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Improvements in the OECD’s Discussion Draft on Profit Split

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On 22 June 2017, the OECD released for public comment the revised discussion draft on the application of the profit split method, which intends to continue the work developed in the OECD Transfer Pricing Guidelines and, in more details, in the BEPS Actions 8-10, whose motto aims to assure that transfer pricing outcomes are in line with value creation.

According to the OECD, the Profit Split method is typically considered to be the most appropriate method in three situations: (i) both parties to the transaction make unique and valuable contributions; (ii) highly integrated business operations; and (iii) transactions with the shared assumption of economically significant risks or the separate assumption of closely related risks.

This post intends to highlight some of the improvements and enhancements that can be drawn out of the 2017 discussion draft on profit split methodologies.

“Anticipated profits” or “actual profit”

The use of the profit split method in cases where both parties make unique and valuable contributions to the transaction raises the issue of sharing “anticipated profits” or “actual profit”. In the 2016 discussion draft, the OECD failed to recognize the difference between cases where a split of actual profits is contractually agreed between the parties (*e.g.* partnerships and joint-ventures), and cases where the parties do not intend to follow the same criterion. Such a broad-based approach adopted by the OECD gave rise to serious concerns in relation to the risk of tax authorities applying the profit split of actual profits during a tax audit, regardless of the contractual arrangement and the transfer pricing method used by the taxpayer.

However, even after BEPS Actions 8-10, the contractual arrangements are still the starting point for the transfer pricing analysis and they may only be disregarded by tax authorities when: (i) the economic substance of the transaction differs from its form; (ii) the conduct of the parties diverges from that reflected in the contractual instruments; (iii) contractual arrangements deviate from those that would have been adopted by independent parties (commercial rationality)[1].

In the 2017 discussion draft, the OECD correctly followed the suggestions of reducing the commentaries on the split of “actual profits” or “anticipated profits”, by providing only general guidance on the matter in section C.4.1. This passage basically states that the determination of the profits to be split should be aligned with the accurately delineated transaction, in which case the performance of a functional analysis seems to be of fundamental importance. The arm’s length standard also corroborates the importance of a case-by-case examination, as unrelated parties do not often use actual profit splits outside of partnership and joint-venture arrangements, because data on actual profits may not be available at the time in which prices are set and measurement of actual profits may be very burdensome in practice.

Given this background, the 2017 discussion draft made some progress on this subject, by explicitly confirming that "*the determination of the profits to be split, including whether those profits are actual profits or anticipated profits, should be aligned with the accurately delineated transaction*"[2].

It also underscored that "*the starting point in the 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*"[3]. This statement reduces the concern generated by the 2016 discussion draft, which allegedly gave much leeway for tax authorities to try to apply the profit split method based on actual profits as a substitute for the taxpayer's transfer pricing method, using information unknown and unforeseeable at the time of the transaction.

Highly integrated business operations

With regard to highly integrated business operations, one of the changes brought on by the 2017 discussion draft involves the deleting of the discussion on sequential integration and parallel integration in a value chain.

In the 2016 discussion draft, the OECD suggested that the application of the profit split method to cases of sequential integration would be limited, because it would be possible to find reliable comparables for each stage of the value chain. That being the case, other transfer pricing methods would be applied, such as the Comparable Uncontrolled Price ("CUP"). However, this segregation between sequential and parallel integration is not very useful in practice, either because it is also difficult to identify reliable comparables for sequentially integrated value chains, or because multinational enterprises (MNEs) are both vertically and horizontally integrated, which gave rise to a phenomenon called "complex integration".

Moreover, the definition of parallel integration proposed by the OECD, in which different parties are involved at the same stage in the value chain, may exist in very limited situations, such as the joint development of intangibles[4].

Apart from being questionable from a business perspective, the differentiation between sequential and parallel integration would also restrict the application of profit split to value chains with an excessively elevated level of integration. Nonetheless, such restriction is not reasonable and appropriate, as the identification of the most appropriate method should take into account the nature of the controlled transaction, the strengths and weaknesses of each method, the availability of reliable information, the degree of comparability between the controlled and uncontrolled transactions, the comparability adjustments needed, among other aspects, without aprioristic restrictions that lack solid foundations.

Therefore, the 2017 discussion draft correctly left behind the discussion on parallel versus sequential integration, since the selection of the most appropriate method should not be restricted by the type of integration found in the value chain.

Relative appropriateness of the selected method

The 2017 discussion draft also states that the selection of the “most appropriate” method should take into account the relative appropriateness and reliability of the selected method as compared to other transfer pricing methods available.

However, as the taxpayer remains not obliged to test every transfer pricing method in each case, this idea of relative reliability of the selected transfer pricing method should be considered as a mere clarification. This is because, to a certain extent, the relative appropriateness of the selected method was already implicit in paragraph 18 of the 2016 discussion draft, which reads as follows: “*A lack of comparables alone is insufficient to warrant the use of a transactional profit split of actual profits under the arm’s length principle. In cases where the accurate delineation of the actual transaction indicates that one of the parties to the transaction assumes only limited risks, but reliable comparables data is scarce, it is likely that a more reliable arm’s length outcome can be reached through the adjustment (…) and interpretation (…) of inexact comparables data rather than through the inappropriate application of the transactional profit split method”****[5]***.

Therefore, the 2017 discussion draft only expressly stated an idea that was already implicit in the text.

Profit splitting factors and questions for public discussions

According to the OECD, the division of profits under the profit split method should be undertaken on the basis of the relative contributions of each part to the value creation, which generally requires the use of one or more profit splitting factors. A functional analysis, carried out in the light of the context in which the transaction takes place, will be helpful in the process of determining the relevant factors to use in splitting profits and their relative weight[6].

The 2017 discussion draft mentions asset-based and cost-based profit splitting factors, posing some questions for public discussion regarding the consideration of capital employed and skilled employees in the analysis of potential profit splitting factors.

A detailed analysis of these questions would require a specific post. For now, it suffices to say that the OECD should consider the adoption of a more **principle-based approach** in the discussions relating to profit splitting factors. As the BEPS project seeks to align transfer pricing outcomes with value creation, the determination of profit splitting factors should be based on a holistic perspective on what creates value within a MNE, in the light of the facts and circumstances of the case.

Thus, capital employed may be taken into consideration in the division of profits under the profit split method, albeit with a few adjustments, such as the appropriate weighting of its gestation lag (i.e. time between the investment execution and the value creation) and its economic lifetime (i.e. period of time during which the investment may create value). Similarly, skilled employees may play a very significant role in the value creation, thus allowing a company to differentiate itself from the competition. Failure to consider such aspects will undermine a comprehensive understanding of the drivers for value creation.

Conclusion

From this overview, it is possible to conclude that the 2017 discussion draft made some progress with regard to the profit split method, solving the main issues raised by the previous guidance, such as the discussions on “anticipated profits” versus “actual profit” and “sequential integration” versus "parallel integration". For the future, the OECD should focus on the development of a **principle-based approach** for the evaluation of transfer pricing issues, based on the arm's length standard and the concept of value creation, which needs to be strengthened and deepened.

[1] For an in-depth analysis of the relevance of contractual arrangements after BEPS, see: Raffaele Petruzzi, "The Arm's Length Principle: Between Legal Fiction and Economic Reality", in: Lang, M., Storck, A. & Petruzzi, R. (eds.), *Transfer Pricing in a Post-BEPS World* (Alphen aan den Rijn: Kluwer Law International, 2016), pp. 21-23.

[2] Paragraph 43 of the 2017 discussion draft, p. 11.

[3] Paragraph 46 of the 2017 discussion draft, p. 12.

[4] Sunny Kishore Bilaney, "Revised OECD Draft Guidance on the Profit Split Method: The Need for Conceptual Refinements!", *Bulletin for International Taxation*, Volume 71, No. 5 (Amsterdam: IBFD, 2017) p. 240

[5] Paragraph 18 of the 2016 discussion draft, p. 8.

[6] Paragraph 54 of the 2017 discussion draft, p. 14.

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