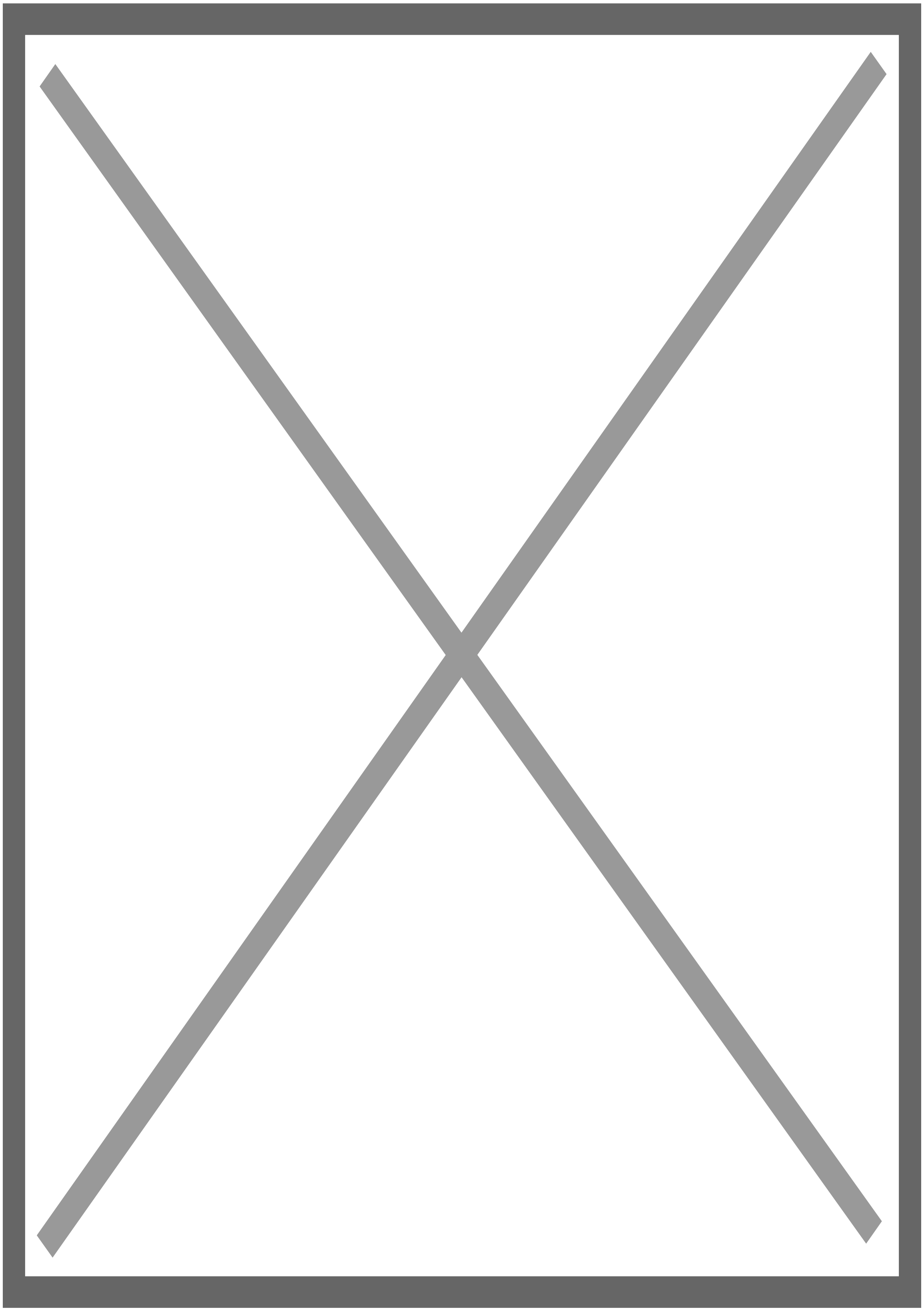
Heading for a split

International Tax



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Stéphane Gelin and Céline Pasquier consider the OECD recommendations for profit split in the context of BEPS

Key Points

What is the issue?

The OECD is making a strong push to favour profit split as the preferred method to fight base erosion and profit shifting

What does it mean for me?

Profit split is complex to implement, with limited guidelines. Overuse of the method would create uncertainty and double taxation for multinational companies

What can I take away?

The business community should continue to engage in the BEPS process to ensure the scope of the project is maintained

In the base erosion and profit shifting (BEPS) action plan presented on 19 July 2013, the OECD called for the setting of transfer pricing in line with value creation (actions 8, 9 and 10) and the re-examination of transfer pricing documentation (action 13). In the aftermath of 2014 deliverables, transfer pricing remains a priority on the OECD's BEPS agenda for 2015.

The OECD discussion drafts released at the end of 2014; actions 8, 9 and 10 on low value-adding services, profit splits, cross-border commodities, and risk and recharacterisation have been highly debated. But new light has been shed on action 13.

On 10 February 2015, the OECD secretary-general, Angel Gurría, announced at the G20 finance ministers and central bank governors' meeting in Istanbul the publication of Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting.

The use of profit splits in the context of global value chain (BEPS action 10) is the subject of a discussion draft issued by the OECD on 16 December 2014. As its introduction reminds us, the purpose of action 10 is to 'develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties […]'. This implies '[clarifying] the application of transfer pricing methods, in particular profit splits, in the context of global value chains'.

Profit split within the framework of OECD transfer pricing guidelines

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, published in July 2010, outline five methods:

1. the comparable uncontrolled price (CUP) method;

2. the resale price method;
3. the cost plus method;
4. transactional net margin method (TNMM); and
5. the profit split method.

Resale, cost plus and TNMM are deemed as ‘unilateral – or one-sided – methods’ because only one party is tested to confirm that it realises an arm’s-length method. CUP and profit split methods are thus bilateral methods: CUP provides directly for the arm’s-length price of the transaction, although it implicitly confirms the margin realised by each party; profit split explicitly allocates an arm’s-length margin to each party, which makes it an efficient tool to fight allocation of profits to low-substance entities.

The guidelines do not favour the application of one method over the others; they recommend using the ‘most appropriate’ one which depends on the transaction at stake, the functional analysis, or the availability of data.

The guidelines recommend resorting to the profit split method because it best reflects the complexity of business transactions, including for highly integrated operations, or when both parties make unique and valuable contributions (such as value-added functions or unique intangibles). The guidelines stress that a weakness of profit split relates to difficulties in its application because information on independent parties is not readily available. It is already difficult to find reliable information on prices applied between independent parties in order to apply CUP.

It seems impossible to obtain information on the level of profit derived by an independent party. To avoid this issue, the guidelines suggest allocating profits based on the division of functions (taking account of the assets used and risks assumed) between associated enterprises. Even in this case, the guidelines indicate that information from associated foreign enterprises may prove difficult to access for the local tax administration, and even for the associated local enterprise.

Profit split in the context of BEPS

In recent discussion drafts and reports issued by the OECD, profit split has gained substantial interest.

Its revised discussion draft, Guidance on Transfer Pricing Aspects of Intangibles (16 September 2014), refers to the method when discussing ownership and valuation of intangibles. On ownership, the draft states that ‘important’ functions related to the development, enhancement, maintenance and protection of intangibles usually contribute significantly to the value of the intangible, and should be compensated accordingly. Thus, pursuant to the draft, profit split methods and valuation techniques would be more appropriate to reward the performance of those ‘important’ functions. This position is not in line with the standard approach. Under this, the legal owner of an intangible asset would subcontract some of the significant above-mentioned functions in exchange for a cost plus compensation, justified by the limited risks borne, for instance, by a mere contract R&D service provider.

The OECD’s Addressing the Tax Challenges of the Digital Economy (16 September 2014) also refers to the use of the profit split method as part of tax aspects relating to digital economy. The report recommends examining the value chain and the consequences of greater integration in multinational enterprises.

In Guidance on Transfer Pricing Documentation and Country-by-Country Reporting (16 September 2014), the OECD refers indirectly to profit split through its risk assessment tool, the country-by-country report, which refers to indicators that are often used as allocation keys when applying that method.

In such circumstances, the discussion draft on the use of profit splits in the context of global value chain released on 16 December 2014 was awaited with great anticipation. The large number of public comments, published on February 10 and running to more than 500 pages, reflected wide expectations on the subject.

BEPS discussion draft on profit split

The discussion draft reminds us that the approach adopted is consistent with the guidelines and states that it is not intended to promote the profit split in cases other than where it ‘is likely to be the most appropriate method’. It also states strongly that a discussion on scenarios does not imply that profit split will be preferable in all cases.

Yet, nine scenarios are presented and all questions offer profit split as a solution. Taken together, they encompass a broad set of facts which go much beyond the limited cases where profit split is deemed best in the 2010 guidelines (eg unique and valuation contributions and highly integrated transactions), which can lead to a potential overuse of this method.

More specifically, some scenarios fail to consider certain factors. Scenario 2, ‘multisided businesses’, presents an integrated internet service model and concentrates on the functions performed by the local subsidiaries, but does not address risk allocation and the routine nature of some of these functions. Scenario 4, ‘integration and sharing risks’, addresses subcontracting with the same approach as in the draft of intangibles by implying that a complex and lengthy development process is exclusive of contractual allocation of risks. Scenario 5 outlines the difficulty of finding comparable companies for one-sided methods, but fails to address the availability of information regarding split of profits between independent parties.

Also, the draft seems to enter into a circular reasoning when stating that aligning taxation with value creation is a BEPS objective and, since profit split is a means to achieve this objective, the solution is simply to identify objective allocation keys when implementing the method.

Hopes for the future

The overall approach of the discussion draft is disputable when trying to build principles to implement a given method based on scenarios that are, in essence, simplistic. In this respect, the draft is closer to a scoping memorandum aiming at favouring a brainstorming session.

One hopes that the public consultation held on March 19 and 20, as these pages were going to press, helped to define the specific cases where profit split is indeed the best method and, more importantly, start the process to define guidelines for practical implementation.