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BEPS update - draft documents released for public review

September 15, 2016

On July 4, 2016, the Organisation for Economic Co-operation and Development (OECD) released three draft documents under the base erosion and profit shifting (BEPS) project which was launched four years ago to address perceived gaps in international tax rules. The draft documents are 1) Revised Guidance on Profit Splits, 2) Additional Guidance on the Attribution of Profits to Permanent Establishments, and 3) Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines.

On September 8, 2016, the OECD published the comments received on the first two draft documents noted above. These comments will be considered by the OECD prior to an upcoming public consultation on these documents. The OECD also published the comments received on the third draft document on August 24, 2016, but no further public consultation will take place regarding this document.

Revised Guidance on Profit Splits

This draft document deals with the clarification and strengthening of the guidance on the profit split method (PSM), as set out in the BEPS Actions 8-10 2015 Final Report. Most notably, the discussion draft clarifies that the PSM is not intended to apply in all situations, and that a PSM should only be applied when it is determined to be the most appropriate method in a particular case after a thorough functional analysis has been performed. Useful specific guidance in this regard is proposed, including:

- A lack of comparables is insufficient to warrant the use of the PSM, and in some cases adjustments or interpretations to inexact comparables should be used, rather than defaulting to a PSM;
- While highly integrated business operations may warrant the use of the PSM, the contribution alone of an intangible or rights in an intangible does not justify the use of the PSM;
- The existence of group synergies alone does not require the use of the PSM, as the marginal system profits arising from those synergies can be allocated to related entities through the use of appropriate allocation keys; and
- Value chain analysis can be used as a tool to accurately delineate a transaction; however, the value chain itself does not indicate that the PSM should be used, as all business operations can be expressed through a value chain.

The de-emphasis of the PSM in the discussion draft is welcome, as it helps to alleviate certain concerns such as those raised in recent literature[1], preceding the discussion draft such as the potential for increased compliance burdens and controversy if the relatively complex PSM were to be overused, and the concern that if applied mechanically and not supported by the functional analysis, applications of the profit split method could mirror formulary apportionment, which is not endorsed by the OECD or its member countries and is not consistent with the arm's-length principle.

Other key themes in the July 4 discussion draft include:

- **Emphasis on risk and control over risk.** Consistent with other central tenets of BEPS Actions 8-10, the discussion draft notes that the PSM would require the economically significant risks associated with the outcomes of the business activities to be controlled, either separately or collectively, by the parties sharing in the actual profits, and each party must have the financial capacity to assume its share of the risks.
- **Use of anticipated or actual profits.** The OECD recognizes the use of either anticipated profits or actual profits as the basis of splitting profits. The use of anticipated profits will most likely apply to situations such as the example included in the discussion draft, where there is a transfer of right to an intangible at a point in time. The splitting of actual profits may be best suited to ongoing arrangements, such as the example included in the discussion draft in which two related companies contribute intangibles and each company commercializes a product using the intangibles in combination.
- ***Ex ante*.** The OECD reiterates that regardless of the use of anticipated or actual profits, profits must be determined based on forecasts rather than on hindsight. The use of *ex ante* information imitates what would have been done between third parties, given that third parties would enter into a transaction using information that would have been known or reasonably foreseeable, and not information based on hindsight.

Generally speaking, the OECD did not provide any radical new approaches to splitting profits among multinational entities, but instead provided further detailed clarification on how best to apply the existing PSM approaches.

Additional Guidance on the Attribution of Profits to Permanent Establishments

The OECD’s second discussion draft focuses on providing examples for the changes to the threshold for permanent establishments (PE) concerning a) dependent agent PEs, including those created through commissionaire and similar arrangements; and b) warehouses as fixed place of business PEs. The main takeaways are:

- Although the threshold for becoming a PE was shortened, by virtue of widening Article 5(5), and narrowing Articles 5(4) and 5(6) of the OECD model treaty, there was no increase in scope and therefore there should be little to no increase in the amount of profits attributable to the PEs; and
- In relation to dependent agent PEs, the discussion draft includes an example in which none of the profits are attributed to the dependent agent PE, indicating that the appropriate analysis of the significant people functions could have a downward impact on the profits attributable to these PEs in certain fact patterns, including potentially zero profit situations.

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[1] Muris Dujsic, Simon Gurr, & Alex Evans, The OECD's Continuing BEPS Work: Will 2017 Be the Year of the Profit Split?, *Bloomberg BNA’s Transfer Pricing Report*, Vol. 24 No. 24 (4/28/16).

Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines

The OECD has also released a draft of the conforming amendments to Chapter IX of the transfer pricing guidelines which deals with business restructuring. The amendments are intended to ensure that Chapter IX is consistent with the major revisions to the transfer pricing guidelines within the OECD's report on Actions 8-10.

Under Actions 8-10, significant changes were made to Chapter I of the transfer pricing guidelines, including delineation of transactions and clarification in respect of risks. The conforming amendments to Chapter IX are aimed at ensuring that all inconsistencies between the revised transfer pricing guidelines and Chapter IX have been addressed, including the removal of all duplication between the chapters. As such, "new" guidance is not necessarily included, but rather inconsistencies with other revised chapters of the OECD Guidelines have been eliminated, and many references to the new revised chapters of the OECD Guidelines have been inserted.

Consultation

Comments on the PSM and PE discussion drafts that were submitted by the September 5, 2016 deadline have now been made publicly available. The OECD will consider the comments and a public consultation will be held on October 11-12, 2016 at the OECD Conference Centre in Paris, France.

The deadline for comments on the conforming amendments to Chapter IX was August 16, 2016; submissions were published by the OECD on August 24, 2016. No further public consultation will be held regarding those proposals.

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