

# B.E.P.S. ACTION 10 – PART I: PROFIT SPLIT METHOD IN THE CONTEXT OF GLOBAL VALUE CHAINS

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## Tags

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## INTRODUCTION

There has been another release on Base Erosion and Profit Shifting (“B.E.P.S.”) deliverables. B.E.P.S. refers to the tax planning that moves profits to a low-tax jurisdiction or a jurisdiction that allows a taxpayer to exploit gaps in tax rules. These deliverables have been developed to ensure the coherence of taxation at the international level. The aim of these deliverables is to eliminate double non-taxation. The measures have been developed throughout 2014, and they will be combined with the work that will be released in 2015.

In the December 16th release on Action 10 (the “Discussion Draft” or “Draft”),<sup>1</sup> Working Party No. 6 on the Taxation of Multinational Enterprises (“M.N.E.’s.”) released various factual scenarios, posed questions and invited affected persons to suggest answers. The goals of the Draft are to assure that transfer pricing outcomes are in line with value creation and to determine whether it is more appropriate to apply the profit split method in some circumstance instead of a one-sided transfer pricing method.

## RELEVANT ISSUES

The Draft identifies relevant issues in the posed scenarios, asks questions, and invites commentary as follows.

### Value Chains

The term “global value chain” describes a wide range of activity, from the consumption of the product to the end use and beyond. Therefore, one particular method of transfer pricing may not be appropriate.

#### **Scenario 1:**

Three associated Original Equipment Manufacturing (“O.E.M.”) enterprises in the durable goods industry are located in different territories in Europe. Each of the O.E.M.’s manufactures finished goods and components for its local market and the European market. They license in technology I.P. from their non-E.U. parent, for which they pay a royalty, but otherwise the European operation of the group is largely independent of the parent. The O.E.M.’s have a number of subsidiaries in Europe providing contract manufacturing services in relation to certain components. Sales and distribution takes place

<sup>1</sup> O.E.C.D. (2014), “BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains.”

through other group subsidiaries, and, in the O.E.M.'s own state, through a division of the O.E.M. itself.

The Draft identifies that a one-sided method can be appropriate and reliable to determine arm's length pricing for the royalty and for the contract manufacturing and distribution services.

However, a one-sided method may not be reliable and the profit split method may be preferable under the following conditions:

- Highly integrated transactions involving O.E.M.'s;
- An over-arching Leadership Board on which all three O.E.M.'s are represented;
- The Leadership Board that makes decision for the business as a whole (e.g., the board identifies the new products to be developed, the location within Europe where the products will be developed, the location where the products will be built, the scope of plant investment is to be made, and strategic marketing);
- The O.E.M.'s trade with each other, buying and selling components and finished goods; and
- The success of the business depends on having a wide portfolio of products to sell across the European market.

#### **Questions:**

1. *Can transactional profit split methods be used to provide a transfer pricing solution to this Scenario? If so, how?*
2. *What aspects of Scenario 1 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?*
3. *Is the application of a transactional profit split method more useful than other methods for dealing with particular aspects of value chains, such as highly integrated functions and the sharing of risks?*
4. *What guidance should be provided to address the appropriate application of transactional profit split methods to deal with these aspects of value chains?*

#### **Multisided Business Models**

This following scenario highlights a multisided and integrated digital economy business model. The diverse functions are carried out by various entities of the M.N.E. group which closely relate to the group's core business model.

##### **Scenario 2:**

The RCo Group provides a number of internet services such as search engines, e-mail services, and advertising to customers worldwide. On one side of the business model, the group provides advertising services through an online platform and charges clients a fee

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based on the number of users who click on each advertisement. On the other side, the RCo Group provides free online service to users that provide the RCo Group with substantial data information such as location-based data, data on online behavior, and users’ personal information. Over the years, the RCo Group refines its methodology for data collection, processing, and analysis. As a result, it provides clients with a sophisticated technology that allows them to target specific advertisements to certain users.

The technology and algorithms used in providing the internet advertising services were originally developed and funded by Company R, the parent company of the RCo Group.

In order to interface with key clients, the group formed local subsidiaries to perform various functions:

- Promote the free use of online services by users, translate advertising into local languages, tailor advertising to the local market and culture, ensure that the services provided respect local regulatory requirements, and provide technical consulting to users.
- Generate demand for and adapt advertising services.
- Regularly interact with Company R staff responsible for developing technology to provide feedback on the algorithms and technologies to enhance business in various markets.

#### **Questions:**

1. *Can transactional profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how?*
2. *What aspects of Scenario 2 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?*

#### **Unique and Valuable Contributions**

The Draft points out that when there are unique and valuable contributions from two parties, the transactional profit split method is the most appropriate method. The term “unique and valuable contributions” is not defined, but it is used in the amendments to Chapter VI, contained in the 2014 report *Guidance on the Transfer Pricing Aspect of Intangibles*. The term connotes a key source of competitive advantage for the business.

#### **Scenario 3:**

Company P, located in country P, is a manufacturer of high technology industrial equipment. Company S, a subsidiary of Company P, markets and distributes the equipment to unrelated customers in country S. Both companies are members of Group X.

Company P conducts extensive R&D activities to develop and improve the technological features of its equipment; it also funds and

has legal ownership of all the technology intangibles it develops. In addition, Company P owns the global trademark, and provides broad guidance to its subsidiaries around the world on its overall marketing strategy. There are several global competitors making similar equipment that operate in Country S, which is a large market for such equipment.

Company S is responsible for sales of the equipment and undertakes marketing activities. Due to the nature of its business, Company S develops close relationships with customers. It provides on-site services, carries an extensive stock of spare parts, and is highly proactive in detecting potential problems. Company S advises customers on equipment choices and suggests modifications for particular local conditions, or to maximize performance efficiency, or to enhance effectiveness. These activities provide a significant competitive advantage as customers place high value on the reliability and performance of the equipment. In this case, Company S is recognized as not merely a “routine” distributor, but its activities constitute a key source of competitive advantage for the Group.

**Questions:**

1. *Does the way in which the term “unique and valuable” is defined for intangibles assist in defining the term “unique and valuable contributions” in relation to the transactional profit split method?*
2. *What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method?*
3. *Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm’s length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?*
4. *What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3?*

**Integration and Sharing of Risks**

The Draft points out that one-sided methods may not be reliable to account for the synergies and benefits created by integration. Moreover, where an M.N.E.’s business operations are highly integrated, strategic risks may be jointly managed and controlled by more than one enterprise in the group, creating a strong interdependence of key functions and risks between the parties.

**Scenario 4:**

Company A, in country A, manufactures and sells sophisticated medical equipment to unrelated customers. In developing a new generation of equipment, it outsources the development and production of certain key equipment components to its associate enterprises, Companies B and C. The development of the components is a lengthy and complex process. The components are highly specific



and unlikely to be useful in other types of products. Companies A, B, and C each control and perform their own research, development, and production processes.

All third-party sales revenue from the equipment will initially accrue to A. The rewards to companies A, B, and C are contractually determined by the M.N.E. group on a profit-sharing basis.

**Questions:**

1. *In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks?*
2. *Would a one-sided method produce more reliable results?*
3. *What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?*

**Fragmentation**

The M.N.E.'s divide various functions within a value chain. This is sometimes referred to as fragmentation of functions. It is difficult to find comparable uncontrolled enterprises with similar specialized activities. In addition, it may be hard to account for the high level of interdependence between the functions performed by the associated enterprises that may be absent in independent enterprises. For this reason, the Draft suggest that it may be feasible to undertake a transactional profit split method approach to identify comparables for some or all the fragmented activities on a combined basis, and to apply the principles of a contribution analysis to divide benchmark profit.

**Questions:**

1. *Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how?*
2. *Can transactional profit split methods be used to provide reliable arm's length transfer pricing solutions for fragmented functions? If so how? Can other methods address the issue of fragmentation, and, if so, how?*
3. *What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?*

**Lack of Comparables**

The Draft points out that one-sided methods can be reliable even when there is a lack of comparables, by broadening the scope of the search to other jurisdictions with similar economic conditions and by making accurate comparability adjustments. However, when limitations to the accuracy of a one-sided method exist, the Draft considers using the transactional profit split method.

*“The M.N.E.’s divide various functions within a value chain. This is sometimes referred to as fragmentation of functions.”*

*“In cases where available comparables for the application of a one-sided method may not be reliable, a transactional profit split approach may offer a better means to measure results.”*

### **Scenario 5:**

An M.N.E. group operates as a supplier of office stationery in a region. The group has operations in several countries, and each operating company supplies stationery products to its local customers. Some larger customers also operate across the region and primarily want to deal with suppliers who can operate regionally. As a result, the activities of each operating company of the M.N.E. involve:

- Selling to local customers,
- Agreeing to terms and taking orders from local customers buying on behalf of their regional organizations, and
- Fulfilling orders placed with other group companies.

All orders are invoiced and fulfilled locally in accordance with the terms agreed. The mix of local and regional business varies from year to year and from operating company to operating company.

#### **Questions:**

1. *How can comparables be found and applied in Scenario 5? What method is likely to be appropriate for determining an arm’s length remuneration for the activities of the group companies?*
2. *How can comparables be found and applied in Scenario 3 (or to any other relevant Scenario in this discussion Draft)?*
3. *What aspects of Scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?*

In cases where available comparables for the application of a one-sided method may not be reliable, a transactional profit split approach may offer a better means to measure results. For example, application of a one-sided method may result in establishing a range of operating margins of 4-10% for one of the parties to the transaction: a baseline return of 7% is adopted which would vary in accordance with a predetermined computation upwards to 10% and downwards to 4% depending on the levels of consolidated profits or sales achieved by the parties to the transaction.

#### **Questions:**

1. *In what circumstances, if any, might an approach described in the last sentence above be appropriate?*
2. *More generally, in what circumstances would a transactional profit split approach be useful in supporting the application of other transfer pricing methods, and what guidance would be useful to develop for the supporting use of such approaches?*

### **Aligning Taxation with Value Creation**

The Draft views the profit split method as a means of achieving an alignment between profits and value creation. But at the same time, the Draft identifies the weakness of the transactional profit split method: because it is subjective, allocation keys can be difficult to verify from objective evidence.

In Scenario 8, the Draft focuses on ways to develop objective profit split factors and asks if there are other factors that are likely to reflect value creation in particular industry sectors. Scenario 1, discussed above, involves a set of integrated activities of three manufacturing O.E.M.'s. In Scenario 8, the Draft looks at the same fact pattern adjusted to account for post-royalty residual profits or losses. These items are split between the O.E.M.'s on the basis of three factors:

- Production capacity – This recognizes capital investment;
- Headcount – This recognizes the key input of labor; and
- Value of production – This recognizes the contribution to actual output.

Each factor is intended to reflect key value drivers in the business, as identified from a detailed functional analysis. These factors may require adjustments to take into account special circumstances.

**Questions:**

1. *In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?*
2. *What guidance is needed on weighting of factors?*

In addition, Scenario 6 considers using a matrix that evaluates the relative importance of the parties' various contributions to value creation.

**Scenario 6:**

Company A, located in country A, purchases technological goods from its associated manufacturer (Company B) located in country B. Company A determines and controls the business development strategy of the group. It decides the markets in which the group will operate and the product range and pricing within each market. Company B obtains the use of relevant I.P. under a license from another group entity (Company C) which developed the I.P. The license fee payable to Company C is subject to a separate transfer pricing analysis based on comparable, independent transactions. Company A sells the products to local distribution entities.

Company B determines and controls the global group manufacturing strategy including the procurement process and the structure of the supply chain. It develops and owns I.P. related to the manufacturing processes for the group's products. The actual manufacturing is carried out on a contract basis by another group entity (Company D) also located in country B.

After undertaking a detailed analysis of the commercial and financial relations between the enterprises in the group, including the functions, assets, and risks of the parties, and considering the availability of potential comparables, the M.N.E. group adopts a transfer pricing methodology based on a split of the total system profit from transactions between Company A and Company B. From their profit shares,

Company A and Company B provide arm's length remuneration to Company C, the local distributors, and the manufacturing entity in country B using one-sided methods.

The allocation of the system profit between Company A and Company B was determined by an analysis of their respective contributions to each of the group's key value drivers. Each of the personnel (i) responsible for, or (ii) accountable for, or (iii) consulted in making, or (iv) merely informed of relevant decisions was taken into account for each process contributing to a particular value driver. The analysis was reviewed and updated annually. Risks and assets were not considered separately as they were considered by the M.N.E. group to be embedded in the processes that managed them.

**Questions:**

1. *How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (e.g., approaches based on concepts of bargaining power, options realistically available, or a R.A.C.I.-type analysis of responsibilities and decision making)?*
2. *Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an M.N.E. operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate?*

There are some weaknesses in the methodology when the cost of the contribution made by the parties may be unreliable. The cost contribution may not reflect correct value of the contribution.

**Question:**

1. *What specific aspects of transactional profit split approaches may be particularly relevant in determining arm's length outcomes for transactions involving hard-to-value intangibles?*

**Dealing with Ex Ante/Ex Post Results**

The Draft suggests that the appropriate approach may be to use a transactional profit split method when dealing with unanticipated events. Scenario 7 shows how a transactional profit split method can be used to determine from the beginning how to share profits when the outcome is uncertain.

**Scenario 7:**

Two associated enterprises jointly agree to share the development of a new product, and each associated enterprise will be responsible for developing and manufacturing one of the two key components. At the outset it is estimated by the enterprises that the development costs will be 100 in total, with 30 estimated to be incurred by one of the parties and 70 estimated to be incurred by the other. Several risks exist. First, there is risk that the project will not produce the

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*“In Scenario 9, the Draft questions whether losses should be split differently from profits.”*

expected returns. Second, there is a significant risk of cost overruns. Each party manages its own cost overrun risk. The parties agree that expected profits from the sale of the new product will first be allocated to provide each party with a routine return on its manufacturing functions; with the residual profit and loss split 30/70 notwithstanding that the actual development costs may vary from what was projected.

**Question:**

1. *How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?*

In Scenario 8, we see how transactional profit split methods do not always results in split of actual profits, e.g., conversion of the profit split into a fixed royalty.

**Scenario 8:**

Parent Company P licenses patent rights relating to a potential pharmaceutical product to subsidiary Company S. Company S is responsible for marketing the product. P performs all of the basic research and most of the development functions, with S contributing to late stage development and marketing. For the purposes of this scenario, both companies are understood to contribute to the development of the intangible. It is possible to weigh the risk of the expenditure based on reported industry data about success rates at each development stage for products in the same therapeutic category. The current and anticipated costs, determined on a net value basis, are contributed by P and S in the ratio 80:20. At the time of the license, projections are prepared on a net present value basis of the expected sales, production and sales costs (including a benchmarked return on those costs), and resulting profits. The respective contributions to product development are then used to split the anticipated profits in the ratio 80:20. At this point, however, P's expected profit from the expected sales is converted to a royalty rate on those sales. In this Scenario, the transactional profit split method is used to calculate a royalty.

**Question:**

1. *Is the application of a transactional profit split method to calculate the royalty in Scenario 8, or in other circumstances to set a price, helpful? What are the advantages and disadvantages?*

**Dealing with Losses**

The Draft points out that under the O.E.C.D. Guidelines (paragraph 1.108), the profits and losses are split in the same manner. In Scenario 9, the Draft questions whether losses should be split differently from profits.

### Scenario 9:

Three companies in a banking group carry on trading in a type of structured financial product through an integrated model. Each operates in one of the main time zones. Profits from this business are allocated between the three companies using a multi-factor profit split methodology that gives different weight to each factor. The greatest weighting is given to the factor based on remuneration paid to the traders in each location, including bonuses based on performance.

However, significant losses may be generated in this line of business and the correlation between bonus compensation and such losses will not be the same as that between bonuses and profits. To ensure the allocation of losses would be in line with what would have been made up-front by independent enterprises, the methodology incorporates principles for the adjustment of the remuneration-based factor where losses are incurred. This is based on an analysis of the group's compensation policy in such circumstances as well as a careful consideration of the types of circumstance in which losses may be incurred in the particular business.

#### Questions:

1. *In what circumstances might it be appropriate under the arm's length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss?*
2. *Are there circumstances under the arm's length principle where parties which would share combined profits, would not be expected to take any share of combined losses?*

The Draft poses additional questions which illustrates the difficulty of the issue:

- *Paragraph 2.114 of the Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?*
- *Finally, what further points would respondents wish to make about the application of transactional profit split methods not covered by previous questions?*

These questions and factual scenarios illustrate the hard work ahead in finalizing the Chapter II of the O.E.C.D.'s Transfer Pricing Guidelines. All comments received in response to the questions provided in the Draft will be made public.

