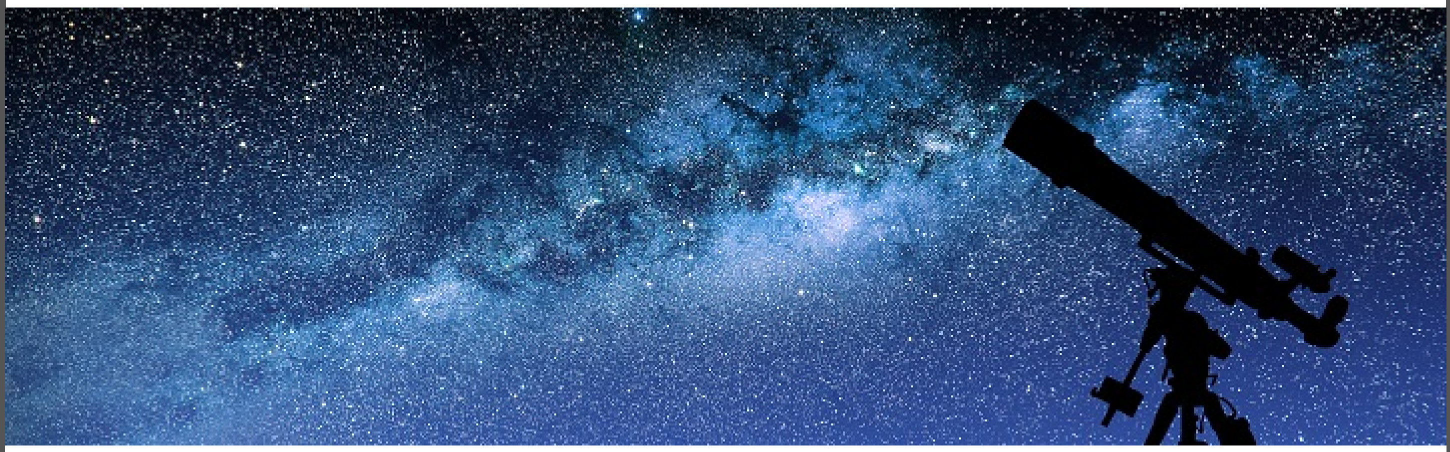
Deloitte.

Global Transfer Pricing | July 12, 2016



OECD releases discussion draft on revised guidance on profit splits

Global Transfer Pricing Alert 2016-025

The OECD on July 4 released a Discussion Draft on Revised Guidance on Profit Splits. The discussion draft follows the work previously undertaken by the G20/OECD in relation to ensuring that transfer pricing outcomes are aligned with value creation (Actions 8-10 of the G20/OECD BEPS Action Plan). It does not reflect, at this stage, a consensus position of the governments involved, but is designed to provide substantive proposals for public review and comment. The introduction to the discussion draft specifically indicates that insofar as the guidance differs from the guidance contained in the 2010 OECD T*ransfer Pricing Guidelines For Multinational Enterprises and Tax Administrations* (“2010 OECD TPG”), it is not to be relied upon by taxpayers or tax administrations.

The discussion draft was eagerly anticipated following the issuance of a first non-consensus discussion draft on profit splits in December 2014, and the public consultation on the topic held at the OECD in March 2015. The BEPS final reports published October 5, 2015, did not incorporate any proposed consensus changes to Chapter II of the 2010 OECD TPG, providing instead that Working Party 6 (“WP6”) would reconvene in 2016 and 2017 to provide such consensus guidance. The discussion draft is the first step in WP6’s mandate regarding profit split for 2016-2017.

Overview of discussion draft

The discussion draft modifies and expands the 2010 OECD TPG Chapter II guidance on profit splits (rather than withdraw and replace it in its entirety, as was the case with Chapter I, Chapter VI, and Chapter VIII). It clarifies and expands on the 2010 OECD TPG Chapter II guidance to conform to the new “risk control” framework of Chapter I.

Along with discussing conditions under which transactional profit splits are most appropriate, the discussion draft also articulates the role of a value chain analysis in accurately delineating a transaction (within the meaning of Chapter I), and in determining the most appropriate transfer pricing method. The discussion draft specifically indicates that the existence of an integrated value chain does not necessarily imply the use of transactional profit splits, as many multinational enterprises (MNEs) operate through a global value chain.

The tone of the discussion draft has significantly shifted from the tone of the December 2014 non-consensus draft that suggested a broad applicability of profit splits to integrated value chains. If the December 2014 draft could reasonably be interpreted as suggesting formulary apportionment of an MNE’s profit as appropriate in certain circumstances, the discussion draft dismisses such an interpretation. The draft contains a number of safeguards and cautions against application of transactional profit splits when it would not be appropriate, including as a default method when comparables are hard to find, other methods are not reliable, or group synergies exist. The discussion draft also recognizes that profit splits are difficult to apply, and are generally not appropriate when a party makes only routine contributions.

Peppered throughout the discussion draft are a number of specific questions on which WP6 is requesting interested parties to comment. For example, when discussing the appropriateness of profit splits to highly integrated value chains, the discussion draft distinguishes “sequential” integration of the value chain from “parallel” integration. In the former case, parties sequentially perform discrete functions in the integrated value chain; it often will be the case that reliable comparables exist for each stage or element in the value chain. In the latter case, multiple parties to the transaction are involved at the same stage of the value chain in contributing assets or sharing functions; it is therefore more likely that an accurate delineation of the transaction will determine that each party shares economically important risks, and a transactional profit split may thus be appropriate. Commentators are asked whether that distinction between “sequential” and “parallel” integration of business operations is a useful refinement, and are also asked to help further define “parallel” integration.

Analysis of discussion draft

Value chain analysis

The discussion draft provides four new paragraphs under Section C.3.4 articulating the role of a value chain analysis in a transfer pricing study. Although that supplemental guidance is issued as part of the guidance on profit splits in Chapter II, the first paragraph on value chain analysis cross-references paragraph 1.34 of Chapter I (broad-based analysis of taxpayer’s circumstances expected in the master file) and indicates that a value chain analysis is merely a tool to assist in accurately delineating a transaction, in particular with respect to the functional analysis, and thereby determining the most appropriate method, which *may* or *may not* be the profit split—there is no causal relationship.

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

Because the value chain analysis discussion appears to provide additional guidance on identifying the commercial or financial relations between the associated enterprises required under paragraph 1.34, commentators are likely to question the placement of such guidance in Chapter II (guidance on profit split), rather than in Chapter I (guidance on accurate delineation) and require clarity in the next draft as to whether or not a value chain analysis is viewed by WP6 as part of a functional analysis to be performed in the accurate delineation of every transaction, or merely as a tool to be applied in transactions in which the profit split is being considered as the most appropriate method. Providing this guidance under Chapter I would reinforce what *appears* to be the intent of WP6, namely, to use value chain analyses to *inform* the selection of the most appropriate method as opposed to *cause* the transactional profit split to be the most appropriate method in every case of an MNE operating through a global value chain.

The main takeaway from the supplemental guidance on value chain analyses provided in the discussion draft is the casting of a value chain analysis as a delineation tool for a specific transaction, rather than as a justification to apply a profit split on every integrated MNE operating through a global value chain. This is a significant change in direction (likely to be welcomed by taxpayers) from the December 2014 non-consensus draft on profit splits, which suggested the latter rather than the former.

Profit split guidance

The overriding purpose of the use of a transactional profit split should be to approximate as closely as possible the split of profits that would have been realized had the parties been independent enterprises. Consistent with the guidance provided in the October 5, 2015, final report under actions 8-10, identifying the economically significant risks each party to a transaction controls, and accurately delineating such transactions (including the respective contributions of each party and the profits to be split), is the starting point to inform whether or not transactional profit splits are appropriate and reliable.

The discussion draft describes transactional profit split as a method whereby the combined profits are split between associated enterprises on an *economically valid basis* that approximates the division of profits that would have occurred in comparable circumstances at arm’s length. The discussion draft distinguishes transactional profit splits of *anticipated profits* from profit splits of *actual profits*. Although most of the guidance provided in the discussion draft addresses splitting actual profits, this distinction, and the provision of separate guidance for these two types of transactional profit splits, expands on Chapter II of the 2010 OECD TPG.

Irrespective of whether anticipated or actual profits are split, the determination of which profits need to be combined (base for the split), and the way combined profits are split (key for the split) must be determined *ex-ante* on the basis of data that is capable of being measured in a reliable and verifiable manner and without the use of hindsight; a key criteria to ensure that profit splits are consistent with the arm’s length standard.

These requirements make profit split keys constructed through subjective weighing of taxpayers’ representations of the various value drivers in their business inappropriate, and significantly decrease the authority granted by the guidance to tax administrations to allocate taxable income between parties based on formulary-type apportionments.

When is a profit split most appropriate?

Transactional profit splits are most appropriate in cases of (i) highly integrated operations, and (ii) unique and valuable contributions by multiple parties.

The use of a transactional profit split of actual profits is most appropriate in cases of high integration of activities performed by the parties, with greater sharing of uncertain outcomes resulting from the economically significant risks controlled by the parties. In contrast, the use of a transactional profit split of anticipated profit does not require the level of integration or risk sharing required for a transactional profit split of actual profits.

The discussion draft includes a paragraph discussing the concept of “integration of activities” within an MNE, distinguishing between “sequential” and “parallel” integration (see above). Although the distinction may be valid as a theoretical matter, it is unclear how useful the guidance is as a practical matter. For example, taxpayers and tax administrations seeking to apply the guidance and determine in a specific transaction whether there is sufficient “parallel” integration of activities to justify the use of a transactional profit split may end up at both ends of the spectrum—resulting in taxpayers benchmarking activities and tax administrations applying a transactional profit split, or *vice versa*. Commentators are likely to provide WP6 with extensive comments on this paragraph and request examples to illustrate when the “sufficient integration” bar is crossed to justify the use of transactional profit splits. Commentators are also likely to question why this guidance on integration of a value does not belong to the guidance on value chain analysis, arguably better suited for Chapter I than Chapter II.

Another situation in which a transactional profit split may be the most appropriate method is when multiple parties make unique and valuable contributions. “Unique and valuable” is defined as cases in which (i) the contributions are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) the use of the contributions in business operations represents a key source of actual or potential economic benefits. Such situations require each party to control the development risks of their unique and valuable contributions and share in the combined profits resulting from their contributions per Chapter I.

Profit to split, profit split key, and delineation of transaction

The discussion draft does not provide many details as to how a transactional profit split of actual or of anticipated profits should be performed. However, some general principles are laid out, most of which highlight how the accurate delineation of the transaction pursuant to the guidance of Chapter I informs the decisions that must be made when designing a meaningful transactional profit split. Specifically, the guidance notes that the measure of profits used as the basis for the profit split will depend on the nature of the integrated operations and the sharing of risks as determined by the accurate delineation of the transaction—profit splitting gross margins involves less integration and risk sharing by the parties than profit splitting operating margins.

Similarly, the guidance notes that the determination of an appropriate profit splitting factor should reflect the key value drivers in relation to the transaction. Although the discussion draft seems to suggest that multiple factors could be weighed into one profit splitting key, such weighing cannot be subjective and must be verifiable by tax administrations. This requirement is likely to make it difficult to use multiple weighed factors as a practical matter, because finding objective and verifiable data to derive the weights will be challenging in most cases.

Finally, the discussion draft provides a useful discussion of how the profits associated with a specific transaction need to be identified, and how required segmentations and allocations may affect the reliability of the analysis.

Chapter II and Chapter VI consistency

Because transactional profit splits are the most appropriate candidate methods when intangibles are involved, consistency in the guidance provided under Chapter II and Chapter VI is of great importance. Paragraph 6.145 of Chapter VI, for example, provides for the comparable uncontrolled price (CUP) and transactional profit split methods, complemented by valuation techniques, as the most likely useful pricing methods. Section D.2.6.2 of Chapter VI discusses the application of transactional profit split methods to intangibles with Chapter II being cross-referenced.

Similarly, although the distinction between *contribution* and *residual* profit splits existed in the 2010 OECD TPG, it is complemented in the discussion draft by a new paragraph addressing the use of valuation methods under Chapter VI sections D.2.6.3 and D.2.6.4 in the application of a residual analysis in a transactional profit split of *anticipated* profits to set a price for the contribution made by the transferor—with Chapter VI being cross-referenced in Chapter II.

There may appear to be a tension in the guidance provided under Chapter II and Chapter VI. Chapter VI appears to suggest that a two-sided transactional profit split is the most appropriate method in more situations than the new guidance provided under Chapter II seems to suggest. Similarly, Chapter VI does not contain the refinement introduced in Chapter II of distinguishing between sequential integration of a value chain and parallel integration. Chapter II suggests that in sequential integration of a value chain it is often possible to reliably benchmark the sequential activities. Applied to the DEMPE functions of Chapter VI (development, enhancement, maintenance, protection, and exploitation of intangibles) this would suggest that exploitation functions that sequentially follow development functions ought to be reliably benchmarked to the extent they are of a routine nature, which would leave valuation methods as the only suggested method to price the

DEMPE functions if no reliable CUP exists. It is unclear whether Chapter VI as currently drafted concurs with that view.

Next steps

Comments are invited by September 5, 2016, and a public consultation will be held on October 11-12, 2016, at the OECD Conference Center in Paris, France.

Contacts

Philippe G. Penelle	Alan Shapiro	Joseph Tobin
+1 202 220 2601	+81362133889	+1 202 220-2081
ppenelle@deloitte.com	alan.shapiro@tohmatsu.co.jp	jtobin@deloitte.com

Useful links

Resources

2016 Global Transfer Pricing Country Guide

Arm's length standard

Transfer pricing alerts

Get connected

Deloitte tax@hand

Join Dbriefs

Follow @DeloitteTax

www.deloitte.com/tax