

OECD releases final revised guidance on application of transactional profit split method

NEW! EY Tax News Update: Global Edition

EY's new Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration [here](#).

Also available is our [EY Global Tax Alert Library](#) on ey.com.

Executive summary

On 21 June 2018, the Organisation for Economic Co-operation and Development (OECD) released the final report on the [revised guidance on the application of the transactional profit split method](#) (the Report). The Report, which has been published as part of Base Erosion and Profit Shifting (BEPS) Action 10, clarifies and expands the guidance on the transactional profit split method (TPSM). It provides the text of the revised guidance on the application of this method, which is to replace section C, part III of Chapter II of the OECD Transfer Pricing Guidelines (OECD TPG). The Report also builds on the work performed and comments received on the discussion drafts that were issued on [4 July 2016](#) and [22 June 2017](#) (2017 Discussion Draft).

As compared to the historic guidance on the TPSM in the OECD TPG, the basic premise has not changed that the TPSM, like any transfer pricing method, can be applicable where it is found to be the most appropriate method based on the relevant facts and circumstances. A lack of comparables, by itself, is insufficient to warrant the use of the TPSM. However, where reliable comparables are available, the Report states it is unlikely that the TPSM will be the most appropriate method. The revised guidance in the Report prescribes that the TPSM may be the most appropriate method in the presence of one or more of the following indicators:

- ▶ Each party makes unique and valuable contributions
- ▶ The business operations are highly integrated such that 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

Furthermore, the Report contains expanded guidance on the application of the TPSM, including how to determine the relevant profits to be split, and considerations with respect to profit splitting factors. The revised guidance also includes 16 examples relating to the principles set forth in the revised guidance and how they may be applied in practice.

The Report now represents a consensus view of the OECD's Committee on Fiscal Affairs and has been approved by the Inclusive Framework on BEPS¹ on 4 June 2018.

Detailed discussion

The Report is aimed at clarifying and expanding the guidance on the TPSM in the context of global value chains. The additional work was set out in [the final report of BEPS Actions 8-10](#).² It contains the text of the relevant guidance that is to be included in Chapter II of the OECD TPG relating to the TPSM.

The structure of the Report follows the 2017 Discussion Draft and contains the following main content: (i) general introductory statements; (ii) selection of the TPSM as the most appropriate method; (iii) general guidance on application of the TPSM; (iv) guidance on determining the profit to be split; and (v) guidance on splitting the profits. Sixteen examples that will be added to Annex II of Chapter II of the OECD TPG are included.

The Report starts with several general considerations relating to the TPSM, including the new consideration that the TPSM is considered particularly useful when parties' compensation can be more reliably valued through determining the relative share of their contributions rather than a direct estimation of the value of those contributions. Also, it reiterates that the reference to profits generally applies equally to losses when applying the TPSM.

The Report provides when the TPSM is likely to be the most appropriate method. These considerations include the strengths and weaknesses of the method, the nature of the transaction and the availability of reliable information.

The main strength of the TPSM is that it offers a solution for situations where both parties make unique and valuable contributions. In this respect, contributions are considered "unique and valuable" if: (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances; and (ii) they represent a key source of actual or potential economic benefits in the business operations. Since no reliable comparables will be available for these contributions which could be used in the application of another method, the allocation of profits based on the respective relative value of parties' contributions may be appropriate.

The TPSM is also considered appropriate for highly integrated operations. In the case of highly integrated business operations, the functional analysis of one party cannot be reliably evaluated in isolation from the functional analysis of another party. The TPSM may be the most appropriate method in that scenario. However, in many instances of integration within a multinational enterprise (MNE), the contribution of at least one party to the transaction can be reliably evaluated by reference to comparable uncontrolled transactions, and the TPSM may not be appropriate.

Highly integrated operations may also result in situations in which both parties share the assumption of economically significant risks or separately assume closely-related risks. The latter will be the case if those risks are so closely inter-related and/or correlated that the consequences of the risks of each party cannot reliably be isolated. This situation could warrant the use of a TPSM based on actual profits, rather than anticipated profits, since actual profits will reflect the materialization of the (jointly assumed) risks of each party. A split of anticipated profits may be most appropriate if one of the parties does not share in the assumption of certain economically significant risks.

Where one party contributes to the control of economically significant risks, but that risk is assumed by another party, in some cases it may be appropriate for the first party to share in the upward and downward consequences associated with that risk, commensurate with its contribution to control. As also mentioned by EY in its comments to the 2017 Discussion Draft, the Report confirms that the mere fact that an entity performs control functions in relation to a risk will not necessarily lead to the conclusion that the TPSM is the most appropriate method.

The absence of comparables can be considered an indication that the TPSM may be the most appropriate method. The lack of comparables alone is not a reason though to apply the TPSM. Conversely, if information on reliable comparable uncontrolled transactions is available to price the transaction in its entirety, it is less likely that the TPSM will be the most appropriate method.

The Report confirms the existing general considerations relating to the application of the TPSM, including those on the two most common approaches to split profits, namely the contribution analysis and the residual profit analysis. The revised guidance includes considerations on determining the profits to be split, such as whether actual or anticipated profits should be split. This provides important clarification on an issue that has generated confusion in the past, namely the distinction between the profit split as a valuation method, which can be used even if actual residual profits are not split (such as in the case of a lump-sum payment form), and the profit split as a way to share in actual profits, depending on the actual delineation of the transaction. (Section C.4.1 and example 13 Scenarios 1 and 2). The revised guidance also includes consideration on how those profits should be measured. It is mentioned that generally the relevant profits to be split are operating profits, but a different measure of profits such as gross profits may also be appropriate in some cases. Regardless of what measurement of profits is used, accounting standards should be selected in advance of applying the method and applied consistently over the lifetime of the arrangement, and any material differences between the accounting standards used by the parties should be identified and aligned.

The splitting of the profits should be done on an economically valid basis that reflects the relative contributions to the creation of those profits. Therefore, the profit splitting factors should reflect these contributions. Depending on the case at hand, the factor can be a figure or a variable, for example splitting can be done based on assets, capital, or time spent. One notable addition to the list of potential profit split factors is the use of headcount. As this is one of the items picked up in the country-by-country reporting filings, this addition may have the unfortunate consequence in practice of encouraging the use of simplistic formulary approaches, notwithstanding the OECD's urging to follow the arm's-length principle. The revised guidance refers to the Local Files and the MNEs' Master File as potential useful sources of information to determine economically valid splitting factors (e.g., the Master File's sections on important drivers of business profit, principal contributions to value creation, and key group intangibles).

Compared to the 2017 Discussion Draft, the Report includes six new examples (examples 7, 9, 10, 11, 12, and 14) and specific amendments to the other examples. The first five examples provide how the provision of unique and valuable contributions can result in the conclusion that the TPSM is likely to be the most appropriate method. The next four examples relate to highly integrated business operations. The TPSM may be the most appropriate method in those situations. However, if one party does not make any unique and valuable contributions nor assumes risks that are economically significant for the business operations, the TPSM may not be most appropriate method as an appropriate return to that party. Such profit can likely be determined using a one-sided method. Example 10 provides an example of parties assuming highly interdependent risks in which the splitting of revenues or gross profits may be most appropriate, as each party thereby would bear the consequences of playing out of risks relating to their own operating costs. The next example provides a numerical example of the application of the residual profit approach. Example 8 emphasizes the importance of accurately delineating the transactions to be covered by the TPSM, including the identification of any separate transactions for which a one-sided transfer pricing method would likely be most appropriate, and the TPSM is likely not the most appropriate. Another example, 7, provides an indication on when to use the TPSM based on anticipated profits or actual profits. The new example 14 illustrates the principles connected to the different measures of profit through two numerical examples. The final two examples describe how the principles related to profit splitting factors may be applied, including the use of asset- and cost-based splitting factors.

Implications

The Report contains the revised guidance on the application of the TPSM. This guidance will be particularly relevant for many global businesses, including those involved in highly integrated activities. The guidance will likely put more emphasis on the actual delineation of the transaction, including the determination whether parties provide unique and valuable contributions, and the selection of the most appropriate method. This will impact both businesses that currently don't apply the TPSM and businesses already applying the TPSM. The latter should assess whether their existing transfer pricing policies are aligned with the revised guidance or require changes.

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2018 EYGM Limited.
All Rights Reserved.

EYG no. 010052-18Gbl

1508-1600216 NY
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com