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Discussion draft issued on revised guidance on profit splits

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On 4 July 2016, the OECD released a discussion draft in respect of revised guidance on the use of the profit split method for transfer pricing (as well as a discussion draft on the attribution of profits to permanent establishments; for additional coverage, see the alert dated 8 July 2016). The draft on profit splits follows the work previously undertaken by the G20/OECD in relation to actions 8-10 of the G20/OECD BEPS action plan on aligning transfer pricing outcomes with value creation. It does not, at this stage, reflect a consensus position of the governments involved, but is designed to provide substantive proposals for public review and comment.

Comments

Selection of the most appropriate method is an essential part of a transfer pricing analysis, and the BEPS work on transfer pricing has re-emphasized this point. The revised draft guidance is helpful in determining when a profit split method is appropriate within the wider framework of the selection of the most appropriate method.

It remains the case that profit splits are complex, and costly for businesses and tax authorities to apply and audit. Profit splits are not the most appropriate method in cases where other methods and data provide a simpler route to a robust result. Confirmation in the revised draft guidance that the profit split method is not always appropriate, and should not be used by default if third-party comparable data is not readily available, is helpful.

While the use of profit splits is appropriate for integrated operations, the difficulty of obtaining and analyzing data remains. Detailed examples showing the outcome in a range of cases would aid businesses and governments. In some cases, a revenue split is more appropriate than a profit split, and the inclusion of examples to illustrate this also would be useful.

An increased use of the profit split method, with its inherent uncertainties, could lead to an increase in audits, disputes and double taxation. It is essential that mutual agreement procedures (and advance pricing arrangements) are available; and the BEPS work on dispute resolution should be helpful here. Consideration should be given to joint auditing of profit splits by tax authorities, with a rollover to mutual agreement procedures, to ensure adjustments and disputes can be dealt with efficiently.

Background

The transactional profit split method is one of the five OECD-recognized transfer pricing methods in the OECD's *Transfer Pricing Guidelines for Multinationals and Tax Administrations* (Guidelines). It determines the division of profits that independent parties would expect to realize from the same or similar transactions. The profit split method identifies the relevant profits or losses and then splits them between group companies on an economically valid basis that would have been agreed upon at arm's length.

The discussion draft clarifies and expands the guidance on the use of the profit split method, particularly in the context of global value chains. New guidance is provided in respect of (i) combining and splitting *anticipated* profits; or (ii) combining and splitting *actual* profits.

Irrespective of which alternative is used, *how* the profit is split must be determined in advance on the basis of information known or reasonably foreseeable at the time the transactions were entered into. This is necessary to conform with the arm's length principle, since third parties would only enter into an agreement to split profits before any profits (or losses) are made, based on the anticipated value of their respective contributions (and would not use hindsight).

The discussion draft notes that the use of a transactional profit split of *actual* profits is most appropriate where there is:

- A high level of integration of activities;
- A greater sharing of uncertain outcomes resulting from risks associated with the transactions; and
- Sharing in the outcomes of the business activities and the risks associated with those subsequent outcomes.

The draft also notes that the difference between the effects of uncertain outcomes on the two approaches may be less significant in practice where a contingent price is determined under a profit split of anticipated profits.

Summary of strengths and weaknesses

The discussion draft sets out strengths and weaknesses of the profit split method. The main strength of a profit split of *actual* profits is as a

pricing solution where the accurate delineation of the actual transaction shows that two or more group companies undertake activities involving the sharing of economically significant risks. This includes, for instance, highly integrated operations in which the group companies each perform similar functions, or where both companies make unique and valuable contributions (e.g. contributions of unique intangibles). It offers flexibility to take into account the specific circumstances of the group companies, and it is less likely that either company will be left with an extreme and improbable profit.

The main weakness relates to difficulties in its application and, in particular, the difficulties of accessing and analyzing the detailed information required. The analysis of the data may require reasonable assumptions to be made based on knowledge of the business, and it is acknowledged that, in most cases, tax authorities will not be able to perform the analysis or verify the information without input from the taxpayer. Further difficulties in application arise in circumstances where it may be necessary to take into account multiple years and, in particular, costs and contributions made in the past that affect the returns to the group in the current period.

Any differences between the relative strengths and weaknesses of profit splits of *anticipated* profits and *actual* profits are not explored in the draft, although comments are invited.

Most appropriate method

The draft guidance makes clear that splitting actual profits reflects a relationship where the group companies share the same economically significant risks (or separately assume closely related risks) associated with the business opportunity and, consequently, should share in the resulting profits or, as is sometimes forgotten, losses. A sharing of risks by group companies may be accompanied by a high degree of integration of functions or the making of unique and valuable contributions, including contributions of intangibles, by each of the companies. However, the contribution of an intangible alone is not sufficient justification for use of the profit split method.

The discussion draft emphasizes that a lack of comparable third-party data alone is insufficient to warrant the use of a profit split of actual profits under the arm's length principle. For example, where one company assumes only limited risks, inexact comparable data is likely to give a more reliable outcome than the inappropriate application of a profit split.

Group synergies

The discussion draft clarifies that there is no need to combine the total profits of group companies and use the profit split method on account of group synergies alone. It is instead appropriate to apply an appropriate allocation key to the additional profits arising from the group synergies.

Value chain analyses

New guidance is given on when and how a value chain analysis may be a useful tool in helping to identify when the profit split method may be appropriate and, if relevant, how the method should be applied. Although all business operations can be expressed through a value chain, the guidance notes that this does not imply that a profit split should be applied in all cases.

A value chain analysis should consider where and how value is created in the business operations, including, in particular:

- Consideration of the economically significant functions, assets and risks;
- Which company performs the functions, contributes the assets and assumes the risks;
- How the functions, assets and risks are interrelated;
- How the economic circumstances may create opportunities to capture profits in excess of what the market would allow (e.g. unique intangibles or first-mover advantages); and
- Whether the value creation is sustainable.

A value chain analysis contributes to the process of accurately delineating the transaction, and also determines the level of integration (which may determine whether a profit split is appropriate).

Guidance for application of profit splits

The Guidelines provide guidance on applying a profit split method. The objective is to approximate as closely as possible the split of profits that would have been realized by third parties. This will depend on the accurate delineation of the actual transaction in terms of functions, assets and risks; the identification of the profits to be split; and the splitting factors that would have been agreed in advance by third parties. The profits and splitting factors should be capable of being measured in a reliable and verifiable way.

Two commonly-used approaches to splitting profits are discussed:

- *Contribution analysis:* Combined profits are divided between relevant group companies based upon a reasonable approximation of the profits that independent parties would have expected to realize. Data from comparable transactions should be used where available.
- *Residual analyses:* Combined profits are separated into two categories: i) each relevant company is allocated an arm's length return for routine contributions that can be directly valued (typically, where there is reliable third-party comparable data); and ii) any residual profit (or loss) is allocated among the relevant group companies based on the relative value of contributions, similar to the contribution analysis outlined above.

Further draft guidance is provided in respect of different measures of profits, criteria for profit splitting factors, examples of asset-based and cost-based profit splitting factors and use of internal data where third party data is not available.

Next steps

Comments are invited by 5 September 2016. A public consultation will be held on 11-12 October 2016 at the OECD in Paris.

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