OECD publishes long-awaited additional guidance on use of profit split methods

August 6, 2018

In brief

The OECD on June 21 published revised guidance on application of the profit split method (the 'Final Report' or 'Paper').

The Final Report follows a mandate in Action 10 of the BEPS Action Plan, seeking clarification on application of the profit split method in light of global value chains. The Final Report, which also succeeds two prior discussion drafts and public consultations over 2016 and 2017, represents a full revision of the current guidance on the use of profit splits in Chapter II of the OECD's Transfer Pricing Guidelines for Multinational Enterprises (TPG)[1], as well as the associated Annex II with examples.

The Final Report, similar to the other BEPS initiatives, aims to tax profits where economic activities take place and value is created. It will take effect as the following sections of Section C, Part II, Chapter II and Annex II to that Chapter in the TPG:

- C1 (s. 2.114 – 2.115): Providing general information on the transactional Profit Split Method (PSM)
- C2 (s. 2.116 – 2.145): Guidance on when the PSM is likely to be appropriate
- C3 (s. 2.146 – 2.153): Providing general guidance on the application of the PSM
- C4 (s. 2.154 – 2.165): How to determine the profits to be split
- C5 (s. 2.166 – 2.183): Guidance on how to split the profits, including example profit split factors
- Annex II: 16 Examples to demonstrate the principles of the new PSM Guidelines

A summary of the key elements and changes to the new profit split guidance plus our observations are set out below.

In detail

C1 – General information on the PSM

The opening section sets out the general purpose of applying the PSM: to establish or test arm's-length pricing with reference to the contribution of each party to the profits arising in relation to the transaction. Similar to the current TPG, the guidance applies equally to losses as it does to profits.[2]

C2 – Guidance on when the PSM is likely to be appropriate

The Guidance first reaffirms that an extensive analysis of each potential TP method is not required; instead, the selected transfer pricing method should be, relatively speaking, the most appropriate and reliable in the case.

Hallmarks

Hallmarks of when such criteria are likely to be met for the selection of the PSM include[3]:

1. The first and potentially 'clearest indicator' is a presence of **unique and valuable contributions** by each party involved in the transaction indicating a strong commercial and financial relationship. This is because comparables are unlikely to be available in the case of unique and valuable contributions (e.g., intangibles), rendering one-sided methods unsuitable. Moreover, individual contributions may be used as a form of splitting the profits in line with how third parties may price the transaction under similar circumstances.

   Although the concepts of 'unique and valuable' are not new, the Final Report provides a definition of the terms. In summary, contributions would be regarded as 'unique' and 'valuable' when similar third-party contributions cannot be found in similar circumstances (i.e., unique) and where the contributions are a key source of profits (i.e., valuable). It also is likely that there would be a relationship between these two factors[4] — i.e., a contribution is unique *because* it is a source of economic advantage, for example in the case of intangibles.

2. There is a **high degree of integration.** Care should be taken to distinguish between the level of integrated activities that might be expected from (1) the normal operation of an MNE through complementary but discrete activities (e.g., Principal selling through a limited risk distributor) and (2) a high degree of integration and inter-dependency where the functions, assets, risks, and economic benefits are strongly interlinked (e.g., investment managers trading on a global book).[5]

   Observation: The concept of 'highly integrated' is at best ambiguous and leaves room for varying tax authority interpretations and applications, despite the definition provided in section 2.133 of the Final Report. Taxpayers therefore should be conscious of the other PSM hallmarks that exist in the case of highly integrated activities when deciding if the PSM is the most appropriate method, as illustrated in Examples 4 and 8 of the Final Report (see below for further information on the examples).

3. There is **shared assumption of economically significant risks or separate assumption of closely related risks**. Taxpayers should ensure that economically significant risks with respect to only the controlled transaction are identified. Risks are sufficiently inter-related to the extent that their outcomes cannot be reasonably separated in reality.[6]

   Observation: This factor arguably is the grayest of the three hallmarks, as, in the context of specific circumstances, taxpayers need to assess 'economic significance' and 'shared assumption' or 'closely related.' Similar to the integration hallmark of PSM, there is once again a high risk that this prong is satisfied in a wide array of circumstances and therefore should not be considered in isolation.

Examples

Examples 1 to 10 of the Final Report focus on the above criteria to identify situations where the PSM is (or is not) likely to be the most appropriate transfer pricing method to be selected.

- Examples 4 and 8 identify situations where the PSM is not likely to be the most appropriate method: for example, in the case of a distributor and manufacturer respectively who, despite being highly integrated, do not make any unique and valuable contributions such as technical or marketing know-how or IP (e.g., akin to a limited risk distributor or contract manufacturer) or do not share in the economically significant risks.
- Examples 6 and 10 are particularly interesting as they suggest a split of profits at the gross profit or even revenue level. The examples reflect situations where the parties are highly integrated but assume separate economically significant risks and as such the parties bear the consequences of how they chose to manage their own costs.

Further guidance

The Final Report makes it clear that **the absence of comparables should not result in the automatic adoption of the PSM**[7]. However, the guidance further explains that the PSM can allow for flexibility to take into account unique arrangements, where such arrangements may not be present in independent enterprises[8]. Moreover, where reliable comparables are available, the PSM is unlikely the most appropriate method[9].

In determining whether different contributions to a transaction are unique and valuable, industry practice in applying a PSM may be an indicator of the appropriateness of the PSM in the circumstances (but note, not determinative factor where other evidence exists).[10].

The Final Report also broadens the list of potential **complexities in applying the PSM.** Although less information generally is needed on independent enterprises (e.g., benchmarking), there are a number of potentially significant practical difficulties, including measurement of profits (see section C4 below), determination of the appropriate contributions and therefore profit splitting factors, and documentation. For documentation, the taxpayer is expected to be able to explain the application and implementation of the PSM in a coherent and comprehensive manner due to the unique nature of the business relationships and profit splitting factors of the related parties.[11]

Observations

Thankfully, the Final Report does not revisit concepts floated during the first discussion draft process of parallel versus sequential integration, and the necessity to undertake detailed evaluation of value chains to identify circumstances when to apply the PSM. Although this limits the additional compliance burden, we encourage taxpayers to undertake a broader value chain analysis, at the very least to check consistency with the group transfer pricing applied.

Our general advice, in line with the guidance, is to analyze the merits of each case individually within the new framework presented to identify the most appropriate transfer pricing method in the circumstances. It is envisaged that the extent to which the above PSM indicators are present will correspond to the lack of factors (e.g., CUPs or comparables) supporting the adoption of other transfer pricing methods.[12]

C3 – General guidance on the application of the PSM

Consistent with the prior transfer pricing guidelines[13], the split of profits should be in a manner economically consistent with how independent parties would do so. Thus, the split of profits should be aligned with the functional analysis, including the assumption of economically significant risks, and be capable of being reasonably measured. Taxpayers also are **expected to determine the appropriate application of the PSM ex-ante** and apply consistently over the life of the arrangement, unless changes can be supported and documented.[14]

Although not new concepts, the Final Report provides further specifics for the methods commonly used to split the profits, being:

- Contribution analysis – considering the overall relative contribution of each party
- Residual analysis – where a party also may make less complex contributions that can be separately priced and compensated before splitting the residual profits.

Observations

Where a PSM is adopted in practice, we more frequently find a residual analysis implemented. This is to be expected, as typically the roles of parties to a transaction in a PSM context are complex with many layers of activities that contribute to the profits being split. For example, they have a functional profile that includes both unique and economically important aspects that fall into the PSM, as well as less complex layers that can be remunerated under other more appropriate transfer pricing methods as part of the residual analysis. This also is reflected in the number of examples in Annex II of the Final Report that are geared toward residual PSMs.

For those newer to the application of residual profit splits, Example 11 provides a detailed residual analysis numerical example in the case of two integrated manufacturers to illustrate the expected mechanics.

C4 – How to determine the profits to be split

First, the approach should align with the accurate delineated transactions as discussed under Chapter I TPG. That is, in the first step, **profits should be those relating to the controlled transaction** under review, with reference to the contractual arrangements and actual conduct of the parties. A segregated transactional profit and loss account therefore may need to be created reflecting the results of the controlled transaction.

Example 12 illustrates where the profits of the controlled transaction are from the combined activities of three related parties, but one of these parties should be remunerated for its routine activities before the profits (i.e., the profits of the controlled transaction) should be split between the non-routine parties.

Second, where the profits of the controlled transaction are the aggregate of two or more related-party results, the financial data of the relevant profits must be **aligned from an accounting perspective** e.g., timing of recognition of revenues and expenses including depreciation. The guidance acknowledges that harmonized management accounting such as product-line profit and loss accounts may be the most appropriate. However as tax returns typically are linked to the statutory accounts, taxpayers should consider whether reasonable adjustments can be made to statutory accounts information in order to harmonize the accounting across the related parties. Regardless of the approach adopted, the taxpayer is expected to be consistent across the life of the arrangement.

Third, the Final Report favors the **split of actual profits where a party shares the same or closely related economically significant risks**. On the other hand, where there are unique and valuable contributions but a party does not assume economically significant risks, the forecast result would be the more appropriate profits to split for said party. Consequently it is assumed (but not specifically stated) that the party assuming the economically significant risks manages and controls such risks in a way that they are responsible for delivering on the anticipated profits, or otherwise bearing the difference (good or bad).

Observation: On a practical level, it seems questionable whether a party can have a unique and valuable contribution to a transaction without bearing economically significant risks. Thus in reality a split based on actual profits is more likely.

Example 13 scenario 1 is particularly interesting. In this case, each party makes unique and valuable contributions but they do not share economically significant risks. Based on the circumstances, the anticipated profits rather than actual profits are split by paying a sales-based royalty or a lump-sum payment calculated via a discounted cash flow valuation technique in line with Ch. VI of the TPG. The example, however, does not fully explore the impact of retrospective adjustments or other elements per the new Ch. VI of the TPG (Special Considerations for Intangibles).

Fourth, the Final Report warns **against the use of hindsight** in determining the profits to be split (i.e., items one to three above) or the profit splitting factors (see section C5 below).

Finally, the new Guidance suggests that **profits can be split at gross or operating level** depending on the circumstances — i.e., whether joint control is exercised over all of the functions, assets, and risks and thus costs borne. An example of two integrated manufacturers is given where they share unique and valuable IP to create innovative products, but separately control their own selling and marketing activities and risks. It is determined that the gross profits more accurately reflect the results from the integrated manufacturing activities and unique IP activities — i.e., before marketing and sales expenses that are separately controlled. A second example of global traders further explains that the operating costs in this case are largely irrelevant to the assumption of economically significant risks and level of integration. ***Note:*** The Final Report acknowledges that a split of operating profits is expected more frequently in practice as income (and expenses) are allocated annually on a more consistent basis.

Example 14 provides further illustration of the mechanics of the residual PSM, in this case showing that the resultant profit split will not vary when the residual profit is split before or after a category of expenses, if the category of expenses is used as the profit splitting factor.

C5 – Guidance on how to split the profits

In summary, anything is possible, so long as it is appropriate and reliable for the case. At the same time, profit splitting factors should be:

1. Objective — i.e., based on objective data not impacted by related-party transactions such as external sales
2. Verifiable, and
3. **Supportable** — i.e., by either comparables/external data (e.g., JV arrangements, or co-marketing or co-promotion agreements that may be seen in specific industries), internal data (e.g., relative contribution based on functions, assets and risks) or both.

The Final Report provides a non-exhaustive list of acceptable profit split factors that may split the profits in an economically viable way that would reflect the relative contribution of independent parties (see list below). At the same time, consideration must be made to the functions, assets, and risks of the contributing entities, the nature of the transaction, and any relevant industry factors.

1. Value of assets or capital.
2. **Costs** — e.g., relative spending or investment, historic or accumulated costs, location savings, risk weighting of costs (for example, in the case of intangibles to obtain a robust measure of the relative value) — although noting that the costs may be a weak measure of contribution, particularly in the case of intangibles.
3. Incremental sales.
4. **Employee compensation, headcount, or time spent** by those employees involved in the unique and valuable contribution.

Note: The Final Report points taxpayers in the direction of their **Master File and Local Files as a source of information to identify drivers of business profit** that could be used to measure the unique and valuable contributions, such as key intangibles.

Observation: The evaluation of drivers of business profits per the Master File and Local Files is an interesting development, meaning that groups should assess whether their profit split factors align with drivers of profit reported by the group. There also is no certainty that tax authorities will not look to other sources (such as company websites) to determine the appropriateness of profit split factors. Deviations may exist in practice due to the specific circumstances of the tested transactions, but groups should be prepared to explain such differences to tax authorities.

Although Examples 15 and 16 are referenced in this section, Examples 11 onward also show how profits may be split in different circumstances, including splitting based on R&D costs (Example 11) and asset-based (Example 15).

The takeaway

The Final Report provides specific hallmarks to consider for selecting the PSM, and through a number of examples, its application. Much like the concerns of taxpayers at the outset of the project, there remains a risk of unwanted proliferation of the PSM, particularly when similar industry practice can be seen. This concern is exacerbated due to the ambiguity of the PSM hallmarks, in particular the notion of 'highly integrated' and 'sharing of economically significant risks.' Perhaps more helpful is the clarification on when the PSM is unlikely to be the most appropriate transfer pricing method to select, i.e., that tax authorities should not default to the PSM even if comparables do not exist. Nevertheless, the Final Report provides taxpayers with a new opportunity to reassess their (de)selection of the PSM in light of their value chains.

We expect that the Final Report and examples on splitting the profits may seem simple in theory, but are complex in practice, and ultimately leave a lot of space open for interpretation. In line with current experiences, the identification and measurement of appropriate profit split factors are likely to create the bigger headaches and be the most significant contentious point/audit risk for those deciding to adopt the PSM. This is especially the case as the Final Report lacks additional assistance on how to identify or use appropriate external data (which cannot be mistrusted) as profit splitting factors.

Key will be ensuring that the drivers of value used to split the profits reflect the contributions of the parties and are consistent with value drivers reported elsewhere by the business, e.g., in the Master file and Local files. It is advisable to check for consistency with any other public sources such as the annual report and accounts, and the company website.

Finally, extra effort should be made to document the PSM in a clear, consistent, and comprehensive manner in order to limit follow-up questions or enquiries.

Endnote:

1. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2017
2. Section 2.115
3. Sections 2.119 to 2.121
4. Section 2.130
5. Sections 2.133 to 2.135
6. Section 2.140
7. Section 2.128
8. Section 2.121
9. Section 2.133
10. Section 2.124
11. Section 2.123 and also 2.148
12. Section 2.143
13. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2017 and previously July 2010
14. Section 2.148

Let's talk

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

Transfer Pricing

Isabel Verlinden, *Brussels*
+32 2 710 44 22
isabel.verlinden@be.pwc.com

Stefaan De Baets, *Brussels*
+32 2 710 4719
stefaan.de.baets@be.pwc.com

Adam Katz, *New York*
+1 646 471 3215
adam.katz@pwc.com

David Ernick, *Washington*
+1 202 414 1491
david.ernick@pwc.com

Susann van der Ham, *Düsseldorf*
+49 211 981 7451
susann.van.der.ham@de.pwc.com

Stuart MacLeod, *Düsseldorf*
+49 211 981 1330
stuart.macleod@de.pwc.com

Global Tax Policy

Stef van Weeghel, *Amsterdam*
+31 88 7926 763
stef.van.weeghel@nl.pwc.com

Pam Olson, *Washington*
+1 202 414 1401
pam.olson@pwc.com

Phil Greenfield, *London*
+44 20 7212 6047
philip.greenfield@pwc.com