



## Global TP Alert 2015-017

### BEPS Final Report Updates Scope of Work for Guidance on Profit Splits

The OECD Secretariat on October 5 published 13 papers and an Explanatory Statement outlining consensus Actions under the Base Erosion and Profit Shifting (BEPS) project, ahead of the G20 Finance Ministers' meeting in Lima on October 8. 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 the transfer pricing guidelines. The G20/OECD will continue its work on some specific follow-up

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areas and a timetable for implementation during the remainder of 2015, 2016, and into 2017.

As part of the 2015 deliverables, the OECD Secretariat issued a short summary of the status of the ongoing 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*. Further work on profit splits will be undertaken during 2016 and into 2017.

In the summary, which describes the scope of work for guidance on the transactional profit split method, the OECD Secretariat recognized that any guidance on profit splits should take into account the rise of integrated models common in the digital economy and the additional guidance provided on (i) the allocation of risk, (ii) group synergies, (iii) the valuation of transactions involving intangibles, and (iv) the splitting of the return on intangibles as a result of the risks incurred and functions performed by different entities within the multinational enterprise.

### **Use of the Transactional Profit Split Method**

In December 2014, the OECD Secretariat released a discussion draft on the use of the 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 that emerged 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 summary now recognizes 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 when the facts of the case make other transfer pricing methods problematic.

The scope of work document states that the revised guidance will be based on existing guidance (in Chapter II of the transfer pricing guidelines) but will clarify and supplement it, with practical application 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 digitized 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 in which 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 between the parties, in particular concerning risk allocation, to the payment of a fee for goods and services. When a sharing of profits would be unlikely to represent an arm’s length outcome, the revised guidance will emphasize 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 the 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 what constitutes “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. The guidance will include references to third-party situations in which profit split models are used.

### **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 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 finalized by June 30, 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. The challenge for the OECD Secretariat will be to provide clear principles to be taken into account consistent with the arm's length standard, and to provide practical guidance that both business and tax administrators can apply without resort to protracted discussions and controversy, particularly given that it will not be possible to provide examples for every situation that may arise given the inherent variety in commercial value chains. Even with additional guidance, uncertainties may remain around the practical difficulties of applying the profit split method in situations involving potentially multiple jurisdictions and ensuring that tax authorities in multiple countries are able to come to a principles-based agreement based on the arm's length standard.

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