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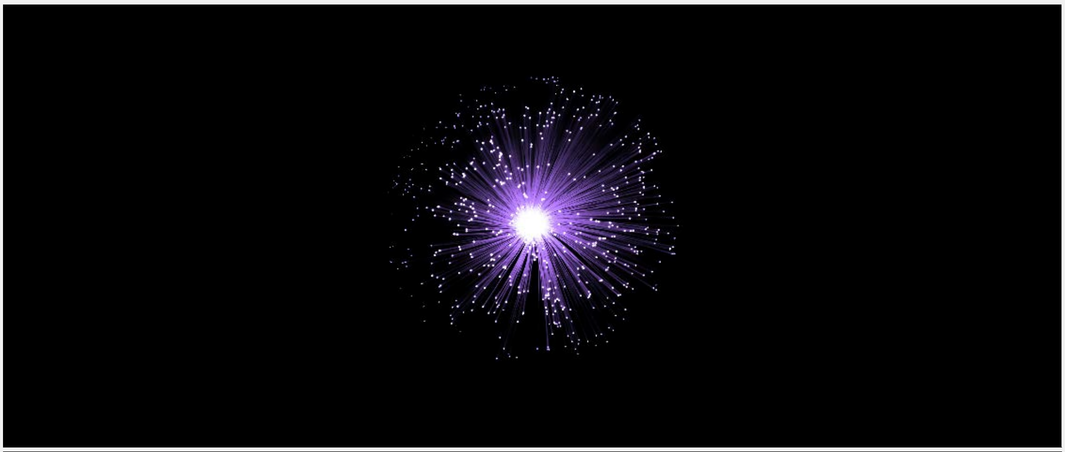

OECD releases third discussion draft on transactional profit splits

Global Transfer Pricing Alert 2017-026

The Organisation for Economic Co-operation and Development (OECD) on June 22 released two non-consensus discussion draft documents concerning the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (TPG).[1] These documents are part of the base erosion and profit shifting (BEPS) project, which began in 2013.

The first discussion draft, which deals with work in relation to BEPS Action 7, contains additional guidance on the attribution of profits to permanent establishments (PEs). The second discussion draft, which deals with BEPS Actions 8 through 10, provides proposed revised guidance on the application of the transactional profit split method. This alert will focus on the discussion draft concerning profit splits. A separate alert will focus on the discussion draft dealing with PEs.

Actions 8 through 10 of the BEPS Action Plan focus on ensuring that transfer pricing outcomes are in line with value creation. In particular, Actions 8-10 invited clarification of the application of the transactional profit split method in the context of global value chains. The June 22 discussion draft is the third round of non-consensus discussion drafts relating to profit splits issued by the OECD -- two earlier drafts were released on December 16, 2014, and July 4, 2016. Comments were submitted by stakeholders on each of the prior discussion drafts, and those comments were published on February 10, 2015, and September 8, 2016, respectively. This revised document replaces the discussion draft released in July of

[1] All references herein to the OECD TPG are references to the 2010 version of the TPG, as modified by the BEPS final reports on Actions 8-10 and Action 15, published October 5, 2015, and adopted into the TPG in May 2016.

2016. Interested parties are invited to send comments on this discussion draft by September 15, 2017.

The more significant unresolved issues from the July 4, 2016, guidance that came out of the public consultations held at the OECD are as follows:

- **Value chain analysis**: Whether to keep the guidance concerning a value chain analysis; and, if so, whether to include such guidance in Chapter II of the TPG, which discusses the selection of the most appropriate transfer pricing method, or whether to include it in Chapter I of the TPG, which discusses the concept of the "accurate delineation of the actual transaction" within a multinational enterprise (MNE);

- **Parallel and sequential integration**: Whether to keep the distinction between parallel and sequential integration of an MNE as a useful tool for tax administrations and taxpayers to inform the selection of the profit split as the most appropriate method;

- **Split of actual *versus* anticipated profits**: Whether the guidance on when the split of actual profits would be the most appropriate method in comparison with those circumstances in which the split of anticipated profits would be the most appropriate method could be further clarified and simplified;

- **Unique and valuable contributions**: Whether a profit split requires that both participants make unique and valuable contributions to the transaction; and

- **Acceptable profit split keys and application:** Whether to clarify or simplify the guidance on which profits to split (e.g., contribution margin, gross margin, or operating margin) and which keys to apply on such profits.

The profit split discussion draft begins to address these unresolved issues, and generally results in simplified guidance compared to the July 4, 2016, non-consensus draft.

The profit split discussion draft does not mention the concept of "value chain analysis." Likewise, the importance of the notion of sequential versus parallel integration as a useful tool to evaluate the appropriateness of a transactional profit split receives little to no attention. Instead, the profit split discussion draft focuses squarely on the question of how the "risk control" framework of the revised Chapter I of the TPG might apply in the context of (i) the selection of the transactional profit split as the most appropriate transfer pricing method, and (ii) the application of a profit split key that may reasonably result in an arm's length outcome.

Some of the other important guidance in the July 4, 2016, non-consensus draft remains in the June 22 discussion draft. This includes the requirement that profit split keys be verifiable and based on internal accounting data or on measurable market data. According to the profit split discussion draft, management representations of where value is created in the MNE generally will not meet this requirement because such representations typically are difficult for a tax administration to verify (i.e., audit) because of their intrinsically subjective nature.

Written comments regarding the profit split discussion draft are due September 15, 2017, and a public consultation will be held at the OECD in November 2017.

Back to top

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Back to top

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Back to top

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