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

On 16 December 2014, the OECD, as part of its work on the Action Plan to address Base Erosion and Profit Shifting ('BEPS'), 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 is 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 a profit split method may be one means of achieving this.

This is an early-stage Discussion Draft and as such does not contain specific proposals. Instead the Discussion Draft sets out a number of scenarios exploring where the use of a profit split method might, and might not, be appropriate and poses questions for businesses. Responses will be taken into account by the OECD in considering revisions to the transfer pricing methods chapter of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.* As with other Discussion Drafts on the BEPS Actions, the views set out do not represent a consensus view from the G20/OECD governments involved but are intended to provide substantive points for public comment.

Deloitte Comments and Business Next Steps

Additional guidance on the use of the profit split method, including practical commercial examples, will be helpful for businesses and tax authorities. It will be important to ensure that the guidance is clear on the principles to be taken into account and consistent with the output from other BEPS work, as it will not be possible to provide examples for every situation that may arise given the inherent variety in commercial value chains.

The Discussion Draft focusses on when to apply a profit split method, and this will require a complete and accurate functional analysis as the starting point. We also agree that there will be many situations where a profit split will not be appropriate and other methods will be better suited. As such, the Discussion Draft's focus on situations where activities by different parties are so closely integrated as to make the application of other methods difficult appears reasonable.

Determination of appropriate 'allocation keys' (factors used to split profits between parties) to value different parties' contribution to the creation of value will be an important consideration, as will determining the level of profit (or loss) that should be split. The guidance should make explicit reference to consideration of what would happen at arm's length between unrelated parties. This might include, for example, evidence provided by commercial court cases looking at infringement of intellectual property rights.   Further guidance on the practical aspects of performing a profit split analysis will be beneficial, and will be helpful in minimising disputes and double taxation.

The Discussion Draft does not make reference to the difficulties in operating a profit split approach in multiple jurisdictions (many profit splits are on a bilateral basis because of these) and in ensuring that tax authorities in multiple countries are satisfied. In practice, in the absence of binding arbitration under mutual agreement procedures, many businesses looking to implement a multi-jurisdictional profit split will seek to do this as part of a multilateral Advance Pricing Agreement in order to ensure certainty and minimise double taxation.

Guidance on when a profit split method should be used

The Discussion Draft sets out that the essential first step in determining appropriate use of a profit split will be a functional analysis of the activities of the parties, taking into account assets used and risks assumed. In many cases this will need to be performed in the broader context of the group's business operations, considering each function's contribution to value creation. Similarly, the Discussion Draft makes clear that the 'most appropriate' transfer pricing method (taking into account their respective strengths and weaknesses) is the one to be selected, and the specific discussion of the profit split method does not imply any change to this basic principle. The Discussion Draft considers the need for additional guidance on when a profit split method would be 'most appropriate' by reference to a number of situations:

- **Global value chains** where there are high levels of co-operation, interdependence and effective pooling of entrepreneurial functions and risks between key group entities.
- **Multisided, integrated business models** such as those in the digital sector where data collected and insights gained in the course of providing free services are used elsewhere in the group in the provision of, for example, advertising services.
- Where two or more group companies make **'unique and valuable contributions'** to intangibles, with reference to the ongoing BEPS work on transfer pricing of intangibles. The example given is a manufacturing group which includes a sales company undertaking a number of additional services which are valued highly by customers and are recognised by the group as a key source of competitive advantage.
- Where a multinational enterprise's business operations are **highly integrated** and enterprises **share and jointly manage strategic risks**. The example is of a group where different companies share in the risks of product development.
- Where an integrated value chains has high levels of **fragmentation** (eg. separation of logistics, warehousing, marketing and sales functions into separate legal entities).
- Situations where a **lack of comparables** would pose a serious impediment to the reliable application of other methods (eg cost plus, CUP).

Aligning taxation with value creation: The Discussion Draft notes that a profit split method may be viewed as one means of ensuring emphasis is placed on value creation in highly integrated groups, provided suitable profit 'allocation keys' or factors are used. It asks for comments on how best to identify such factors, how to weight factors appropriately, whether particular factors are likely to reflect value creation better in particular industries or sectors, and how other approaches can be used to refine the results of detailed functional analyses in order to improve the reliability of profit splitting factors.

'Hard-to-value' intangibles: The Discussion Draft asks what specific aspects of a profit split approach may be particularly relevant in determining arm's length outcomes for transactions involving 'hard-to-value' intangibles.

Dealing with unanticipated results: The Discussion Draft considers whether a profit split method can be applied to deal with situations with unanticipated results where the risks are effectively shared between group companies.

Dealing with losses: The Discussion Draft acknowledges that there may be losses instead of profits, and considers whether there are circumstances in which a profit split method should be applied in a different way to losses.

Timetable

Comments are invited by 6 February 2015. A public consultation meeting will be held on the Discussion Draft at the OECD in Paris on 19-20 March 2015. Registration details will be published on the OECD website in due course.

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