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OECD releases new guidance on transactional profit split method and hard-to-value intangibles

Global Transfer Pricing Alert 2018-020

The Organisation for Economic Co-operation and Development on June 21 released two consensus reports concerning the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (TPG).[1] These reports are part of the base erosion and profit shifting project, which began in 2013.

The first report contains revised guidance on the transactional profit split method of Chapter II of the 2017 OECD TPG. The second report deals with the implementation of the OECD's approach to hard-to-value intangibles (HTVI) in Chapter VI of the 2017 OECD TPG. The guidance on the HTVI approach in Chapter VI was adopted in the final BEPS deliverable of October 5, 2015. Both of the 2018 reports are discussed below.

2018 profit split report

The June 21 profit split report is the fourth and final round of proposed guidance relating to the transactional profit split method. It contains new provisions and examples that replace the current versions of Section C of Part III, Chapter II of the 2017 OECD TPG and Annex II to Chapter II of the 2017 OECD TPG, respectively.

The immediately preceding round of guidance was a non-consensus discussion draft released on June 22, 2017. The 2018 profit split report retains the same basic approach of the 2017 discussion draft, but expands upon that draft, especially in the examples.

[1] All references herein to the OECD TPG are references to the 2017 version of the TPG.

Overall, the 2018 profit split report continues to focus 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 split factor that may reasonably result in an arm's length outcome.

The three profit split indicators

The 2018 final report sets forth three factors the presence of which indicate that the transactional profit split method may be the most appropriate method. Those three factors are:

- Whether each party is making unique and valuable contributions;
- Whether the business operations of the parties are so highly integrated that the parties' contributions cannot be reliably evaluated in isolation from each other; and
- Whether the parties share the assumption of economically significant risks or separately assume closely related risks.

The 2018 final report also includes a definition of the term "unique and valuable contributions," which covers not just assets used (such as intangibles) but also "functions performed." Furthermore, the 2018 final report states that the existence of unique and valuable contributions is "perhaps the clearest indicator" that a transactional profit split may be appropriate.[2]

Several examples, which will be contained in Annex II to Chapter II of the OECD TPG, illustrate how these factors should be applied, both separately and in a single case:

- Unique and valuable contributions: Examples, 1, 2, 3, 4, and 5 (transfer of intangibles);
- Highly integrated business: Examples 6, 7, 8, and 9 (integration results in unique and valuable contributions) ;
- Shared assumption of economically significant risks or closely related risk: Example 10; and
- Combination of factors: Example 12.

Methods and factors to split profits

The 2018 final report contains the same two profit split methods as the 2017 discussion draft: the contribution analysis and the residual analysis. The contribution analysis divides profits on the basis of the relative contribution of the enterprises. The residual analysis is a two-step process: in the first step the returns that can be reliably benchmarked are determined, and in the second step the remaining profits are split using a contribution analysis. Example 11 illustrates a residual analysis.

Like the 2017 discussion draft, the 2018 final report eschews adopting a prescriptive list of profit splitting factors.[3] Profit

[2] *See* 2018 Profit Split Report at ¶ 2.126.
[3] *Id*. at ¶ 2.166.

split factors should be verifiable and based on internal accounting data or on measurable market data, if available.[4] Internal data such as assets, costs, and headcount may be used.[5] For self-developed assets, which may not be on the balance sheet, valuation techniques such as discounted cash flow may be used. Example 15 illustrates an asset-based allocation and Example 16 illustrates a cost-based allocation.

Profits to be split

The 2018 final report recognizes that it may be necessary to segment results of the enterprises to reflect the accurate delineation of the transactions that are subject of the profit split.

The measure of profits to be split will depend on the risks the enterprises share.[6] In many cases, operating profit may be the most appropriate measure of profits to split because the enterprises share in the risks of the entire business. However, if the enterprises share only the risks associated with the volume of sales and production of the products, and they do not share the risks associated with selling the products in the marketplace, then a split of gross profit may be appropriate. Examples 10, 14, and 16 and Par. 2.164 illustrate when it may be appropriate to split operating profit in comparison to other measures of profit such as gross profit.

The 2018 final report provides guidance on when it is appropriate to split actual or anticipated profits:

- The splitting of *actual* profits is appropriate when all the relevant parties share the assumption of the same economically significant risks or separately assume closely related, economically significant risks.

- A split of *anticipated* profits, in contrast, would be more appropriate if one of the parties does not share in the assumption of all of the economically significant risks.

These concepts are illustrated in Example 13 of the 2018 profit split report.

Whether actual or anticipated profits are split, the basis for splitting profits must be determined on the basis of the information known or reasonably foreseeable at the time the parties entered into the transaction.[7]

Observations on 2018 profit split report

In public consultations over previous non-consensus versions of the 2018 profit split report, there was significant discussion on how the risk control framework in Chapter I of the OECD TPG applied to transactional profit splits. The risk control framework includes guidance in the following paragraphs:

- Paragraph 1.94 states that if a party does and has the capability to financially assume a risk and it has the capability and performs the decision-making function

[4] *Id.*
[5] *Id.* at ¶¶ 2.169 to 2.173.
[6] *Id.* at ¶ 2.162.
[7] *See* 2018 Profit Split Report at ¶ 2.161.

with respect to the risk, the fact that other parties also exercise decision-making functions need not be considered in the allocation of risk;

- Paragraph 1.95 states that if two or more parties have the capability to assume a risk financially and have the capability and perform the decision-making function with respect to the risk, then the assumption of risk should be respected; and

- Paragraph 1.105 states, in part, that in circumstances when a party contributes to the control of risk, but does not assume the risk, compensation that takes the form of a sharing in the potential upside and downside, commensurate with that contribution to control, may be appropriate.

The final guidance cites paragraphs 1.95 and 1.105 but omits 1.94. If a tax administration interprets the failure of the OECD to cite paragraph 1.94 as indicative that only paragraphs 1.95 and 1.105 need be considered in the evaluation of the transactional profit split method, then some structures in which one party only contributes to control over economically significant risks, but does not assume them within the meaning of paragraph 1.94 in the accurately delineated transaction, might be inappropriately analyzed using a profit split rather than an alternative method that is consistent with the accurately delineated transaction.

Application of the profit split method can pose significant challenges. The examples in the 2018 final report, although helpful at a basic level, do not address some of the more challenging issues, and often assume away the situations that may be seen most often in practice, such as the presence of HTVI, what might constitute a "unique and valuable function," the determination of profits to be split, and profit splitting factors. As a result, careful planning and detailed documentation will be important, whether one wants to apply the profit split method or not. The additional uncertainty may lead to a renewed focus on the benefits of advance pricing agreements (APAs) and the mutual agreement procedure (MAP) process.

2018 HTVI report

The 2018 HTVI report has been incorporated as an annex to Chapter VI of the TPG. The 2018 HTVI report (i) presents the principles that should underlie the application of the HTVI approach by tax administrations; (ii) provides examples intended to clarify the application of the HTVI approach in different scenarios; and (iii) addresses the interaction between the HTVI approach and access to the MAP process under an applicable tax treaty.

The 2018 HTVI report focuses on information asymmetry between taxpayers and tax administrations, and states that the application of the HTVI approach should be underpinned by the following four principles:

- Tax administrations may consider *ex post* outcomes as presumptive evidence about the reasonableness of the assumptions of the *ex ante* pricing arrangements.
- In performing valuations, tax administrations should consider whether the associated enterprises could or should reasonably have known and considered *ex ante* the information related to the probability of achieving the actual income or cash flows, and whether it has considered such information. Thus, taxpayers have the possibility to rebut the presumptive evidence of *ex ante* pricing allegedly provided by the *ex post* outcome by demonstrating the reliability of the information supporting the pricing methodology adopted at the time of the transfer. The final guidance makes clear that tax authorities should not confuse the actual returns with the appropriate *ex ante* average of all possible returns appropriately probability weighted to value the *ex ante* average arm's length price at the time the transaction is entered into. This point was not included in the previous discussion draft, although it was extensively discussed in comments prepared by Deloitte Tax LLP and submitted to the OECD.
- When a revised valuation shows that the intangible was transferred at an undervalue or overvalue, the revised price may be assessed taking into account price adjustment clauses and/or contingent payments without regard to whether the original transaction contained such clauses.
- Tax administrations should apply audit practices to ensure that presumptive evidence based on *ex post* outcomes is identified and acted upon as early as possible.[8]

Significantly, the 2018 HTVI report includes language discussing the type of information that may be taken into account, saying that tax administrations may consider not only *ex post* outcomes but also any other relevant information related to the HTVI transaction that becomes available and that could or should reasonably have been known and considered by the taxpayer at the time of the transaction.[9] The 2018 HTVI report also makes clear that, even if the HTVI approach is not applicable to a particular transaction, an adjustment may still be appropriate under other parts of the OECD TPG (including other sections of Chapter VI) because, for example, the original valuation did not correctly value the potential value of the transferred intangible.[10]

Finally, the 2018 HTVI report states that tax administrations may make adjustments that reflect an alternative pricing structure that differs from the structure adopted by the taxpayer.[11] The guidance provides that such structure must be of a type that would have been made by independent enterprises in comparable circumstances, such as milestone payments, royalties with or without adjustable elements, or price adjustment clauses.[12] However, the guidance does not require that the adjustments reflect the amount unrelated

[8] *See* 2018 HTVI Report at ¶ 17.
[9] *Id.* at ¶ 8.
[10] *Id.* at ¶ 9.
[11] *Id.* at ¶16.
[12] *Id.*

parties would have provided had they adopted such a structure.

The examples in the 2018 HTVI report illustrate these concepts.

Example 1 presents two scenarios. The first demonstrates how the guidance should apply in the event a taxpayer cannot demonstrate that its original valuation was appropriately risk-adjusted or that the *ex post* development was unforeseeable at the time of the initial transfer. The example provides that the adjustment must reflect the *ex ante* risk-adjusted valuation taking into account the additional information. The second scenario illustrates that no adjustment is required because the potential adjustment falls within the exemption provided by item (iii) in paragraph 6.193 of Chapter VI of the OECD TPG, when the difference between the financial projections and actual outcomes does not reduce or increase the compensation for the HTVI by more than 20 percent of the compensation determined at the time of the transaction.

Example 2 demonstrates how a tax administration might consider applying an alternative payment structure, in this case a milestone payment, consistent with paragraph 16 of the 2018 HTVI report, as described above.

The 2018 HTVI report concludes by noting the increased level of certainty that bilateral and multilateral APAs can provide for the transfer of HTVI. The guidance further advises that, in the event application of the HTVI approach leads to double taxation, tax administrations should provide broad access to the MAP process under the applicable tax treaty.[13]

Observations on 2018 HTVI report

The final HTVI guidance provides tax administrations with a powerful tool, because it does not provide any mechanism requiring tax administrations to be held to the same standards as taxpayers when assigning probabilities to uncertain events, including providing evidence that every possible risk outcome has been considered and a probability measure assigned to it. Similarly, the examples in the 2018 HTVI report do not provide guidance that would help make HTVI determinations on the part of tax administrations more objective, for example by showing in detail how *ex ante* probabilities are to be adjusted based on *ex post* evidence. Finally, the guidance continues to sanction changing the form of a transaction with relative ease, even though such a change in form may change the contractually agreed upon risks of the parties.

The HTVI implementation guidance will require taxpayers to prepare fairly detailed and extensive documentation documenting of the risks that were considered and how those risks were weighted in arriving at the price for a transaction. Taxpayers may also want to consider adopting forms of payment that will adjust with changes in circumstances or price adjustment clauses to make it more likely that they will fall within the HTVI 20 percent safe harbor. Finally, in light of the guidance, taxpayers may want to consider entering into an

[13] *See* 2018 HTVI Report at ¶¶ 34-39.

APA, because many tax administrations will forgo the possibility of HTVI adjustments in the context of an APA.

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