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Dbriefs

Profit split method: New OECD guidance and practical applications

The Dbriefs Transfer Pricing series

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Agenda

- New guidance: what has changed?
- Local experience
  - India
  - China
  - New Zealand
- Controversy/rulings
- Emerging issues
- Questions and answers

New guidance: what has changed?

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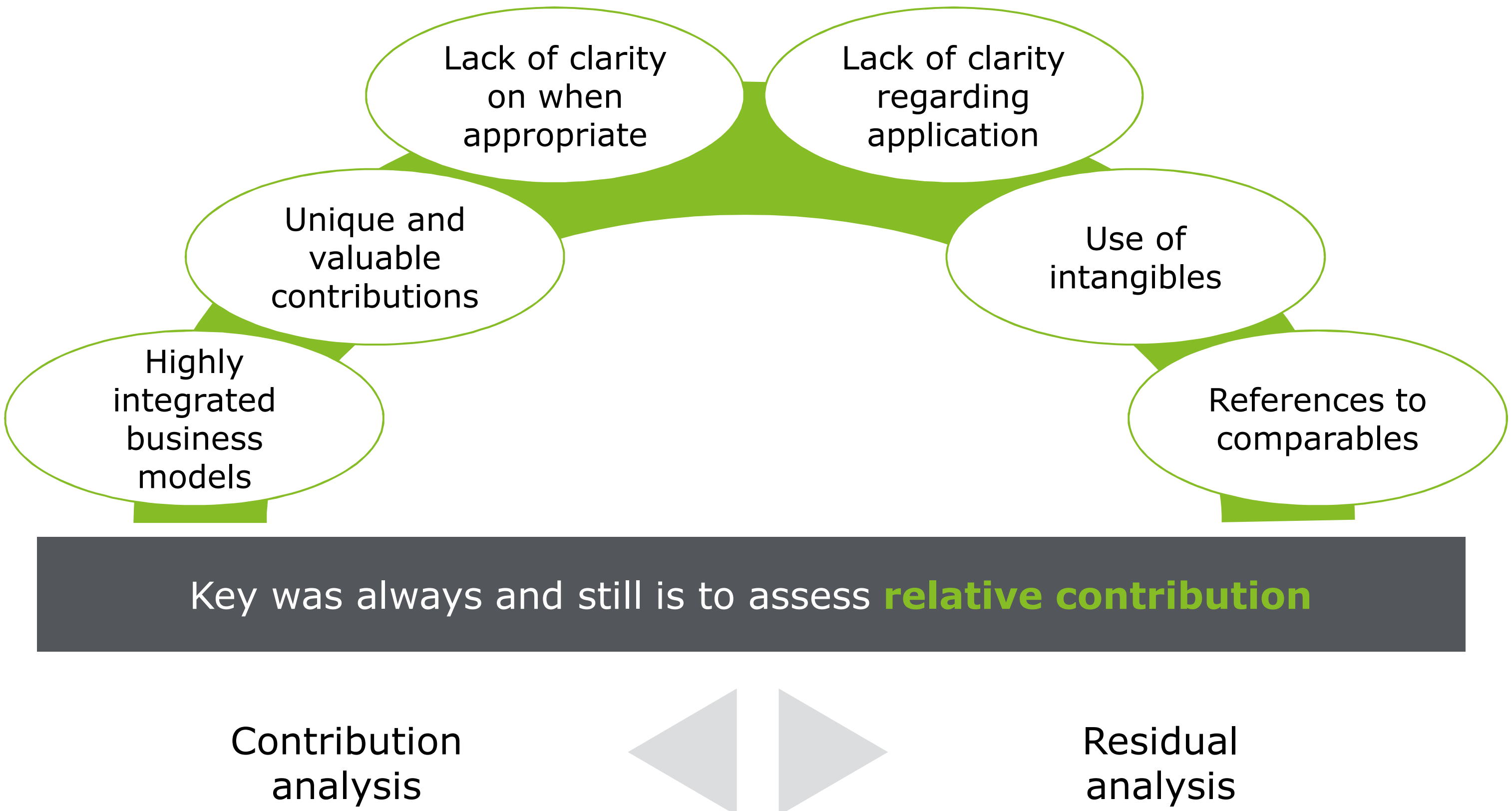
Profit split method basics – prior to June 2018



New guidance: what has changed?

When to apply the profit split method

- Acknowledgement that there is no need to undertake “exhaustive analysis”
- No longer a reference to a weakness being an “extreme result”
- Lack of comparables not a reason to use per se, but an **indication of appropriateness**
- New para 2.124 particularly interesting

> **Para 2.124**
>
> It is sometimes argued that a transactional profit split method is rarely used among independent enterprises, and thus its application in controlled transactions should be similarly rare. Where such a method is determined to be the most appropriate, this should not be a factor since transfer pricing methods are not necessarily intended to replicate arm’s length behaviour, but rather to serve as a means of establishing and/or verifying arm’s length outcomes for controlled transactions.

- Clear drive towards intended **increased use**

New guidance: what has changed?

When to apply the profit split method (Cont'd)

Unique and valuable

- Contributions that are not comparable to those made by uncontrolled parties
- Represent a key source of actual or potential economic benefits
- Significant risks relating to unique and valuable intangibles are assumed by the parties involved

High integration of business activities

- A particularly high degree of integration in business operations is an indicator for the use of the PSM
- Complementary activities could lead to the use of PSM if each are not comparable to uncontrolled arrangements and there is proven an visible inter-dependency
- Parties jointly perform functions, use assets and or assume risks

Shared assumption of risk

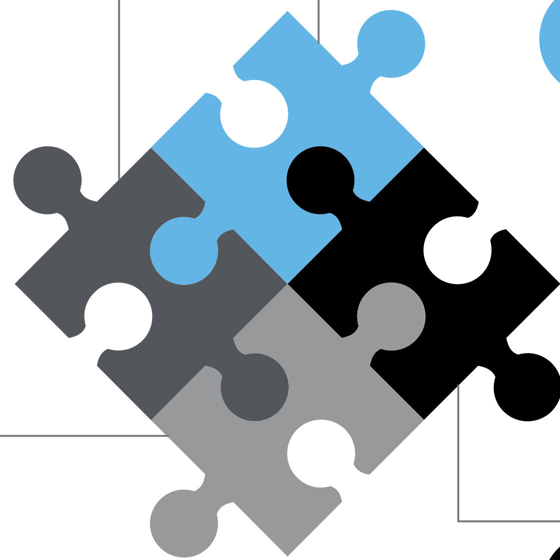
- Shared assumption of one or more economic risks incurred should be taken into account
- When risks are separately assumed by the parties, PSM can still be used if those risks are closely inter-related or correlated
- Assumption of risk should commensurate with the contribution to the control of the risk

New guidance: what has changed?

How to apply the profit split method – additional recommendations

Use of actual or anticipated profits
No longer a discussion of "ex ante" and "ex post" but rather type of profit split should be driven by level of shared assumption of **risk**. Also need to look to contract.

Use of comparables
New guidance acknowledges difficult to find. Presents **range of options** as to when could use. Leaves door open for valuations/subjective analyses if necessary.



Measures of profit
Key metric still gross or net profits. **Control of operating expenses** specifically noted as key for trading businesses.

Internal data
New sections discuss segmenting out other profit flows. Lists master file and local file as potential data sources.

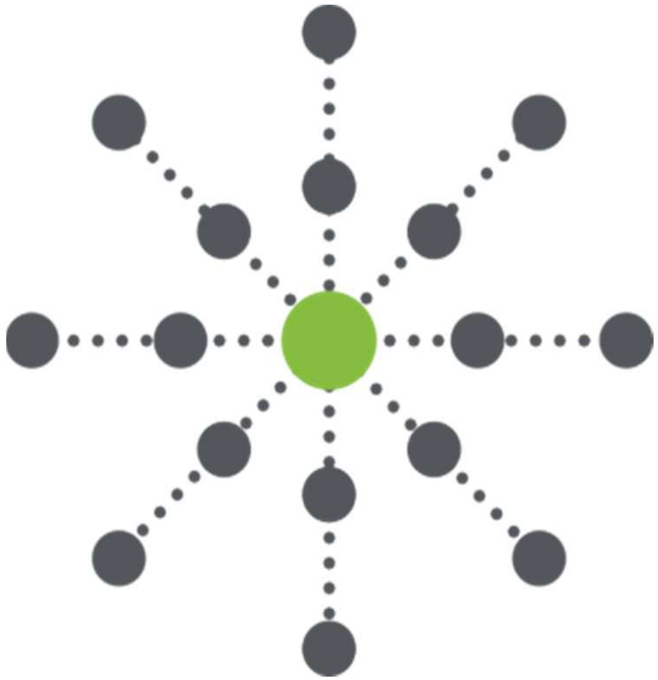
Economic profit split

An arm's length approach

- **Profit shares must align with risks**. Economic profit split (EPS) follows the arm's length principle that the economically significant systemic risks assumed by each entity determines the split of the global profit
  - In the market, risks and expected returns should be aligned
  - Higher systemic risk $\rightarrow$ higher expected profit
- **Fixed costs determine profit shares**. Split global profits for a particular period based on relative fixed cost commitments
  - Split ratio (determined ex-ante)
  - Fixed costs are also the maximum loss potential of parties in the current period
  - Split current contribution margin ex-post using fixed cost ratio

Profit split method enhances tax transparency

- **Breaking the complex code^**: PSM offers solutions for highly integrated operations for which one-sided method would not be appropriate
- **Country-by-country reporting (CbCR) – an enabler for PSM***: In the CbC era since more countries are implementing country-by-country reporting (CbCR), thus, tax authorities have an overview over the value chain provided by the taxpayer in the CbC report
- **Intricate value chain analysis***: Due the value chain analysis submitted by the taxpayer in the CbCR, the tax authorities have a complete view of the activities which can be considered as routine and have a clear eye on the activities- both routine as well as non-routine
- **Less likelihood of an improbable result^**: Both the parties to the transaction are evaluated, thus division of profits from joint efficiencies are achieved which satisfy both the taxpayer and the tax administration



*Article by McKinsey on Lexology- Googbye TNMM, Hello PSM

^ OECD TP guidelines 2017

Polling question 1

What proportion of your total related party dealings is the profit split method currently applied?

- More than 50% of your related party dealings
- Covers 25-50% of your related party dealings
- Up to 25%of your related party dealings
- Used profit split method in prior years but not in the current year
- Not used profit split method previously

Local experience

India

Highly integrated business operations
Background

- A U.S. based group, engaged in the production of chemicals, has globally integrated business. Each entity makes unique and valuable contribution towards the overall business, leveraging on unique capabilities of other entities
- The entities carry out one or more of the activities such as research and technology, manufacturing covering various levels of activities, sales and technological services
- Intellectual property of the group is legally owned by the parent but its economic ownership is shared globally by all the group entities
- Group uses profit split method for sharing group profits between different entities based on their contributions
- Entity in India carries on all the functions, i.e., manufacturing, sales and technology services (STS), and research and technology services (R&T)

Highly integrated business operations

Key value drivers

Integrated process flow

Parent

Significant value and profit drivers

Management function

- Oversees and directs the functions of the group companies

Research & Technology (R&T)

- Identification of new R&T opportunities
- Development and sharing of process knowledge

Manufacturing

- **Sales and operations planning**
- **Production planning**
- **Manufacturing**

- Matching demand-supply of different manufacturing plants
- Take decisions on the manufacturing, product mix and quantity for the entire group
- Local sites manufacture as per the schedule of the group

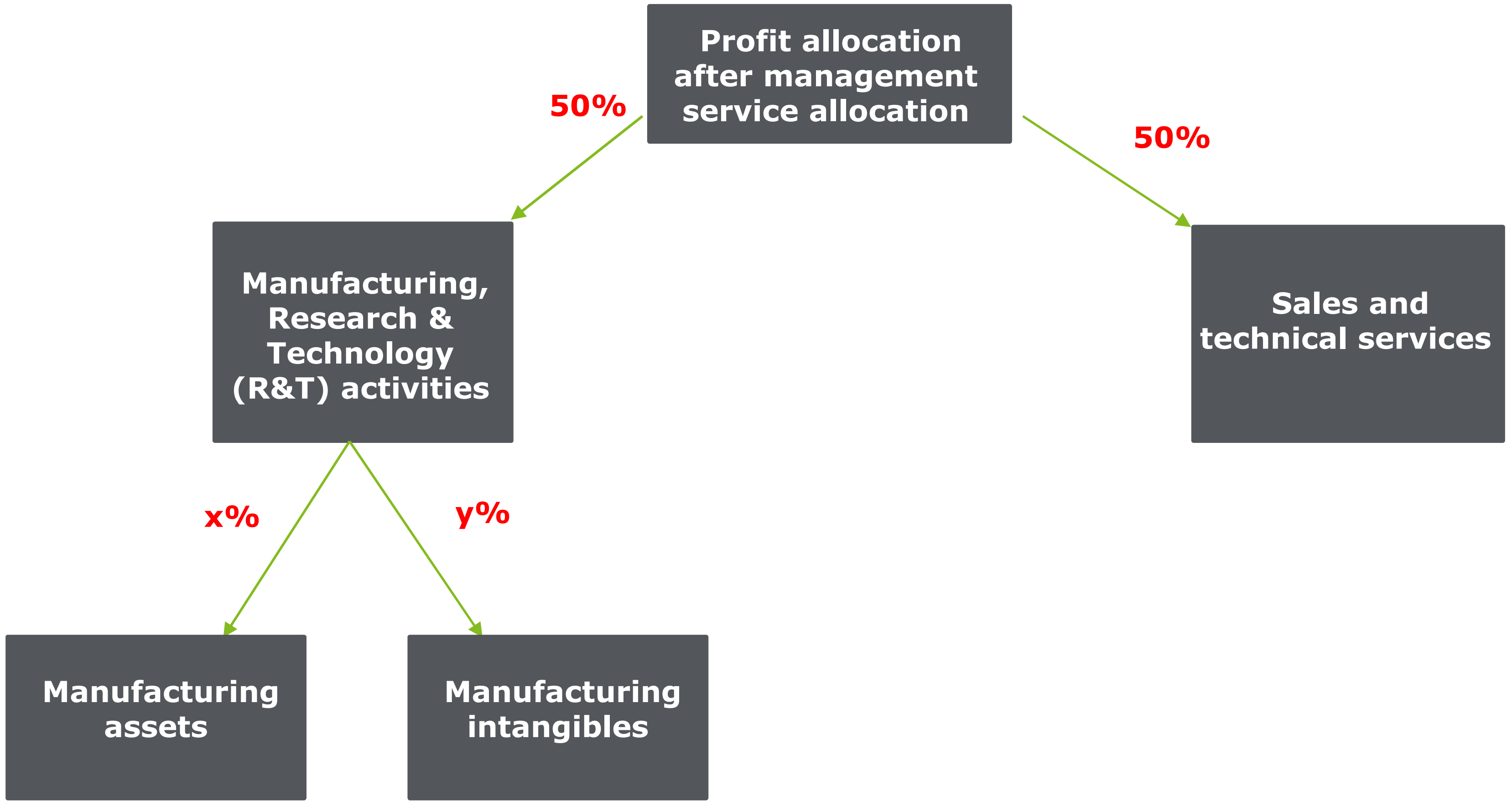
Sales & Technical Services (STS)

- Fixing the sales price
- Link between the R&T team and the sales team

Measure of profitability at the local entity level is often disconnected from its functionality – not necessarily reflected by the value added by that entity

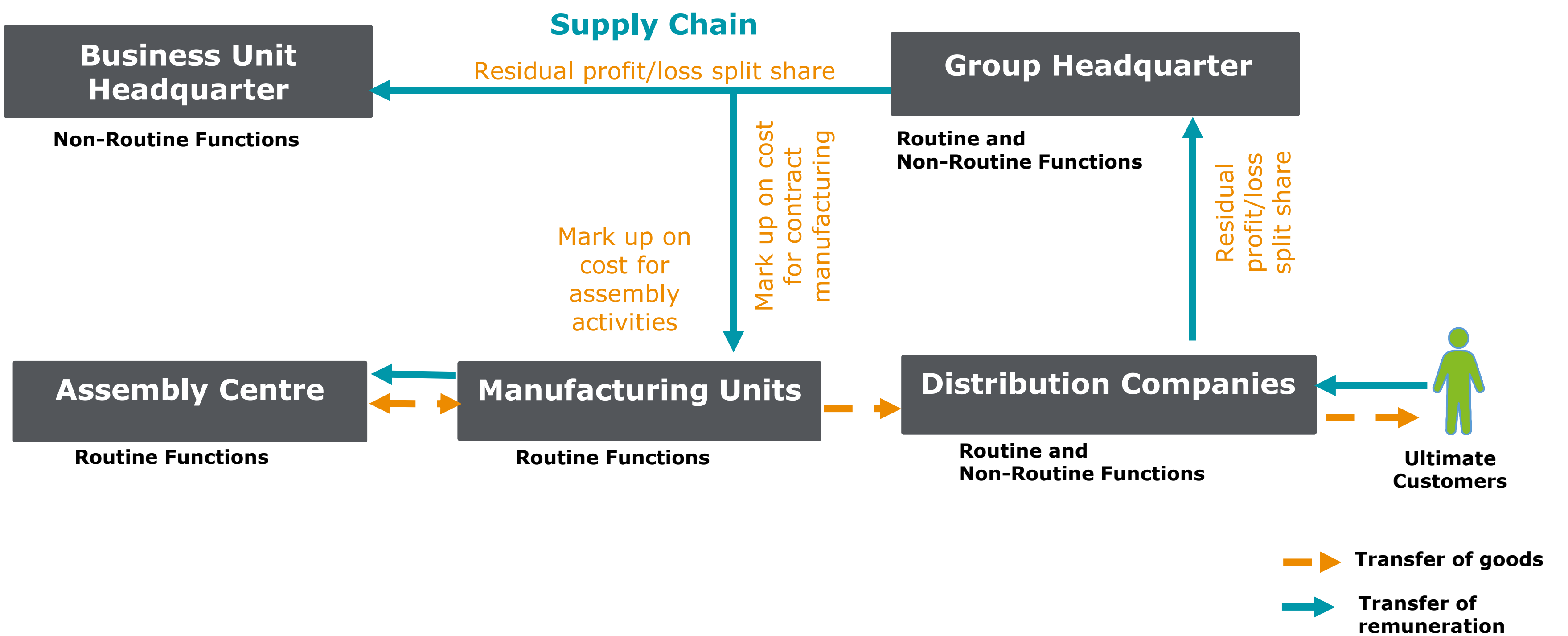
Highly integrated business operations
Profit split methodology

Profit split flow chart



Contribution analysis
Business model

Group entities classified as business headquarter, group headquarter, assembly center, manufacturing units and distribution companies.



As the operations of the MNE Group are considered highly integrated, Residual Profit Split Method (RPSM) was selected as the most appropriate transfer pricing method.

Contribution analysis
Profit split method

Remuneration for routine contributions

- Routine returns assigned to the routine functions (pertaining to contract manufacturing, assembly services, routine management services, and routine distribution function) performed by various group entities

Allocation of the residual profit/loss to the non-routine contributions

- Residual profit/loss is allocated across the group entities (group headquarter, business headquarter and distribution companies) identified as entrepreneurs as they perform significant value adding functions which constitute the “value drivers” of the MNE business. The process chart for determination of such residual return is depicted below

Identification of key value drives and sub processes

- Identify key value drivers in the value chain(i.e., R&D, marketing and sales, fabrication etc.)
- Determine key sub-processes within each of the aforesaid key value drivers

Value contribution analysis per entity type

- Undertake value contribution analysis by assigning weights/values to
  - Key value drivers
  - Different sub processes within value drivers
  - Different entity types within the MNE Group

Selection of residual profit split method

- Based on the value contribution analysis, a residual profit split model being built to determine the arm’s length outcome

Determine the final residual profit split allocation

- Based on the residual profit split model, determine the final residual profit split ratio between the entrepreneurial entities (with all distribution entities achieving same ROS)

China

China
Current environment

- Prevailing China IP rules – brief/not complete
  - Bulletin 45 and Bulletin 42 replaced relevant parts of Circular 2
  - Bulletin 6
- Limited to IP developments and intra-group service
  - Very general with no concrete operational guidance
  - No specified method for IP valuation
- In practice, many tax officials prefer profit split method for IP valuation
  - No guidance on IP economic life, discount rate, etc.
  - No distinction between routine and non-routine IPs
  - For inter-company services, tax authorities do have some practical experience on cost sharing

China
Potential IP ownership issues

- Currently, mainly two types of enterprises possibly viewed as IP owners
  - Companies having R&D activities with substantial risks and expenses
  - Companies with "New and High Tech Enterprises" title
    - With substantial R&D expenses to sales ratio (>=3%)
    - Approved by a government agency set up a few years ago in which the SAT has very limited role
    - If approved, enjoying a much lower income tax rate – 15% instead of 25%

China
Possible arguments if challenged

- If challenged, unless with supports of no IP ownership
  - Arguing R&D expenses as for routine IPs
  - If failed, using profit split method with shorter life and higher discount rate?
  - For companies with “high and new tech enterprises” title
    - Giving up the title – currently no penalty except giving up tax benefits, but in the future?
    - Maintaining the title and increasing profit margin due to IP ownership – could be costly and time consuming partly because of using profit split method

China

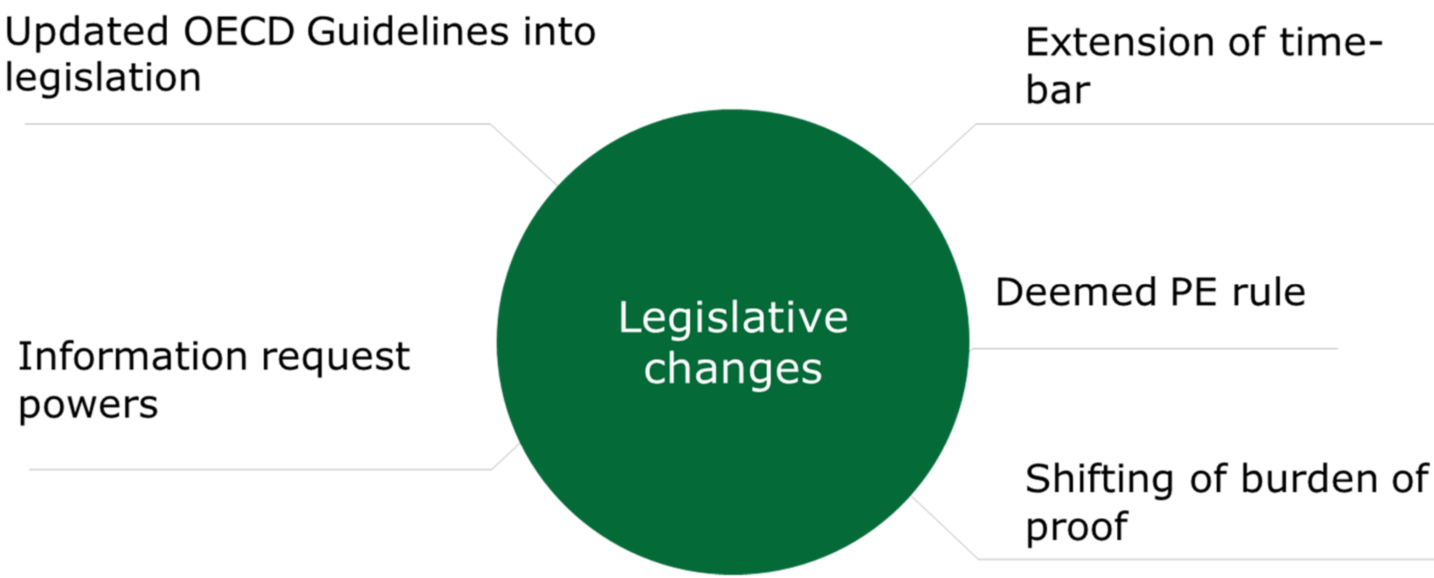
MAPs – importance of related parties' locations

- If a company makes TP adjustments because of IP ownership, MAP would be necessary, and location of relevant foreign related party is important
- If foreign related parties are non-U.S. companies
  - Not too difficult because the Chinese rules and BEPS are reasonably consistent
  - Profit split method is accepted by many countries, and preferred by the Chinese tax authorities
- If ultimate foreign related parties are U.S. companies
  - If "cash boxes" own IPs, no "double" taxation, but would the Chinese tax authority make higher adjustment?
  - If U.S. entities own IPs, could China SAT and U.S. IRS reach any agreement?
    - Would SAT accept smaller residual profit pool because of platinum?
- No IP cost sharing up to this point

New Zealand

New Zealand
Current environment

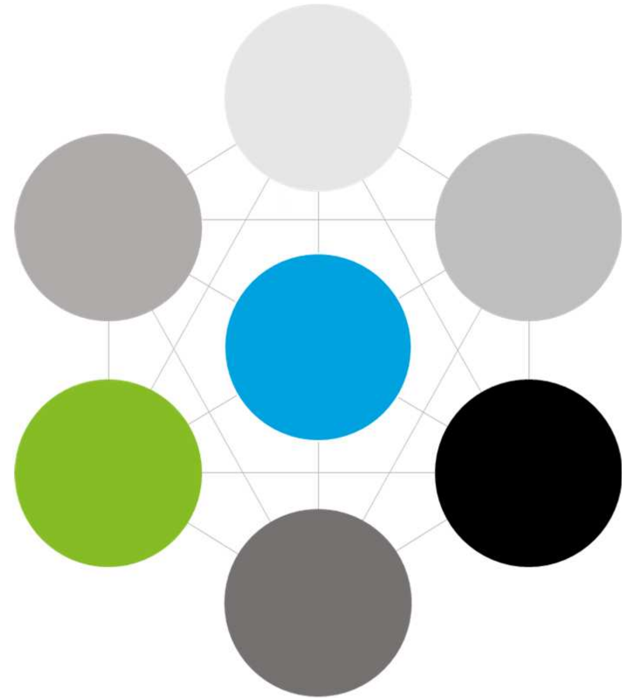
- BEPS concerns lead to audit activity of MNEs
  - Profit split approach as a challenge to TNMM
  - Seeking transparency on value chain of MNEs
- Active participant in OECD BEPS discussions



New Zealand

Practical impact of profit split application

- Tax authority aggressiveness in audits
  - Seek to understand entire value chain
  - Lengthy information requests
  - Overstated value of local contributions
  - Simplistic/unrealistic profit split approaches
  - Onerous to rebut – regional hub/spoke models may mean factual and financial analysis of numerous jurisdictions required



Polling question 2

Have you had any interactions with a tax authority where the profit split method has been raised as an alternative to an existing transfer pricing method?

- Yes, but the profit split method was not used to complete the audit
- Yes, and the profit split method was used to conclude the audit
- Yes, but the profit split method was adopted for future years only
- No, I have no experience on that
- Not sure/not applicable

Controversy/rulings

Controversy/rulings
Implications

- Greater uncertainty in risk/outcomes of audit
  - Larger pool of profit to split rather than one-sided analysis
  - More data to analyse
  - Requirement to understand situation in multiple jurisdictions
- Potential APA considerations
  - Can achieve greater certainty
  - But requires detailed understanding of value chain, and involvement of multiple tax authorities
  - CbC reporting may drive greater consistency across jurisdictions
- Importance of documentation and other evidence

Infogain India Pvt. Ltd (ITA No. 6134/Del/2012)

Facts of the case

- Infogain India was established in 1997 as a backend software services company. It rendered services to its parent in U.S., Infogain U.S. During AY 2008-09, there was a significant change in the functional matrix of the group
- Pursuant to this change, Infogain India transitioned from a back-end software services company to being fully responsible for the execution and delivery of software services to the end customers. Infogain India was responsible for significant delivery functions while Infogain U.S. was also responsible for marketing, client identification and customer relationship management functions. Activities performed by Infogain India and Infogain U.S. were closely linked and collaborative
- Considering the above business relationship, the taxpayer adopted profit split method (PSM) as the most appropriate method for determining arm's length price (ALP) of the international transactions

Issue under litigation

- During the audit, revenue rejected PSM, and applied TNMM instead. Revenue contended that the assesse adopted PSM only to camouflage the losses at the net level. Aggrieved, assesse preferred appeal before the ITAT
- ITAT upheld PSM since the activities performed by Infogain India and Infogain U.S. were inextricably interlinked and both the entities contributed significantly to the value chain of the business. ITAT also rejected revenue’s stand that PSM was adopted only to camouflage losses at net level

Global One India Pvt. Ltd (ITA No. 5571/Del/2011 and ITA No. 5896/Del/2012)

Facts of the case

- Global One India provides internet and related network services to the group's customers in India. These services include internet direct connections, installation/configuration of routers, etc. It also provides fully managed support solutions developed around basic network services
- Taxpayer's transactions were highly integrated, interconnected and interdependent. It involved more than one entity to complete a transaction. A transaction passes through a number of AEs, and each group entity makes a contribution in an integrated manner for the transaction to complete
- Accordingly, the taxpayer adopted profit split method (PSM) as the most appropriate method (MAM) for benchmarking the transactions, taking into account contribution of each entity, which was unique, valuable and integrated

Issue under litigation

- During tax audit, revenue concluded that assesse operated as a standalone entity in India and rejected PSM stating that taxpayer did not bring any evidence to show that it had unique intangibles to use PSM as the MAM
- ITAT rejected revenue's stand and observed that the taxpayer's operations were highly integrated, interconnected and interdependent and the group relies on the functions of each of its entities to generate revenues. Further, each group entity owns assets and employs manpower, with the help of which they operate different locations of the network and thus contribute to the entire Group
- ITAT concluded that when one transaction requires deployment of assets and functions of different entities located in different geographical locations, to ultimately deliver services and when such combined efforts generate revenues, then PSM can be adopted as the MAM

Indian court rulings – PSM not applied

Marubeni India Pvt. Ltd.(ITA 94/2015)

Facts of the case

- The assesse primarily rendered agency services on behalf of its parent and other group companies. The assesse also liaised between various business departments of the group and their suppliers/customers in India. Apart from undertaking such activities, the assesse was also engaged in trading on its own. The assesse adopted TNMM as the MAM

Issue under litigation

- Revenue opined that assesse provided some crucial services to its AEs which formed basis of sourcing activities carried out by AEs from or to India
- Revenue held that assesse was making sizeable investments in exploring and analyzing Indian market, developed several unique intangibles which gave advantage to the AEs. It was also held that the assesse performed all critical functions while rendering services to its AE s by assuming significant risks
- Revenue thus concluded that the assesse developed and made available its supply chain and human intangibles to its AEs
- Revenue placed reliance on Delhi ITAT's order in case of Li & Fung (India) Pvt. Ltd. and adopted PSM as the MAM and held that 70% of the total profit earned by its AE from the goods traded from or to India should have been given to the assessee
  - ITAT upheld that the risk of the assesse in mediating between its AEs and suppliers from India was limited and minimal with least capital employed and its role in the international transactions was confined merely to acting as a mediator between the AEs and buyers/sellers in India
  - Given the above reasons, ITAT upheld that the assessee's transfer pricing method, i.e., TNMM is most appropriate
  - Aggrieved, the Revenue appealed before the Delhi HC But, even the HC upheld the decision of the ITAT

Emerging issues

Emerging issues

- Digital business models
  - Common factors
    - Cross-jurisdictional scale without mass
    - Reliance on intangible assets
    - Data, user participation, and network effects
  - One sided TNMM focussed on “in-market” activity
  - Value creation and DEMPE activities not undertaken by MNE in the market. Consider whether profit split and TNMM produce consistent results
- Financial transactions
  - Locations of risk management
  - Financial technology and automation on risk taking processes

Questions and answers

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