may be helpful in the process of determining the relevant factors to use in splitting profits, including the weighing of splitting factors in cases where more than one factor is used. The value chain analysis thus can serve as an objective measure to identify the relative contributions to the creation of profits by the parties to the transaction.

Actual versus anticipated profits

The discussion draft outlines two variations of the profit split method: a split of 'anticipated profits' and a split of 'actual profits.'

A profit split of 'anticipated profits' is a pricing arrangement that applies profit splitting factors to the anticipated profits of an enterprise resulting from its own contributions and also from those made by an associated enterprise, in order to determine the pricing of the transaction (e.g., a royalty). Typically such a split of anticipated profits would be used in conjunction with a discounted cash flow technique to determine the anticipated profits, according to the discussion draft.

A profit split of 'actual profits' applies profit splitting factors to split the actual profits derived in each taxable period from commercialising products. Under this approach, the basis to split the combined profits is established *ex ante*, but applied to actual combined profits from the transaction each year.

Application of method — The discussion draft states that the application of the profit split method should be performed in the same context as independent enterprises' experience, i.e., on the basis of information known or reasonably foreseeable at the time the transactions were entered into, to avoid using hindsight. This means that irrespective of whether anticipated or actual profits are used, the basis upon which the profits are split — including the profit splitting factors and the way in which the combined profits are calculated — must be determined *ex ante* on the basis of information known or reasonably foreseeable by the parties at the time the transactions were entered into.

The discussion draft states that a split of actual profits requires a high level of integration, such that the activities and associated risks of both parties can be considered as a single, cohesive business. There is a greater sharing of uncertain outcomes resulting from risks associated with the transaction where the profits or losses that are split are the 'actual' profits or losses. The discussion draft notes that under a split of actual profits, each party remains exposed to the effects of the risks associated with business activities of the other party, and the outcome for each party will depend on the overall performance of the business in relation to those risks. For those reasons, the discussion draft observes that a profit split of actual profits would be appropriate only to the extent that the functional analysis demonstrates that both parties exercise some control over the relevant risks. Doing otherwise would imply allocating to a party the impact of risks it does not control.

Measures of profits

The discussion draft states that the measure of profits used as a basis for the profit split will depend on the nature of the integrated operations and the sharing of risks as determined when accurately delineating the actual transaction:

- If **gross profits** are used, this should reflect the findings of the functional analysis — e.g., the parties share not only the market risk (affecting volumes of sales and price changes) but also risks associated with producing or acquiring goods or servicing including relevant costs of intangibles which affect the level of gross profit.

- If **operating profits** are used, this should reflect the finding of the functional analysis that the parties also share risks that affect the operating expenses (which may include investments in intangibles).

The takeaway

The OECD's BEPS project has fundamentally focused on transparency and aligning transfer pricing outcomes with value creation. This objective has been visible across many of the OECD's BEPS workstreams, particularly Action 8 (Transfer Pricing Aspects of Intangibles), Action 9 (Risk and Capital), and Action 13 (Transfer Pricing Documentation and Country-by-Country reporting).

Against this backdrop, the discussion draft focuses on defining the situations in which profit splits are appropriately used (either by a taxpayer or tax administration). The discussion draft thus notes that one-sided transfer pricing policies still may have a significant role, for both taxpayers and tax administrations, grounded in holistic functional analyses that consider the recent changes made to Chapters I to III of the OECD Transfer Pricing Guidelines and the new 'risk control' framework in particular.

The recognition of a value chain analysis that is capable of capturing where value is created within multinational enterprises' value chains, the contributions to value creation by local operations and, ultimately, whether the allocation of income and expenses across the entire organisation, can be accomplished under arm's-length conditions by means of a one-sided transfer pricing method or profit split method could prove to be a significant addition to the transfer pricing guidelines.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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