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An Evaluation of the OECD's Final Guidance on Application of the Transactional Profit Split Method

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The Organisation for Economic Co-operation and Development ("OECD") earlier this year released its final guidance on the application of the transactional profit split method ("TPSM"). The final TPSM guidance clarifies and significantly expands the existing guidance on when a profit split method may be the most appropriate method. Since most countries around the world follow the OECD transfer pricing guidelines, this final guidance will be relevant to multinational taxpayers. This article summarizes the final TPSM guidance, points out differences with the 2017 discussion draft on the TPSM, and provides commentary on the final TPSM guidance.

On June 21, 2018, the OECD released its final guidance on the application of the TPSM. This guidance ("Final TPSM Guidance") addresses Action 10 of the OECD's Action Plan on Base Erosion and Profit Shifting ("BEPS"), which required the development of:

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... clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains....

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The Final TPSM Guidance follows a series of four documents¹ from the OECD addressing revisions to the guidance on the TPSM in Chapter II of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines"). The OECD received numerous comments from the public on the earlier documents, and the Final TPSM Guidance represents a significant evolution from the initial document addressing the topic.

This article summarizes the Final TPSM Guidance, points out differences between the Final TPSM Guidance and the last discussion draft on the TPSM issued in 2017 (the "2017 Discussion Draft"), and provides commentary on the Final TPSM Guidance.

Overview of the Final TPSM Guidance

The Final TPSM Guidance replaces the current provisions of Section C of Part III, Chapter II of the OECD Guidelines in their entirety. It clarifies and significantly expands the guidance on when a profit split method may be the most appropriate method. It describes the following indicators as being relevant to the determination of the TPSM as the most appropriate method:

- Each party makes unique and valuable contributions
- The business operations are highly integrated so the contributions of the parties cannot be reliably evaluated in isolation from each other
- The parties share the assumption of economically significant risks, or separately assume closely related risks

The Final TPSM Guidance includes a discussion of each of these indicators and why the TPSM may be the most appropriate method when one of these indicators is present.

The guidance makes clear that while a lack of comparables is, by itself, insufficient to warrant the use of the TPSM, if, conversely, reliable comparables *are* available it is unlikely that the TPSM will be the most appropriate.

In addition, the Final TPSM Guidance includes guidance on the following items:

- The strengths and weaknesses of the TPSM

¹ These are: (1) BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains, December 16, 2014, (2) section on Scope of Work for Guidance on the Transactional Profit Split Method in Actions 8-10: 2015 Final Reports on Aligning Transfer Pricing Outcomes with Value Creation, October 5, 2015, (3) BEPS Actions 8-10: Revised Guidance on Profit Splits, July 4, 2016, and (4) a discussion draft titled BEPS Action 10: Revised Guidance on Profit Splits, June 22, 2017.

- Approaches for splitting profits—The Final TPSM Guidance includes two commonly used approaches to the TPSM:
 - A contribution analysis, which divides total profits between the parties based on the division of profits that would be expected between independent enterprises; and
 - A residual analysis, which first assigns profits to the routine contributions of each party and then allocates the remaining combined profits between the parties based on the relative value of their contribution to the residual profit.
- Measures of profits—The Final TPSM Guidance provides guidance on the specific measure of profits—gross profits or operating profits, actual or anticipated profits—to be split.
- Profit splitting factors—Asset/capital-based factors, such as operating assets, intangibles, capital employed; cost-based factors such as R&D spend and marketing spend; and other factors, such as incremental sales and headcount are discussed as measures that may be used to capture the relative contributions of the parties. The Final TPSM Guidance notes that cost-based factors need to consider several issues, such as differences in timing of the expenditures by each party.

Sixteen examples are included in the Final TPSM Guidance to illustrate the principles discussed in the text and demonstrate how the TPSM might be applied in practice. These will be included in Annex II to Chapter II of the OECD Guidelines.

Changes from the 2017 Discussion Draft

The Final TPSM Guidance, barring the examples, carries through much of the language in the 2017 Discussion Draft with some revisions that are more in the nature of clarifications than substantive changes.

The primary changes in the Final TPSM Guidance as compared with the 2017 Discussion Draft lie in the Annex containing the examples. While the 2017 Discussion Draft included ten examples to illustrate the principles discussed in the 2017 Discussion Draft, the Final TPSM Guidance includes sixteen examples. Some examples are relatively unchanged from the 2017 Discussion Draft whereas others have been edited significantly, possibly in response to comments on the 2017 Discussion Draft. The new examples include situations not illustrated in the earlier examples, including situations in which the TPSM is the most appropriate method given highly integrated operations or inter-related economically significant risks, or provide numerical applications of the TPSM.

The following is a discussion of the differences in the examples:

- Examples 1 through 5 are relatively unchanged from the 2017 Discussion Draft. One change of note is to Example 3. Although the facts of Example 3 are substantially the same in the 2017 Discussion Draft and the Final TPSM Guidance, the conclusions differ. The 2017 Discussion Draft concluded that the TPSM was the most appropriate method given the facts because the

risks of the parties are closely inter-related and inter-dependent upon each other, while the Final TPSM Guidance concludes that the TPSM is the most reliable because both parties make unique and valuable contributions.

- Examples 6 through 10 in the 2017 Discussion Draft are reordered and revised. Examples 6, 7, 8, 9, and 10 in the 2017 Discussion Draft correspond to Examples 8, 6, 16, 13, and 15, respectively, of the Final TPSM Guidance. The conclusions in the examples remain the same but some of the examples make additional points. Example 6 of the Final TPSM Guidance now elaborates on the sharing of economically significant risks of the two asset managers. Example 16 of the Final TPSM Guidance draws a parallel between the splitting of profits based on the relative development costs and a cost contribution arrangement. Example 15 removes the references to the automotive industry and now notes that the related parties engage in design activities in addition to manufacturing. It adds that the manufacturing and design activities of the companies are highly interdependent and the entities both perform relevant control functions in relation to the economically significant risks.
- Examples 7, 9, 10, 11, 12, and 14 of the Final TPSM Guidance are new.
 - In Example 7, two related parties offer international trade facilitation, freight forwarding, and customs broking services to unrelated customers. The example notes that although arm's-length pricing for their joint activities is readily available, their operations are highly integrated and interdependent such that it is not possible to use a one-sided method to determine an arm's length outcome for either of their respective contributions, and thus a TPSM is likely to be the most appropriate method. If the companies also share the assumption of economically significant risks, a profit split of actual profits is likely to be appropriate.
 - In Example 9, two related parties develop intangibles that do not have significant value by themselves. However, engineers from the companies working together determine that the combination of the intangibles creates a unique and valuable drug. The example concludes that the high level of integration and interdependency between the contributions of the two companies makes the TPSM the most appropriate method.
 - In Example 10, Company A performs all the control functions and assumes all the risks related to the overall production and sale of a new generation of products whereas Company B performs all the control functions and assumes all the risks related to the development of a key component. The example concludes that while Company A and Company B each assumes separate economically significant risks, those risks are highly interdependent. As a result, the TPSM is the most appropriate method.
 - Example 11 presents a scenario with three related entities, two of which make unique and valuable contributions. The third entity acts as a distributor and its purchases are priced using a resale price method. The example provides a numerical calculation of the residual profit split method using relative R&D expenses of the parties as an allocation key.

- Example 12 presents a scenario similar to Example 11 with three related parties, two of which make unique and valuable contributions while the third performs benchmarkable marketing and distribution activities. Similar to Example 11, the third entity's compensation is determined using a resale price method (or transactional net margin method) and the compensation of the first two entities is determined using a TPSM. Unlike Example 11, however, Example 12 does not provide a numerical illustration of the TPSM.
- Example 14 provides some illustrations of the effect of choosing different measures of profits to determine the relevant profits to be split when applying a TPSM. The example provides numerical illustrations of a residual profit split when (1) operating profit is split, (2) operating profit before overhead expenditures is split, and (3) operating profit before expenditure in relation to the unique and valuable intangible is split.

Comments on the Final TPSM Guidance

Level of Use of the TPSM

One of the objectives of the OECD's Action Plan on BEPS was to align profits and taxation with value creation. The additional guidance on the TPSM was meant to be one of the approaches for addressing this objective—the TPSM allocates profits within a multinational group to its members using allocation factors. If those allocation factors are related to value creation, then an appropriate application of the TPSM could presumably help in meeting the objective of aligning profits with value creation.

However, a key concern of taxpayers has been that the singling out of the TPSM for additional guidance could lead to the misuse or overuse of the TPSM. This overuse could lead to a move away from the arm's length standard, and in the extreme case of systematic, prescriptive use of the TPSM, could constitute formulary apportionment of profits. A major concern of taxpayers throughout the process, therefore, has been that the new guidance should not introduce an effective bias in favor of the TPSM and against other methods.

The Final TPSM Guidance has changed very significantly from the first discussion draft released in December 2014. The OECD received numerous comments from the public on its discussion drafts on the TPSM, and it is clear that the Final TPSM Guidance has tried to address some of those comments. The Final TPSM Guidance addresses the concern around overuse of the TPSM to some extent by emphasizing the *relative* reliability of the selected method over other methods and noting that the TPSM guidance is not meant to be prescriptive. Nevertheless, the potential overuse of the TPSM in practice remains a concern since some tax authorities have shown a greater inclination to apply the TPSM than others under the same circumstances.

Examples in the Final TPSM Guidance

The examples in the Final TPSM Guidance could be interpreted in ways that confirm some taxpayer concerns regarding a potential overuse of the TPSM. Certain aspects of the examples may appear to encourage the selection of the TPSM as the most appropriate method without a consideration of other relevant factors pointing away from the TPSM. In principle, the examples should not be read as

overwriting any of the principles of the OECD Guidelines but it remains to be seen how tax authorities will interpret these examples. We discuss some aspects of the examples that may appear to encourage an overuse of the TPSP.

- As noted in the Final TPSP Guidance, the choice of the most appropriate method should depend on the *relative* appropriateness and reliability of the different methods.² However, the examples generally assume the TPSP to be the most appropriate method without consideration of the other methods. For instance, Example 1 presents a situation in which one party takes the development of a new pharmaceutical formulation to a certain stage and then licenses its intangible property to another entity for further development and commercialization. In addition to not discussing the contractual terms of the transaction (e.g., how risks are allocated between the parties—see point below), the example assumes that both parties make unique and valuable contributions and, thus, the TPSP is the most appropriate method. There is no discussion of why the TPSP is more reliable than the other methods, such as the comparable uncontrolled price (“CUP”) method. The pharmaceutical industry, in particular, sees numerous deals between third parties in these situations, i.e., when one party does the initial development of a pharmaceutical molecule and licenses the right to further develop and commercialize the molecule to an unrelated party. It is possible to find information on such arrangements in public databases. The example, thus, appears to reach the conclusion of TPSP as the best method without due consideration of other methods, such as the CUP method.
- The examples may give the impression that whenever multiple parties make unique and valuable contributions or share in economically significant risks or engage in highly integrated operations, the TPSP will be the most appropriate method. In other words, the examples seem to imply that meeting these conditions is sufficient for the selection of the TPSP as the most appropriate method. However, as the Final TPSP Guidance notes, the TPSP *may* be the most appropriate method in these situations—which by no means implies that the TPSP *will* be the most appropriate method whenever these conditions are met. In fact, the Final TPSP Guidance clarifies that the “presence or absence of one or more of the indicators...will not necessarily lead to the conclusion that the transactional profit split will (or will not) be the most appropriate method in a particular case.”³ The two examples in which the TPSP is not selected as the most appropriate method (Examples 4 and 8) assume that one of the parties does not assume economically significant risks, does not make unique and valuable contributions, and is only integrated with the other party to a limited degree. These two examples thus do not allay the impression that meeting one of the three conditions would be sufficient for application of the TPSP.
- Several examples assume unique and valuable contributions and, therefore, apply the TPSP as the most appropriate method. However, the examples generally do not explain why the

² Paragraph 2.118 of the 2017 Discussion Draft.

³ Paragraph 2.145 of the Final TPSP Guidance.

contributions are considered unique and valuable; in particular, why they are considered unique. In fact, some of the examples relying on unique and valuable contributions as a basis for applying the profit split present commonplace situations in which the contributions might not be unique and valuable. We have already discussed Example 1 above: While the intangibles of Company A are likely valuable, it is also common to find similarly situated third parties entering into arrangements to license just such intangibles, thus making the CUP method potentially more appropriate than the TPSM. Similarly, in Example 13, Company A owns a trademark and associated goodwill, which is not determined to be a hard-to-value intangible. While the trademark is valuable, it is not clear from the example why it is considered unique. It may be possible to find comparable trademarks in the retail fashion industry. By not clearly articulating why a contribution is unique and valuable, the Final TPSM Guidance may run the risk of encouraging an application of the TPSM in situations in which other methods may be more appropriate.

Role of Contracts

The sharing of risks plays a prominent role in the discussion on the appropriateness of profit splits in the Final TPSM Guidance. The Final TPSM Guidance, however, makes just one reference to contracts—more than halfway through the Final TPSM Guidance, in paragraph 2.161.⁴ Under paragraph 1.94⁵ of the OECD Guidelines, when multiple parties control risk, the contractual allocation of risk to one or more of those parties will be respected. In principle, the evaluation of the TPSM as the most appropriate method should factor in the contractual allocation of risk. If the contract does not specify a sharing of risks between the parties even though both parties control the economically significant risks, a tax authority or taxpayer should not be allowed to assume the sharing of risks in contradiction to the contract and select the TPSM as the most appropriate method based on an inference of shared risks. The distinction between a split of actual profits and a split of anticipated profits is important in this respect as they may correspond to significantly different allocations of risk between the parties.

For instance, it is common for multiple entities to collectively control economically significant risks through their membership in global committees within the multinational group. It is possible that the intercompany arrangement in place allocates risks to all the entities controlling the risks, in which case there is a sharing of economically significant risks and the TPSM may be an appropriate method for evaluating the arm's length pricing between the relevant entities. Alternatively, the intercompany

⁴ Paragraph 2.161 of the Final TPSM Guidance states “Additionally, it should be remembered that the starting point in the accurate delineation of any transaction will generally be the written contracts which may reflect the intention of the parties at the time the contract was concluded.”

⁵ Paragraph 1.94 of the OECD Guidelines states “Furthermore, in some cases, there may be more than one party to the transaction exercising control over a specific risk. Where the associated enterprise assuming risk...controls that risk..., all that remains...is to consider whether the enterprise has the financial capacity to assume the risk. If so, the fact that other associated enterprises also exercise control over the same risk does not affect the assumption of that risk by the first-mentioned enterprise....”

contract may assign the economically significant risks to one of the parties to the transaction. In this case, it would not be reasonable to assume shared risks or to split actual profits as if risks were shared, ignoring the risk allocation embodied in the intercompany contract.

The absence of a clearer reaffirmation of the Chapter I guidance on the role of contracts could possibly encourage some tax authorities to argue for a TPSM irrespective of the contractual relations.

Degree of Integration

The second sentence in paragraph 2.133 of the Final TPSM Guidance states that a “high degree of integration means that the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with, and cannot reliably be evaluated in isolation from, the way another party to the transaction performs functions, uses assets and assumes risks.” Thus, a high degree of integration is defined as a state in which the activities of related parties are interlinked and cannot reliably be evaluated in isolation, suggesting that a TPSM will be the most appropriate method when a high degree of integration exists.

This guidance could be interpreted in different ways by tax authorities—what one tax authority considers interlinked activities or reliable evaluation of activities in isolation may be different from what another tax authority considers interlinked activities or reliable evaluation of activities, thus raising risks of controversy and inconsistent application across tax authorities. The level of integration and its implications for the appropriateness for the application of the TPSM could be another cause of overuse of the TPSM.

Application to Profits and Losses

Paragraph 2.115 of the Final TPSM Guidance notes that the TPSM should generally also apply, and apply in the same way, regardless of whether the transaction(s) result in a relevant profit or loss. We generally agree but note that while the TPSM should be used consistently, the way certain allocation keys are used and measured may need to vary in the case of profits versus losses. For instance, employee bonuses may be assumed to reflect the employee's positive contribution to profits. In the case of a profitable aggregate result, allocating more profit to entities paying out more in bonuses (other factors equal) might be appropriate. But if the aggregate result is a loss and entities doing better pay larger bonuses, it is much less likely to be appropriate to allocate a larger proportion of the loss to entities paying larger bonuses. Therefore, the appropriate treatment of such a factor is likely to be different in the case of losses than in the case of profits. This does not mean, however, that either multinational enterprises or tax administrations should be permitted to apply inconsistent methods in profit and loss situations. For example, neither multinational enterprises nor tax authorities should be permitted to selectively apply a profit split to years in which there are combined profits for tax purposes and apply the transactional net margin method to years in which there are combined losses.

Data Issues

The examples in the 2017 Discussion Draft were primarily focused on the selection of the TPSM as the most appropriate method and less so on the application of the TPSM. As noted in the Final TPSM

Guidance, data issues may materially impair the reliability of the TPSM such that another method is most appropriate. The Final TPSM Guidance now includes two examples illustrating the application of the TPSM. However, the examples make several simplifying assumptions and it is important to keep in mind that the practical application of the TPSM is likely to be significantly more complicated than the simple examples illustrate. Considerations include how a contribution analysis is applied in comparison to a residual analysis, and how the profit-splitting factors are chosen, weighted, and applied. The availability of sufficient information to reliably determine the profits to be split and the relative value of each party's contribution is an important issue in determining the relative reliability of the TPSM.

Conclusion

The Final TPSM Guidance clarifies and significantly expands the existing guidance on when a profit split method may be the most appropriate method. The Final TPSM Guidance, barring the examples, carries through much of the language in the 2017 Discussion Draft with some revisions that are more in the nature of clarifications than substantive changes. The Final TPSM Guidance has come a long way since the initial discussion draft released in December 2014. Nevertheless, taxpayers remain concerned about the potential overuse of the TPSM in practice, which could lead to inappropriate conclusions on arm's length pricing, greater disagreement between tax authorities and greater uncertainty for taxpayers. While the Final TPSM Guidance addresses the concern around overuse of the TPSM to some extent by emphasizing the *relative* reliability of the selected method over other methods and noting that the TPSM guidance is not meant to be prescriptive, certain aspects of the Final TPSM Guidance may be interpreted by some to encourage the selection of TPSM as the most appropriate method as discussed in this article.

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