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BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

The OECD on 16 December issued a non-consensus discussion draft on the use of profit splits in the context of global value chains in connection with Action 10 of the Action Plan on Base Erosion and Profit Shifting (BEPS) to develop "rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to . . . (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains."

The discussion draft does not contain specific proposed modifications to the OECD's transfer pricing guidelines, but rather, presents eight scenarios whereby the profit split method could potentially be applicable, and solicits comments from interested parties to elaborate on these scenarios regarding the relative reliability of such methods. The eight scenarios reflect many of the themes in the proposed changes to Chapter VI of the OECD's transfer pricing guidelines on intangibles and Chapter I on risk. The discussion draft is an attempt to define an applicable transfer pricing method, if rights to intangible returns are split between the developer and others under Chapter VI or the multinational enterprise's operations are determined to be integrated and interdependent, which creates valuable synergies, as suggested in the proposed revisions to Chapter I.

To date, taxpayers' unilateral use of profit splits has been confined for the most part to a narrow set of circumstances or to situations in which taxpayers obtain government agreement as part of an advance pricing agreement or mutual agreement procedure. The fact that no language has been proposed may suggest that governments are struggling to find an approach that would enable profit splits to be reliably applied in a broader, more general context. It also may reflect the concerns of some countries regarding the direction of the changes in Chapters I and VI.

The discussion draft contains several scenarios in which the parties appear to have intended to share the operations and risks of the business, but leaves unanswered the question whether taxpayers in similar situations could have structured their business in a different way so that profit split is not the most reliable method. In the past few years, many businesses have structured their business using principal companies, or have employed cost sharing or other arrangements to avoid some of the perceived difficulties in applying the profit split method.

Importantly, the discussion draft does not suggest specific solutions to many of the issues that made profit splits challenging for MNEs to apply, including:

- The lack of comparable or transactional profit splits;
- Allocation keys to split profits that do not end up being simply a form of formulary apportionment;
- Determining the income and expenses to derive the profits to be split;
- Treatment of losses;
- Creation of partnerships for tax and commercial purposes;
- Reduction in the protection of the rights afforded to separate entities with respect to creditors;
- Splitting profits between more than two entities and the impact of transfer pricing adjustments to routine entities on participants splitting profits.

The discussion draft requests comments on how to address many of these concerns; others are unaddressed.

(1) Method Selection

Consistent with proposed guidance in Chapter VI, the discussion draft cautions that one-sided methods, including the comparable uncontrolled price (CUP) method and the transactional net margin method (TNMM), are generally not reliable methods for intangibles transactions. The discussion draft asks whether the applicability of the profit split methods can be expanded beyond intangibles to include routine transactions that may take place in a "highly integrated" business model, in part because independent comparable companies performing a single activity cannot provide the same level of integration with a company's operations as a wholly owned subsidiary. For example, it is stated that a comparable company providing only warehousing, logistics, sales, or marketing activities could not provide the same level of integrated service as a wholly owned subsidiary providing the same service but in combination with other wholly owned subsidiaries. Some will question the validity of this statement.

(2) Specifics of OECD Guidance on Profit Split Methods

Below we describe briefly each one of the scenarios in the discussion draft.

1) Value Chains

In Scenario 1, three controlled manufacturers located in the same region with similar capabilities coordinate their product offerings and investments through a Leadership Board on which all three are represented. This scenario assumes that all IP licensing and tangible product transactions can be analyzed using other methods. The Leadership Board effectively creates a three-way controlled "transaction" that the discussion draft appears to suggest can only be analyzed using the profit split method. Although a profit split may appear reasonable in this factual situation, it may be possible that the MNE group did not structure the transaction as described above, but rather as a more typical principal/contract manufacturing structure, and the tax authorities, after performing a detailed functional analysis, determined that the "substance" of the parties' activities was better described as above than as the MNE group had structured the transaction. See the discussion draft on risk and recharacterization.

Even if a profit split method is applied to determine target profit levels for each enterprise, the results of the profit split would still need to be reflected in the individual transactions among the entities as payments for goods or services. Otherwise, the profit split approach may lead to a virtual partnership, with tax and legal business liability implications extending beyond transfer pricing.

2) Multisided Business Models

In Scenario 2, the discussion draft offers the example of an MNE in which Company A offers advertising services and related technologies, such as targeting and user interfaces to clients, charging a fee to the client per click on hosted advertisements. Company B offers free online services to end-user customers and gathers information on their behavior, location, and personal information, which is used to enhance the value of the advertising sold by Company A.

Many may question whether the activities of Company A are fundamentally different than the activities of comparable companies or that the services Company A provides are fundamentally more valuable than the services of third parties because of integration with or the control that Company B exercises over Company A.

3) Unique and Valuable Contributions by a Distributor

The discussion draft discusses the application of the transactional profit split method in scenarios in which both parties make "unique and valuable contributions." Scenario 3 presents the example of a distributor whose "activities constitute a key source of competitive advantage for the Group" because the distributor:

- develops very close relationships with customers;
- provides on-site services;
- carries an extensive stock of spare parts;
- has a highly proactive maintenance program to detect likely problems before they arise; and
- provides extensive advice to customers on equipment choice, makes modifications for particular local conditions, and for maximizing performance efficiency and effectiveness of the customer's operations.

As part of this scenario, the discussion draft asks whether the definition of "unique and valuable contributions" in Chapter VI intangibles guidance should be expanded to include the activities defined above. Some may question why comparable independent distributors in similar industries cannot be found that provide similar activities.

4) Integration and Sharing of Risks – Joint Development of Intangibles

The discussion draft argues that in addition to integrated value-added functionalities, some MNEs operate in a manner that shares significant business risks, which should also be compensated but may be difficult to analyze without a profit-split methodology. In Scenario 4, Company A develops a complex technological product and outsources development of certain critical components to related entities, Companies B and C. All entities are required to conduct intensive research and development to develop their respective components, and each bears the potential for failure. Thus, the risk of the final product is shared among all entities. In this case, the application of the profit split method appears to be predicated on the taxpayer's choice to jointly develop the intangibles and spread the product development risks among three legal entities. A profit split method may more reliably align with the taxpayer's desire to share intangible development costs and risks among the three entities. However, the parties may not have structured the transaction as described above. Company A may have entered into a contract research agreement with Companies B and C but failed to manage and control the "important functions" described in the proposed revisions to Chapter VI and, therefore, the tax authorities in Countries B or C may have concluded that in substance the transaction is more like the transaction described in this example than a contract research structure.

Fragmentation – Limited Functional Entities

The discussion draft notes, without providing a scenario, that occasionally in the operation of a complex MNE, necessary functions may be fragmented among multiple subsidiaries, such as separation of distribution activities into specialized activities such as logistics, warehousing, marketing and sales, etc. The guidance notes that it may be difficult or impossible to find comparables for such specialized functions, and thus a transactional profit split method may be appropriate.

An MNE may require the services of multiple entities, performing routine functions, but it is unclear why the MNE would not be able to attribute reliable returns to those entities based on the profitability of functionally similar independent companies through a reliable application of the TNMM. In fact, one may argue that independent companies provide more functions, for example sales and marketing activities, and are subject to more risks than related companies.

5) Lack of Comparables for Distributors Sharing Regional Customers

In Scenario 5, the discussion drafts asks how reliable comparables may be found for a group of controlled distributors that generate both wholly local business and regional-level business for all companies within the region by developing relationships with large customers spanning the region. This is a common fact pattern that some taxpayers address through the use of “cost sharing” arrangements whereby the cost of maintaining relationships with global customers are shared among the companies that make sales to such global customers in proportion to reasonably anticipated benefits. Other alternatives may achieve similar results.

Use of the TNMM range in connection with profit split

In Paragraph 32, the discussion draft attempts to reconcile the TNMM with a profit split. The discussion draft suggests that taxpayers could adopt a policy that varies distributor returns within the TNMM range as the global profitability of the enterprise increases or decreases, allowing for some flexibility.

6) Aligning Taxation with Value Creation

The discussion draft notes that the OECD, as part of the BEPS Action Plan, is attempting to revise its rules to align taxation with value creation. The draft notes that a common criticism of allocation key techniques used in profit split methodologies is the difficulty in verifying the accuracy of such keys. The discussion draft refers to the first example of the three manufacturers operating in the European market, and assumes that any post-royalty residual profits are split between the three controlled manufacturers based on three factors: production capacity, headcount, and value of production, which are intended to reflect capital investment, labor, and the contribution to actual output, respectively. To some, this would appear reasonable, but there is a consideration that this example is rarely seen in the real world. One concern is that any set of allocation keys adopted in tightly drawn examples could be used in factual patterns that are not so tightly drawn. In other fact patterns, such an allocation could resemble formulary apportionment. Also, the suggested profit split approach among these entities may give rise to a partnership.

RACI Matrix

In Scenario 6, the discussion draft questions whether a qualitative functional analysis can be converted to a more scientific profit split by using a responsibility assignment matrix that assigns each entity to one of the following four levels for each function:

- R: Responsible
- A: Accountable
- C: Consulted
- I: Informed.

The discussion draft concedes that RACI does not consider risks and assets separately, but rather assumes that they are aligned with the functions. The RACI analysis is applied to “each of the group’s key value drivers.” The scenario neither enumerates the key value drivers considered, nor how the RACI matrix can be calculated to arrive at profit shares.

7) Ex Ante vs. Ex Post Results

The discussion draft notes that sometimes there are significant differences between ex ante and ex post results. In those cases, a profit split method can determine from the outset how parties will determine the share of uncertain outcomes.

In Scenario 7, two related enterprises agree to assume responsibility for the development of the two key components of a product. They agree to share residual profits on a 30-70 basis, based on the relative size of projected development costs. However, each party assumes its own development cost overrun risks. Therefore, the actual development costs would not necessarily be split on a 30-70 basis between the parties. The discussion draft solicits comments on how to deal with unanticipated events or results in applying a transactional profit split.

In Scenario 8, the discussion draft notes that sometimes profit split methods can be used on an ex-ante basis to determine arm's length royalties. In this scenario, Company P conducts the basic R&D for a product, with subsidiary Company S performing marketing activities and some late-stage development. Risk-weighting the expenditures using development stage success rates, the costs and consequently the profits are split 80-20. P's expected profit is then converted to a royalty rate. However, depending on how much actual sales differ from projected sales, the transfer pricing policy of a royalty rate may result in a different split of profits than was originally indicated by the profit split method.

The discussion draft acknowledges that a direct application of a profit split method based on actual profits would require "end of year calculations to true-up the profits to equate to the profit split ratio," and this may create administrative compliance issues. The draft asks about the pros and cons of allowing a royalty implementation of a profit split method.

8) Losses

The existing OECD transfer pricing guidelines note that references to "profits" should be applied equally to "losses," however, the discussion draft includes a scenario whereby profit split methods may be applied differently when losses are split rather than profits.

In Scenario 9, a banking group trades a structured financial product through an integrated model in different time zones. Profits are allocated using a profit-split method that places the greatest weight on compensation to its traders, including bonus performance. However, there may be significant losses, and the correlation between bonus compensation and loss will not be equivalent to the correlation between bonus compensation and profit in profitable times. Consequently, the methodology includes adjustments when losses are incurred, based on analysis of the compensation policy and the circumstances in which losses are incurred.

(3) Question 31 -- Concerns regarding availability of financial data:

The discussion draft asks whether the concerns expressed in the OECD transfer pricing guidelines regarding the reliability of profit split methods remain valid. These concerns are summarized as follows:

- Accessing Foreign Data: "Associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates."
- Measuring Consolidated Profits: "It may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies."
- Segmented Operating Expenses: "When the transactional profit split method is applied to

> operating profit, it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises' other activities."

Experience suggests that for many companies these concerns remain.

(4) Comments

Profit splits generally have been used unilaterally by MNEs in a few defined situations in which the structured economics of the transaction clearly called for a profit split, and in advance pricing agreements and other situations directly involving a government's consent. The discussion draft clearly illustrates the challenges of reliably applying the profit split method on a more general basis to a broader range of potential transactions.

The use of profit split as the most reliable method in many cases discussed in the draft is based on the assumption that one-sided methods are not reliable because adequate comparables do not exist due to the integrated, interdependent, synergistic operation of many MNEs. This issue goes to the heart of the application of the arm's length standard, and is likely to be the subject of vigorous debate in the context of this discussion draft and the discussion draft on risk and recharacterization.

The State Administration of Taxation (SAT) might find a few scenarios as illustrated in the discussion draft particularly relevant to China's practices. For example, scenarios regarding the unique and valuable contributions made by the local distributors which might be defined as "routine distributors" from the MNC's perspective, the fragmentation of functions of the MNC group which leaves only routine returns for each "limited function and risk" group subsidiaries as well as the lack of comparables for the controlled transaction in question. Through the recently concluded transfer pricing investigation cases and the bilateral advance pricing arrangements (APAs), it is clear that the SAT is trying to move away from those traditional one-sided transfer pricing methods with more emphasis on analyzing the relative contributions made by the PRC subsidiaries in the context of the MNC group's global value chain, which will usually imply the application of the profit split. Nevertheless, as many of the concerns surrounding the applicability of profit split remain unaddressed in the current discussion draft, how the SAT will respond (including the possible revision of China's domestic transfer pricing laws and regulations) remain to be observed upon release of the final report in this particular area.

Comments on the discussion draft are due to the OECD by 6 February 2015.

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