EUROPEAN COMMISSION
DIRECTORATE-GENERAL
TAXATION AND CUSTOMS UNION
Direct taxation, Tax Coordination, Economic Analysis and Evaluation
Direct Tax Policy and Cooperation

Brussels,
Taxud/D2

DOC: JTPF/012/2018/EN

EU JOINT TRANSFER PRICING FORUM

THE APPLICATION OF THE PROFIT SPLIT METHOD WITHIN THE EU

Meeting of 24 October 2018

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Background

- 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.
- The BEPS Actions 8-10 Report issued in October 2015 did not include a revised guidance on the PSM, but only outlined the scope for revising Section C, Part III Chapter II of the OECD Transfer Pricing Guidelines. The revised guidance was then issued in June 2018 and it generally followed the mandate given in the BEPS Actions 8-10 Report.

The description of the Method

- The profit split method is one of the five transfer pricing methods and the only two-sided method defined by the OECD Transfer Pricing Guidelines (TPG).
- The method examines the division of profits that independent companies would have expected for a transaction in comparable circumstances.
- In general, there are two commonly used approaches for splitting the profits the (i) contribution analysis and (ii) the residual analysis.
- Under the contribution analysis the combined profits from the controlled transactions are allocated between the associated enterprises on the basis of the relative value of functions performed by those associated enterprises engaged in the controlled transactions.
- A residual analysis is designed to divide the combined profits from the controlled transaction into two stages. In the first stage, it assigns an arm's length compensation for routine (typically simpler) contribution to each participant in the transaction by applying one of the traditional transactions methods or the transactional net margin method (TNMM). In the second step, it allocates any residual profit (or loss) among the participant parties in the controlled transaction based on the relative value of their contribution.

The work of JTPF - State of Play

- At the JTPF meeting on 8 March 2018 it was decided that the Secretariat should undertake a survey on the application of the PSM.
- The results of the Survey were presented at the JTPF Meeting of 26 June 2018. The Secretariat received 17 replies from Member States and 11 replies from NGMs.

The survey - preliminary conclusions

- Despite the fact that the survey did not show a direct correlation between the PSM and one specific industry, the PSM turned out to be more frequently applied in the financial sector, industrial equipment, the automotive industry, the IT sector, the trade in consumer goods, the pharmaceutical industry, the chemical industry, the food industry and the oil and gas industry.
- The main challenge in the application of the PSM highlighted by the survey is the choice of the appropriate splitting factors, their relative weights and the valuation of the contributions, especially heterogeneous contributions (they featured in practically all of the replies as one of the main challenges in applying the PSM).

- Further the lack of a common methodology on determining the profit splitting factors has been indicated as a cause that exacerbates the challenges and could undermine the prospects for applying the PSM even in circumstances where this may be the most appropriate method.

Area of work

The PSM may be more and more applied in the coming years due to the increasing degree of integration of the new business models. Close integration is one of the required conditions under the OECD Guidelines to use the PSM. In certain sectors, such as for example the digital economy, the degree of integration is so high that a one-sided method may not be possible to apply; in addition, comparables on the market may not be found.

In light of this there is a need to further clarify how the method works with particular reference to when the PSM should be applied and how to split the profit.

This Paper is an attempt to address these issues with the aim to explore how the application of the method could be simplified for both the taxpayers and tax administrations.

The application of the method should guarantee a sound, fair and objective allocation of profit avoiding mentally complexity as far as possible.

When to use the Profit Split Method

There is a need to clarify when the profit split is the most appropriate method to apply for allocating profit.

The key rule in transfer pricing prescribes that the selection of a method should always be based on a functional analysis. The aim should be to find the most appropriate method for a particular case.

The OECD report on the use of the PSM lists the following indicators for the purpose of determining whether the PSM should be considered as the appropriate method for a fair profit allocation:

- ✓ the existence of a unique and valuable contribution by each party to the controlled transaction;
- ✓ a high level of integration regarding business transactions to which the transaction relates;
- ✓ The shared assumptions of economically significant risks by the parties to the transaction.

Where all parties to a transaction make unique and valuable contributions, e.g. intangibles, and these contributions cannot be benchmarked to contributions made by uncontrolled parties in comparable circumstances or their use in business operations represents a key source of actual or potential economic benefits, the PSM may be regarded as the most appropriate method.

The OECD noted that the lack of closely comparable, uncontrolled transactions which would otherwise be used to benchmark an arm's length return for the party performing the less complex functions should not *alone* lead to a conclusion that the PSM is the most appropriate method. Instead, the critical test should be that the lack of close comparables should be a consequence of the fact that all parties make unique and valuable contributions. If not (i.e. in the absence of unique and valuable contributions), an appropriate method using uncontrolled transactions that are sufficiently comparable, but not identical to the controlled transaction, is likely to be more reliable (depending on the actual facts) than an inappropriate use of the PSM.

The high integration in relation to controlled transactions means that the functions performed, assets deployed and risks borne by parties to the transaction are so highly interlinked (they may be involved in same stage of the value chain) that they cannot be reliably evaluated on a separate basis using a traditional transaction method. An example of highly integrated business operations may be a distributor's use of a trademark/name or a manufacturer's use of design and process technology developed by the licenser where the exploitation function cannot be reliably benchmarked.

The revised OECD TPG heavily relies on the notion of the control of risk. However, the factual determination of risk borne and the control over risk in a MNE group can be rather arbitrary and unclear. The new approach also mentions joint control of risk, which may open the door to further complexity in determining the associated return from the risk borne in these situations.

Where, according to an accurately delineated transaction, each party to the controlled transaction shares the assumption of one or more of the economically significant risks in relation to that transaction or the various economically significant risks are separately assumed by the parties but are closely interrelated, the PSM may be found to be the most appropriate method. For example, associated enterprises may perform functions jointly, own assets jointly and/or share assumption of risks to such an extent that it is impossible to evaluate their respective contributions in isolation.

<u>Question 1</u>

Do you agree that the circumstances described point to the main situations in which PSM has to be considered the most appropriate method? Are there any other hallmarks to consider for selecting the PSM? Do you have any suggestion on how to better delineate the relevant situations?

<u>How to split the profit</u>

According to the OECD TPG, the profit should be split based on the division of profits that independent companies would have expected for a transaction in comparable circumstances.

The division of the profit involves the determination of the factors that bring about the combined profit, setting a relative weight to each factor and calculating the allocation of profits between the associated enterprises.

The determination of the appropriate profit splitting factor(s) should reflect the key contributions to value in relation to the transaction.

The OECD TPG refer to macro categories of possible splitting factors and classify them as asset- and cost-based but do not establish a prescriptive list of criteria or of splitting factors.

The survey showed that even in broadly similar industries and circumstances, largely different splitting factors were used.
The more recurrent splitting factors that emerged from the survey are:

- Cost-based related to development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE functions);
- Salaries, including bonus payments (also capitalised over a number of years) and headcount/FTE(weighted by salary);
- Significant people functions;

- Royalty rates publically available;
- Operating costs;
- Working capital;
- Metrics of risk-taking (economic capital contribution);
- Comparable market opinions identified through expert surveys, including independent industry experts, competitors, and business managers.

Furthermore, different methodologies on determining the profit splitting factors appear to be in use. For example, there was mention of the value chain analysis and the analysis of functions, assets and risks based on functional interviews of the key managers. While a functional analysis determines the functions, assets and risks carried out by the MNE in the controlled transaction, the value chain analysis focuses on the context of the controlled transaction. The profitability of similar MNEs in the relevant industry sector is looked at when conducting a thorough value chain analysis. Understanding the value contribution of an intangible to similar MNEs should provide a broader understanding of the industry sector and the value of the intangible in question in the context of the MNE and the industry sector itself. With this exercise, the value chain analysis takes a holistic approach and looks at value drivers and critical success factors for the business as a whole.

The choice of various splitting factors on a case-by-case basis transpired as one of the main challenges. The choice of the appropriate splitting factors, their relative weights and the valuation of the contributions feature in practically all of the replies as one of the main challenges in applying the PSM.

To summarise, there appear to be a wide range of splitting factors being applied, even with broadly similar industries and circumstances. There are also a range of different methodologies being applied to determine the profit splitting factors.

The lack of clear guidelines on the choice of splitting factors could lead to resource-intensive disputes between taxpayers and tax authorities and create legal uncertainty which will need to be addressed.

If the PSM is to be developed as an efficient method for allocating group profits between group entities it could be useful to examine whether clearer more harmonized guidelines might lead to improvements and whether indeed the factors giving rise to profits are really so diverse within similar industries.

Question 2

Do you agree that we it would be useful to address the tax uncertainty linked with the choice of splitting factors?
Do you agree that the most recurrent splitting factors should be identified?

The need for simplification

To support cross-border economic activities in the EU market, there is a need to streamline the application of the PSM in order to achieve:

- **Certainty**: Complexity favours aggressive tax planning which may trigger deadweight losses for the economy and at the same time risks for double taxation.
- **Efficiency**: Compliance costs to business and administration costs for governments must be reduced.

- **Fairness**: Fair outcomes must be guaranteed for all stakeholders including small MNEs which may have less resource to afford high tax compliance costs.

Simplifying the PSM does not mean rejecting the arm's length principle but rather implies addressing the limits of its application, as those may arise in certain specific situations. Indeed, a simplified mechanism should not be rejected by default if it produces a sound and fair result.

Departing from "labels", what is at stake is a proper and efficient allocation of taxable income by means of mechanisms aimed at facilitating cross-border trade.

<u>Question 3:</u>

Do you agree that given the cost of dealing with transfer pricing a simplified mechanism for splitting profit is needed?

<u>The way forward</u>

The application of the PSM in allocating profits is often accompanied by a **residual analysis;** a methodology frequently used in practice that appears to imply less uncertainty compared to the contribution analysis. This is also reflected in the number of examples in annex II of the OECD Final Report as well as in the examples of our survey.

Typically, the roles of parties to a transaction in the PSM context are complex with many tiers of activity that contribute to splitting the profits. For example, the functional analysis should include both unique and economically important aspects that fall within the PSM as well as less complex tiers (i.e. routine activities) that can be remunerated as routine functions.

Under the residual analysis, the combined profits from controlled transactions are allocated between the associated enterprises based on a two-step approach:

- ✓ First step: arm's length remuneration of the so-called routine functions (i.e. activities making non-unique contributions). The remuneration of the routine functions transaction is determined by applying one of the traditional transactional transfer pricing methods or the transactional net margin method (TNMM).
- ✓ Second step: the residual profit (or loss) that remains after having remunerated the routine activities is allocated among the parties based upon a reasonable approximation that would result in a division of profits that independent parties would expect to realise.

The first step of the analysis does not present particular challenges as the routine activities are easy to benchmark and their remuneration is determined by applying the other transfer pricing methods (in practice, more often the TNMM).

A challenge arises when it comes to the question of how to split the residual profit.

As the survey showed, the identification and measurement of appropriate profit splitting factors could give rise to a high degree of uncertainty.

The OECD Final Report does not provide for prescriptive guidelines regarding the choice of splitting factors and ultimately leaves a lot of space for interpretation. In a nutshell, it is possible to take any position, provided that this is appropriate for the case and leads to a reliable outcome.

The survey showed that splitting the residual profit is a subjective exercise. In fact, even the most accurate functional/value chain analysis would be unlikely to rectify this inherent subjectivity. This is mainly because the PSM usually features as the most appropriate method for profit allocation if there are unique and valuable contributions by more than one party to the transaction. In this context, comparables may be almost impossible to identify. In addition, one would need to rely heavily on the contribution of intangibles, which may also involve some extra subjectivity.

Considering that there is no objective reference to rely on for ascertaining the proper allocation of the residual profit, a simplified mechanism for splitting the residual profit could bring efficiency and reduce legal uncertainty. In such case, the outcome would therefore not be more arbitrary than that of a highly complex method aiming at accuracy. Such an objective could be pursued by either (i) pre-determining the splitting factors or (ii) using a formulaic approach to split the residual.

This should not be taken as a rejection of the arm's length principle but rather as a way to address the limits of its application, as these may arise in certain specific situations. Indeed, the arm's length umbrella is still be used to determine (i) when the profit split method should be applied and (ii) the remuneration of routine activities (first step).

Furthermore, in the absence of objective evidence that the arm's length principle is always reflected in the outcome of applying the PSM, there is no reason why the attribution of the residual profit through pre-determined splitting factors or the use of a formula would turn out to conflict with the established principles for a fair allocation of profit.

Question 4:

Do you agree that a simplified approach is possible under the umbrella of the arm's length principle?

Proposal for a simplified mechanism to split the residual profit

It would therefore be worth investigating whether a list of pre-determined splitting factors per industry or business structure could be developed by analysing which are the splitting factors with the highest recurrence per each industry or sector.

In this context, a formula could present a fair solution, which could be developed by analysing and weighing the contributions to the value creation of the different factors such as costs linked to the creation of intangibles, property values, sales, labour and/or capital.

Question 5:

Do you agree it would be useful to investigate the possibility of predetermining the list of splitting factors?
Do you agree it would be useful to investigate the possibility of developing a formula to split the residual profit?