Ireland

BEPS Action 10: Use of profit splits in the context of global value chains

On 5 October 2015, ahead of the G20 Finance Ministers' meeting in Lima on 8 October, the OECD Secretariat published thirteen papers and an Explanatory Statement outlining consensus Actions under the Base Erosion and Profit Shifting ('BEPS') Project. These papers include and consolidate the first seven reports presented to and welcomed by the G20 Leaders at the Brisbane Summit in 2014. The recommendations under each of the BEPS Actions are intended to form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the model tax treaty and transfer pricing guidelines. The G20/OECD will be continuing its work on some specific follow-up areas and a timetable for implementation during the remainder of 2015, 2016 and into 2017.

As part of the 2015 output, the OECD Secretariat issued a short summary of the status of the on-going work on the use of profit splits, in advance of additional guidance to be included in the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ('the Guidelines'). Further work on profit splits will be undertaken during 2016 and into 2017.

Deloitte Comments and Business Next Steps

Additional guidance on the use of the profit split method including practical commercial examples will be helpful for both businesses and tax authorities. It will be important that the guidance is clear on the **principles** to be taken into account, as it will not be possible to provide examples for every situation that may arise given the inherent variety in commercial value chains. Consideration of integration of business models and the digital economy will be key elements of the work.

Businesses will remain concerned by the **practical difficulties** of operating a profit split approach in multiple jurisdictions and in ensuring that tax authorities in multiple countries are satisfied. This is an area where a requirement for joint audits of profit splits would be a proportionate and helpful approach, with automatic rollover into mutual agreement procedures.

Many businesses implementing a multi-jurisdictional profit split will seek to obtain a multilateral Advance Pricing Agreement in order to ensure certainty and minimise double taxation (particularly where mandatory binding arbitration is not available under mutual agreement procedures).

Use of the Transactional Profit Split Method

In December 2014, the OECD Secretariat released a Discussion Draft in relation to the use of a profit split method for transfer pricing in the context of global value chains. This was in response to the objective in the G20/OECD BEPS Action Plan that transfer pricing rules should be improved to **'put more emphasis on value creation in highly integrated groups'**, and the observation that use of the profit split method may be one means of achieving this. The G20/OECD has now outlined the themes emerging from the responses to the Discussion Draft, and scoped the further work to be done to clarify, improve and strengthen the guidance on (i) **when** it is appropriate to apply a transactional profit split method and (ii) **how** to apply the transactional profit split method in a reliable way. Importantly, the scope now recognises that the **profit split method 'may not be straightforward for taxpayers to apply, and… tax administrations to evaluate.'** It notes that it may be the **most appropriate method** to align profits with value creation in accordance with the arm's length principle, particularly where the facts of the case make other transfer pricing methodologies problematic.

The scope of work sets out that the revised guidance will be based on existing guidance (in Chapter II of the Guidelines) but will clarify and supplement it, with practical application being illustrated through examples. The starting point remains a robust functional analysis. In selecting the most appropriate method, attention should be given to the consequences of **greater integration of business models as a result of the digitised economy,** and the potential role of profit splits to account for such integration. In addition, the work will develop approaches to transfer pricing in situations where the availability of comparables is limited.

Selection of the 'Most Appropriate' Method

The approach to applying the arm's length principle continues to require the selection of the **most appropriate transfer pricing method.** The sharing of profits or losses under a profit split reflects **a fundamentally different commercial relationship**, in particular concerning risk allocation, to the paying of a fee for goods and services. Where a sharing of profits would be unlikely to represent an arm's length outcome, the revised guidance will emphasise the need to **use and adjust the best available comparables** rather than a profit split method. This will be more reliable than an inappropriate use of a profit split method. This work is linked to that of the G20 Development Working Group on toolkits to help low income countries address the challenge of the lack of comparables.

Highly Integrated Business Operations

The work will consider when **significant integration of business operations** may lead to a transactional profit split being the most appropriate method. It will include guidance on the relevance of a **value chain analysis**. It may be helpful to distinguish between **sequential integration** of a global value chain (which may involve group companies performing different activities linked through transactions between them in a coherent value chain, and which may not warrant the use of a profit split) and **parallel integration**, which may involve group companies performing similar activities relating to the same revenues, costs, assets, or risks within the value chain.

Unique and Valuable Contributions

Additional guidance and examples will be provided to clarify **'unique and valuable'** contributions (other than in relation to intangibles) in considering when a transactional profit split method might be the most appropriate. Guidance will also be provided on when a transactional profit split should be selected as the most appropriate method in cases involving the performance of **important functions relating to the development, enhancement, maintenance, protection or exploitation of intangibles.** This will include by reference to third party situations that use profit split models.

Synergistic Benefits

Additional guidance will be provided on dealing with scenarios with **significant group synergies** and, if appropriate, how profit split methods could be applied to them.

Profit Splitting Factors

The guidance will focus on the need for a strong correlation between **profit allocation factors and the creation of value** in order to ensure an outcome that is consistent with the arm's length principle. The sensitivities and practical application of various mechanisms for allocation, including the capability to independently verify underlying data, will be included.

Use of Profit Split to Determine Transactional Net Margin Method Range, Royalty Rates and Other Payment Forms

Guidance will be provided on evaluating whether a transactional profit split method can be used to support results under a transactional net margin method, or to determine royalty rates or otherwise help simplify pricing outcomes.

Timetable

A Discussion Draft on profit splits will be released for public comments in advance of a public consultation to be held in May 2016. The guidance is expected to be finalised by 30 June 2017.

Deloitte EMEA Dbriefs Webcast

The EMEA Dbriefs programme includes a webcast on *BEPS: Round-up of 2015 Deliverables* on Tuesday 20 October 2015 at 13.00 BST/14.00 CEST. For further information and to register for the webcast, visit www.emeadbriefs.com.

Contacts

Lorraine Griffin
Tel: 01 417 2992
Email: **lorgriffin@deloitte.ie**

Pieter Burger
Tel: 01 417 2446
Email: **piburger@deloitte.ie**

Conor Hynes
Tel: 01 417 2205
Email: **chynes@deloitte.ie**

Daryl Hanberry
Tel: 01 417 2435
Email: **dhanberry@deloitte.ie**

Pádraig Cronin
Tel: 01 417 2417
Email: **pcronin@deloitte.ie**

Joan O'Connor
Tel: 01 417 2476
Email: **joconnor@deloitte.ie**

Deirdre Power
Tel: 01 417 2448
Email: **depower@deloitte.ie**

Karen Frawley
Tel: 01 417 2613
Email: **kfrawley@deloitte.ie**

Tom Maguire
Tel: 01 417 2469
Email: **tmaguire@deloitte.ie**

Declan Butler
Tel: 01 417 2822
Email: **debutler@deloitte.ie**

Louise Kelly
Tel: 01 417 2407
Email: **lokelly@deloitte.ie**