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**EU JOINT TRANSFER PRICING FORUM**

**DISCUSSION PAPER ON THE TRANSACTIONAL PROFIT  
SPLIT METHOD (PSM)**

**Meeting of 8 March 2018**

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## 1. Background

Looking back at the 1979 OECD Transfer Pricing Guidelines, the profits split method had been excluded as an acceptable transfer pricing method. It was incorporated for the first time into the 1995 update to the Guidelines as a prescribed method. However, under the approach of the hierarchy of methods it could be applied only where the traditional transaction methods were out of the question. In the 2010 Guidelines the OECD moved away from a hierarchy of methods into a "most appropriate method" approach, which put the profit methods and the traditional transaction methods on equal footing.

In September 2015, the OECD issued its final Report on BEPS Actions 8-10 "Aligning transfer pricing outcomes with value creation" (BEPS Actions 8-10 Report). The Report did not include revised guidance on the PSM, but instead identified the scope of work to be undertaken for the revised guidance. In terms of timing, the OECD would issue the draft revised guidance in 2016, followed by a public consultation. The guidance would be finalised in the first half of 2017.

The OECD worked on a revised discussion draft in 2016 and 2017; this was published on 23 June 2017. The OECD work on finalising the guidance is still ongoing. Nevertheless, we consider the work sufficiently advanced at OECD level in order to review the main points of the draft guidance and discuss ways forward in the EU.

The key thrust of the draft Guidance on the application of the transactional PSM is linked to the way multinational businesses tend to structure; that is, by centralising their functions, risks and the allocation of their most valuable (intangible) assets. Thus it seems that the PSM, when applied properly, could serve as the solution to many transfer pricing challenges within highly integrated business models where there are unique commercial relations among the members of a multinational group (MNE) and so, comparables are often not identifiable.

## 2. The PSM in the Programme of Work of the Joint Transfer Pricing Forum (JTPF) 2015-2019

The JTPF programme of work 2015-2019 refers to the PSM as one of the topics on which the JTPF will provide output and foresees that work will focus on the practical application of the PSM in the EU, e.g. on determining the profit to be split, the need for a high degree of cooperation between tax administrations or the need and potential measures for defending the profit to be split against arrangements with entities that do not participate in the profit split. It mentions that another angle for further work could be an evaluation of models available to split the profits, their pros and cons in substance and as regards their practical application as well as the compliance burden they may create.

## 3. Mandate for Review of the PSM in the BEPS Actions 8-10 Report

The BEPS Actions 8-10 Report outlined the scope for revising the Guidance on the PSM. It included the following items:

- Most appropriate method – the revised guidance should avoid the selection of the PSM method solely on the basis of the difficulties in identifying comparables' data; it should instead emphasise the need for using and adjusting the best available comparables.

- Highly integrated business operations – the revised guidance should clarify in which cases close integration between the parties would result in the PSM being considered as the most appropriate method.
- Unique and valuable contributions – in selecting the most appropriate method, it was established that there is a need for additional guidance and examples in order to clarify when contributions would be considered "unique" and "valuable".
- Synergistic benefits – additional guidance should be provided on the application of the PSM in cases of significant group synergies.
- Profit splitting factors – the revised guidance should focus on the need for a strong correlation between profit splitting factors and the creation of value. Various mechanisms and their sensitivities should be explained in detail and compared with practical examples.
- Use of profit split to determine TNMM range, royalty rates and other payment forms – the need for additional guidance was deemed necessary, to decide when the PSM can be used to support results under a TNMM, or to determine royalty rates, or other payment forms.

#### 4. Main points of the Draft Guidance on the PSM

##### 4.1. Strengths and Weaknesses of the PSM

The main strengths include:

- Addressing cases where comparables' data for the use of one-sided methods would be unavailable due to the fact that the parties to the transaction make unique (i.e. not comparable to contributions by uncontrolled parties) and valuable contributions. This is particularly the case when internal data is used in order to determine the relative values of the parties' contributions in terms of functions, assets and risks.
- Flexibility in cases where (some of) the specific facts and circumstances which have to be considered are not in place between independent enterprises. In cases of high uncertainty about the outcome of the risks involved, the PSM provides flexibility by enabling the sharing of actual profits, therefore taking into account the outcome of the risks.
- Direct evaluation of all relevant parties to the transaction as part of the pricing of the transaction.

The main weaknesses include:

- Associated enterprises and tax administrations may face difficulties in accessing all the underlying accounting information, subsequently putting the data on a common comparable basis and applying it consistently over time. Within an MNE group, obtaining the necessary information from other group members may not be a straightforward process.
- An additional burden in segmenting the accounting information in order to match the scope of the delineated transaction.
- Difficulties in identifying appropriate profit splitting factors, especially in cases where the unique and valuable contributions are of different nature.

##### 4.2. The PSM as the most appropriate method

The draft Guidance lists 3 features of an accurately delineated transaction which can indicate that the PSM could be the most appropriate method:

- Unique and valuable contributions – the contributions are "unique" when they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and "valuable" when they represent a key source of actual or potential economic benefits in the business operations. This is often the case when there is a transfer of partially developed intangibles and it is impossible to identify comparable transactions.
- Highly integrated business operations – the business operations are "highly integrated" when 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 in which another party to the transaction performs functions, uses assets and assumes risks. This is especially the case where the functions of the parties are non-routine and the contribution by one party would have a significantly higher value when used in the business together with the contribution by the other party.
- A shared assumption of economically significant risks, separate assumption of closely related risks – it is highlighted that the split of actual profits would be more appropriate in this case, since the paying out of these risks is reflected in the actual profits, rather than anticipated profits.

It is important to note that, based on the draft Guidance, the lack of comparables alone is not sufficient for deciding that the PSM is the most appropriate method.

#### 4.3. Approaches to splitting the profits - Contribution Analysis and Residual Analysis

The essence of the Guidance on the contribution analysis and residual analysis and the relevant examples remains relatively unaffected by the new draft Guidance. The arm's length principle is re-affirmed by stating that the profits shall be split on an economically valid basis while the overarching objective should be to approximate as closely as possible the split of profits that would have been realised had the parties been independent enterprises.

- Contribution analysis – the profits from the transactions in question are divided between the associated enterprises based on appropriate comparables, or, in the absence of such comparables, on the basis of internal data with the aim to approximate the relative value of the contributions of each associated party to the controlled transaction;
- Residual analysis – it is a two-stage approach applicable in cases where the parties perform a mix of routine and unique functions. At the first stage of the residual analysis, the profits realised through routine functions are first established using a one-sided method (commonly a TNMM). At the second stage, the remaining profits would be split based on the relative value of the contributions, i.e. in the same way as in the contribution analysis.

#### 4.4. Determining the profits to be split

In determining the profits to be split, the accounting information shall be re-established on a common comparable basis and in a consistent manner over time. In addition, the associated enterprises shall arrive at the "transactional" profits to be split, i.e. the accounting information shall be segmented in order to match the scope of the delineated transaction.

#### 4.4.1 Split of actual vs anticipated profits

- Splitting of actual profits – it is appropriate to apply that approach where (i) the parties share economically significant risks or (ii) separately assume closely inter-related risks and therefore account should be taken of the actual paying out of those risks.
- Splitting of anticipated profits – alternatively, if one of the parties does not share the economically significant risks, a split of anticipated profits would have to be applied.

In any case, the draft Guidance cautions against applying the profit split with hindsight, i.e. based on information which the parties knew about or could reasonably foresee at the time that the transactions were entered into.

#### 4.4.2. Operating profit vs gross profit

The amount of profit to be split should reflect the extent to which the risks in the value chain are shared.

For example, if the parties to the transaction make unique and valuable contributions and share the risks in manufacturing, the measure of gross profits (reflecting only revenues and cost of goods sold) would be more appropriate.

Alternatively, if the parties to the transaction make unique and valuable contributions and share risks beyond manufacturing (e.g. at the level of distribution), it would then be more appropriate for the split to take into account the operating expenditure (e.g. marketing expenditure) and use operating profit as the profit to be split.

#### 4.5. Profit splitting factors

The draft Guidance outlines that it is not desirable to establish a prescriptive list of criteria or profit splitting factors. The profit split can be done on the basis of external data (i.e. under uncontrolled transactions like joint ventures), but it is recognised that reliable comparables are difficult to identify.

Alternatively, internal data can be used to determine the profit splitting factors. This would involve, for example asset- or cost-based profit splitting factors, but the draft Guidance also mentions incremental sales, employee compensation, headcount (as part of a question) and time spent on a task. Asset or capital-based profit splitting factors are particularly appropriate when the relative contributions of the parties consist in such tangible or intangible assets, or capital. Cost-based profit splitting factors would often be used where the contributed relative value would be strongly linked to the expenses borne, e.g. in marketing expenses. The timing of expenditure and time span when that expenditure should be taken into account is also an important consideration highlighted in the draft Guidance.

As with the profit to be split, the financial or managerial accounting data may need to be segmented in order to draw up a subset relative to the transaction in place.

In any event, there should be a strong correlation between the profit splitting factors, the relative contributions of the parties and the creation of value in the parties' value chain.

## 5. Way Forward - Scope of future work by the JTPF on PSM

The JTPF will take into account the work accomplished by the OECD on the PSM and focus on aspects where it would be useful to explore further the practical side within the EU. Those aspects are summarised below.

### 5.1. Cooperation between associated enterprises

The PSM is the only two-sided method (i.e. it is based on information from at least two tested parties), as mandated in the OECD Transfer Pricing Guidelines. Therefore, there is a need for a high degree of cooperation between associated enterprises in the EU in terms of obtaining the relevant managerial or financial accounting data or economic valuations. It is critical to align the accounting approaches in order to facilitate the application of the PSM and reach the highest degree of accuracy where this is determined as the most appropriate method.

### 5.2. Cooperation between tax administrations

The benefits of cooperation between tax administrations on identifying audit targets and performing tax controls and audits have already been identified in the JTPF Programme of Work. In the context of the PSM, the need for enhanced cooperation between tax administrations is a necessity. In both the ex-ante and ex-post scenarios, this would be an important added value that would help the system work and take account of all relevant associated enterprises in splitting the profit. Tools like multilateral controls and joint audits would be of particular importance in this regard.

### 5.3. Models of splitting the profits and profit splitting factors

The OECD Working Party 6 has decided that it is not desirable to put together a prescriptive list of criteria for splitting profits. Generally, it appears that the draft Guidance on the PSM and the examples of profit splitting factors remained at high level. Therefore, further work is needed as regards the practical application of models available for the splitting of profits and profit splitting factors (e.g. where the unique and valuable contributions by the parties are of largely different nature). The JTPF is the appropriate framework for looking at these elements within the EU.