Public Discussion Draft

BEPS ACTION 10: DISCUSSION DRAFT ON THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAINS

16 December 2014 - 6 February 2015

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DISCUSSION DRAFT ON THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAINS

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Public comments are invited on this discussion draft which deals with work in relation to Action 10 ("Assure that transfer pricing outcomes are in line with value creation" in the context of "other high-risk transactions") of the BEPS Action Plan.

The Action Plan on Base Erosion and Profit Shifting, published in July 2013, identifies 15 actions to address BEPS in a comprehensive manner, and sets deadlines to implement these actions.

Action 10 of the BEPS Action Plan identifies that work needs to be undertaken to develop "rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to . . . (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains."

Further, the report on Addressing the Tax Challenges of the Digital Economy developed in relation to BEPS Action 1 has identified issues in the digital economy that need to be taken into account in the course of the work on transfer pricing. The report noted in particular that the work should devote attention to the consequences of greater integration in MNEs, and should evaluate the need for increased reliance on value chain analyses and profit split methods. The report noted that this work should also address situations where comparables are not available and could consider improvements to the guidance on the use of profit splits and other profit methods along the lines already applied in connection with global trading and other integrated financial services businesses.

In accordance with this mandate, Working Party No. 6 on the Taxation of Multinational Enterprises, has considered a number of scenarios where it may be more difficult to apply one-sided transfer pricing methods to determine transfer pricing outcomes that are in line with value creation, and where the application of a transactional profit split method may be appropriate. This draft uses these scenarios to provide the context in which questions are posed concerning the application of the transactional profit split method. The questions are intended to elicit responses which will then be taken into account by Working Party No. 6 in considering revisions to the guidance on the use of the transactional profit split method in Chapter II of the Transfer Pricing Guidelines. The questions involve, in particular, the circumstances in which the application of a transactional profit split method is likely to be appropriate, and the ways in which the factors used to split the profits can align profits and value creation.

For convenience, the current text of the Transfer Pricing Guidelines relating to the application of transactional profit splits is reproduced in an Annex to this discussion draft, together with the text of Examples 17 and 18 from the (interim) guidance on transfer pricing aspects of intangibles.

The discussion draft necessarily concentrates on the guidance currently provided on the transactional profit split method in Chapter II, but respondents are reminded that such guidance is provided within a

framework of a thorough functional analysis to understand how the associated enterprises operate in the context of the value chain to which they contribute, and of a requirement to select the most appropriate transfer pricing method to the circumstances of the case. The separate discussion of the transactional profit split method in this discussion draft should not be taken to imply any change to this wider framework.

The views and proposals included in this discussion draft do not represent the consensus views of the CFA or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comment.

This discussion draft is submitted for comment by interested parties. Comments should be submitted by **6th February 2015 (no extension will be granted)** and should be sent by email to **TransferPricing@oecd.org** in Word format (in order to facilitate their distribution to government officials). They should be addressed to Andrew Hickman, Head of Transfer Pricing Unit, Centre for Tax Policy and Administration.

Please note that all comments received regarding this consultation draft will be made publicly available. Comments submitted in the name of a collective "grouping" or "coalition", or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective, or the person(s) on whose behalf the commentator(s) are acting.

A public consultation on the discussion draft and other topics will be held on 19-20 March 2015 at the OECD Conference Centre in Paris. Registration details for the public consultation will be published on the OECD website in due course. Speakers and other participants at the public consultation will be selected from among those providing timely written comments on the discussion draft.

Introduction

1. Action 10 of the BEPS Action Plan invites clarification of the application of transfer pricing methods, in particular transactional profit split methods, in the context of global value chains. This document invites responses to questions that seek to gain insight about experiences and best practices in applying transactional profit splits, and views on how current guidance might be amended in order that transactional profit splits can assure that transfer pricing outcomes are in line with value creation. Respondents are encouraged to provide practical examples to support their comments.

2. Chapters I – III of the Transfer Pricing Guidelines set out the framework for applying the arm's length principle in a transfer pricing analysis. As is described in the current wording of and proposed revisions to Section D of Chapter I[1], an essential first step in this process is to accurately delineate the transaction, which in turn relies heavily on an analysis of the functions performed by the parties, taking into account the assets used and risks assumed, as well as the other economically relevant characteristics of the transaction. Importantly, a thorough functional analysis cannot be performed in isolation: the broader context of the MNE group's business operations will often be essential to understanding the functions, assets and risks of the parties to a transaction, and their contribution to value creation.

3. The integrated nature of many MNE groups and the ways in which they interact with each other means that finding comparables (or comparables for which reasonably reliable adjustments can be made)

[1] See Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures), December 2014

can give rise to practical difficulties. In some such cases, transactional profit split methods may provide an appropriate solution. However, as is stated in paragraph 2.2 of the Guidelines: "The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. For this purpose, the selection process should take account of the respective strengths and weaknesses of the OECD recognised methods; the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods; and the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them." The separate discussion of the transactional profit split method in this discussion draft should not be taken to imply any change to this wider framework.

4. **The scenarios included in this discussion draft have been provided to illustrate points for discussion only and should in no way be taken to imply that transactional profit split methods will be the most appropriate method in the circumstances outlined in those scenarios. Similarly, the scenarios are necessarily brief for the purposes of identifying discussion points, and should not be interpreted to imply that the proper process of a thorough transfer pricing analysis can be dispensed with.**

Value chains

5. BEPS Action 10 invites clarification of how transfer pricing methods, including transactional profit split methods, apply to global value chains. The OECD report, *Interconnected Economies: Benefiting from Global Value Chains*, describes a global value chain as the "full range of firms' activities, from the conception of a product to its end use and beyond . . . . It includes activities such as design, production, marketing, distribution and support to the final consumer." The report notes that global value chains "are very heterogeneous across industries, companies, products and services." [2] In addition, the report on *Addressing the Challenges of the Digital Economy* refers to global value chains and identifies a number of specific issues generated by the key features of the digital economy that warrant attention from a tax perspective. It notes that work on the actions of the BEPS Action Plan should take these issues into account to ensure that the work can fully address BEPS in the digital economy. In this regard, the report states:

> [W]ork in this area should devote attention to the implications of the increased integration of MNEs and the spread of global value chains, in which various stages of production are spread across multiple countries. In this context, the work should evaluate the need for greater reliance on functional analyses (assets used, functions performed, and risks assumed) and on value chain analyses and should also address situations where comparables are not available because of the structures designed by taxpayers and the unique intangibles involved. In specific situations the functional analysis may show that the use of profit split methods or valuation techniques (e.g. discounted cash flow method) is appropriate. For these situations, it would be helpful to provide simpler and clearer guidance on the application of transfer pricing methods, including profit splits in the context of global value chains.[3]

6. Since the term global value chain describes all a firm's activities in relation to a product or service, there can be no assumption that a particular transfer pricing method is more appropriate in

[2] OECD (2013), Interconnected Economies: Benefiting from Global Value Chains, OECD Publishing. http://dx.doi.org/10.1787/9789264189560-en, p14

[3] OECD (2014), Addressing the Tax Challenges of the Digital Economy, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing. http://dx.doi.org/10.1787/9789264218789-en, p16

determining arm's length prices for transactions between associated enterprises within that global value chain. Instead Chapters I-III of the Guidelines and in particular the guidance on method selection in paragraph 2.2 apply in analysing global value chains. A global value chain is likely to involve extensive and varied functions involving many enterprises and multiple transactions; there seems to be very little experience of using a transactional profit split method in a way that could appropriately and comprehensively reflect the range of contributions to value in a diverse value chain. The fact that an MNE group disseminates its value chain amongst a number of enterprises in different jurisdictions does not imply that transactional profit split methods will be necessary or appropriate to benchmark arm's length returns for those enterprises. In many cases, the structure of the MNE group's value chain will allow the identification of relatively discrete, stand-alone elements which can be reliably priced using one-sided methods.

7. However, there seems to be some experience of using transactional profit splits to address challenges posed by specific features of global value chains, in a way that one-sided transfer pricing methods may be less well equipped to do. In particular, where there is significant integration involving parties to a specific transaction or transactions within that value chain, for example in the effective sharing of key functions and risks, the reliability of one-sided methods may be reduced. One-sided methods may not be able to account reliably for the interdependence of the key functions and risks, or for the synergies and benefits created by such integration. In such cases transactional profit split methods may be an appropriate means of determining an arm's length outcome, which takes into account the specific contributions of the parties to value creation.

8. The following scenario involves the use of a transactional profit split method to target one part of the global value chain which poses challenges because of high integration of functions and risks.

Scenario 1

9. Three associated Original Equipment Manufacturing enterprises in the durable goods industry are located in different territories in Europe. Each of the OEMs manufactures finished goods and components for both their local and the European market. They license in technology IP from their non-EU parent, for which they pay a royalty, but otherwise the European operation of the group is largely independent of the parent. The OEMs have a number of subsidiaries in Europe providing contract manufacturing services in relation to certain components. Sales and distribution takes place through other group subsidiaries, and, in the OEM's own state, through a division of the OEM itself.

10. In this scenario one-sided methods can reliably be used to determine arm's length pricing for the royalty and for the contract manufacturing and distribution services.

11. However, the way in which the three OEMs interact with each other in the European market is highly integrated. It has an over-arching Leadership Board, on which all three OEMs are represented, and which takes decisions for the business as a whole (*e.g.* what new products are developed, where they are developed, where they will be built, what plant investment is to be made, strategic marketing, *etc*.) The OEMs also buy and sell both components and finished goods to each other, and the success of the business depends on having a wide portfolio of products to sell across the European market. There is a high level of co-operation and interdependence between the OEMs and an effective pooling of entrepreneurial functions and risks. The alternative to a transactional profit split method in this case would involve pricing a complex web of transactions, for many of which, it may be difficult to find reliable comparables due to the very high degree of interdependence of the key functions, assets and risks of the associated enterprises.

12. In this case, a transactional profit split method could be applied to the residual profits achieved by the three OEMs (after the royalty payment and after payments for manufacturing and distribution services).

Questions

1. Can transactional profit split methods be used to provide a transfer pricing solution to this scenario? If so, how?

2. What aspects of Scenario 1 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?

3. Is the application of a transactional profit split method more useful than other methods for dealing with particular aspects of value chains, such as highly integrated functions, and the sharing of risks?

4. What guidance should be provided to address the appropriate application of transactional profit split methods to deal with these aspects of value chains?

Multisided Business Models

13. The following scenario involves a multisided and integrated digital economy business model which reflects a global value chain with diverse functions carried out by various entities of the MNE group which closely relate to the core business model of the MNE group.

Scenario 2

14. The RCo Group provides a number of internet services (*e.g.* search engines, email services, advertising, *etc*.) to customers worldwide. On one side of the business model, advertising services provided through an online platform are charged to clients for a fee that is generally based on the number of users who click on each advertisement. On the other side, online services are offered free of charge to users, whose use of the services provides the RCo Group with a substantial amount of data, including location-based data, data based on online behaviour, and data based on users' personal information. Over the course of years of data collection, refinement, processing, and analysis, the RCo Group has developed a sophisticated technology that enables it to offer to its clients the ability to target specific advertisements to certain users. The more extensive the online services, and the greater the extent of the associated data, the more valuable and attractive the other side of the business model becomes for clients wishing to advertise.

15. The technology used in providing the internet advertising services, along with the various algorithms used to collect and process data in order to target potential customers, were originally developed and funded by Company R, the parent company of the RCo Group.

16. For larger markets and in order to deal with key clients for advertising services, the group has established a number of local subsidiaries. These local subsidiaries perform two functions: they promote the use of online services provided free of charge to users, translate them into the local language, tailor them to the local market and culture, ensure that the services provided respect local regulatory requirements, and provide technical consulting to users. In addition, they generate demand for and adapt advertising services. In doing so, they also regularly interact with staff members in Company R in charge of developing the technology and make suggestions, notably on the algorithms and technologies used and

their adaptation to local market features, and on new features that would be attractive to users in their market.

Questions

5. Can transactional profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how?

6. What aspects of Scenario 2 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?

Scope

17. Current guidance at paragraph 2.109 of the Transfer Pricing Guidelines discusses the application of transactional profit split methods in cases where both parties make "unique and valuable contributions." This section of the discussion draft focusses on the appropriate scope for the application of transactional profit split methods, *i.e.* when such methods are likely to be the most appropriate method for determining the arm's length price for the tested transaction or transactions.

Unique and valuable contributions

18. The Guidelines note that transactional profit split methods may be the most appropriate method in cases where both parties make "unique and valuable contributions" to a transaction, in particular, where both parties contribute unique intangibles. The term "unique and valuable" is not defined, but the term is used in the amendments to Chapter VI at paragraph 6.17 contained in the 2014 Report, *Guidance on the Transfer Pricing Aspects of Intangibles*, in defining unique and valuable intangibles. That definition may suggest that "unique and valuable contributions" involve contributions which constitute a key source of competitive advantage for the business, and create difficulties in terms of finding reliable comparables.

19. The following scenario involves a situation where the parties arguably do provide highly valuable functions which are an important and substantial source of value creation and competitive advantage for the MNE group's business.

Scenario 3

20. Company P, located in country P, is a manufacturer of high technology industrial equipment. Company S, a subsidiary of Company P, markets and distributes the equipment to unrelated customers in country S. Both companies are members of Group X. Company P conducts extensive R&D activities to develop and improve the technological features of its equipment. It funds and has legal ownership of all the technology intangibles it develops. Company P also owns the global trademark, and provides broad guidance to its subsidiaries around the world on its overall marketing strategy. There are several global competitors making equipment which is similar (in terms of functionality, performance, and reputation) to that made by Group X. These global competitors also operate in Country S, which is a large market for such equipment.

21. Company S is responsible for sales of the equipment and undertakes marketing activities. Due to the nature of its business, this entails developing very close relationships with customers, including providing on-site services (often in remote locations), carrying an extensive stock of spare parts, and a highly proactive maintenance programme to detect likely problems before they arise. Company S also provides extensive advice to customers on equipment choice, makes modifications for particular local

conditions, and for maximising performance efficiency and effectiveness. These activities provide a significant competitive advantage as customers place high value on the reliability and performance of the equipment. In this case, Company S is recognised as not merely a "routine" distributor, but its activities constitute a key source of competitive advantage for the Group.

Questions

7. Does the way in which "unique and valuable" is defined for intangibles assist in defining the term "unique and valuable contributions" in relation to the transactional profit split method?

8. What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method?

9. Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm's length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?

10. What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3?

Integration and sharing of risks

22. Paragraph 2.109 of the Guidelines also provides that transactional profit split methods can offer a solution for highly integrated operations for which a one-sided method would not be appropriate. As noted above, one-sided methods may not be able to account reliably for the interdependence of the key functions and risks, the synergies and benefits created by such integration. Moreover, where an MNE's business operations are highly integrated, strategic risks may be jointly managed and controlled by more than one enterprise in the group, creating a strong interdependence of key functions and risks between the parties. This is the case in certain global financial trading operations, but also exists in other kinds of business operations.

23. The following scenario involves a situation where the enterprises share in the risk of product development.

Scenario 4

24. Company A, in country A, manufactures and sells sophisticated medical equipment to unrelated customers. In developing new generation of equipment, it outsources the development and production of certain key components in the equipment to its associate enterprises, Companies B and C. The development of the components is a lengthy and complex process. The components are highly specific to the equipment under development and unlikely to be useful in other types of products. Companies A, B and C each control and perform their own research, development and production processes.

25. All third-party sales revenue from the equipment will initially accrue to A. The rewards to companies A, B, and C are contractually determined by the MNE group on a profit-sharing basis.

Questions

11. In what circumstances might the application of a transactional profit split method be an

appropriate approach for dealing with sharing of risks?

12. Would a one-sided method produce more reliable results?

13. What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?

Fragmentation

26. Fragmentation of functions is common in an integrated value chain. It may involve, for example, the separation into different legal entities of logistics, warehousing, marketing, and sales functions (or aspects of these functions) within a value chain. In some cases, it may prove difficult to find comparable uncontrolled enterprises that are similarly specialised in their activities and carry out just the narrow activity conducted by the controlled enterprise. In addition, it may be difficult to account for the very high level of interdependence between the functions performed by the associated enterprises that may be absent in independent enterprises.

27. Because of fragmentation, available data on similar independent transactions may generally not have a comparable mix of functions, assets and risks to the tested party or parties. High levels of integration may mean that comparables from independent enterprises do not reflect the same functional and risk profiles. Where fragmentation gives rise to significant comparability challenges, it may be feasible to support the outcomes of pricing based on potential comparables with a transactional profit split approach. Such an approach could identify a comparable for some or all of the fragmented activities on a combined basis (such as a sales and distribution company in the example above), and the principles of a contribution analysis (as described in Chapter II of the Guidelines at section C.3.2.1) used to divide the benchmarked profit.

28. Related to this, the interim guidance on Chapter VI contained in Guidance on Transfer Pricing Aspects of Intangibles (2014) mentions the potential for using transactional profit split methods in cases where one party holds the legal ownership of intangibles while another performs important functions relating to the development, enhancement, maintenance, protection and exploitation of those intangibles, and another party provides funding (see paragraph 6.57-6.58 and examples 17 and 18).[4]

Questions

14. Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how?

15. Can transactional profit split methods be used to provide reliable arm's length transfer pricing solutions for fragmented functions? If so how? Can other methods address the issue of fragmentation, and, if so, how?

16. What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?

[4] For convenience, examples 17 and 18 are reproduced in the Annex at the end of this document

Lack of comparables

29. All of the issues set out in this section on the scope of the transactional profit split method touch on an issue which reduces the reliability of one-sided methods: the potential lack of reliable comparables. In such cases, reliable arm's length solutions can often still be found through the application of one-sided methods, for examples, by broadening the search for comparables to other markets with similar economic conditions, and by making reasonably accurate comparability adjustments. However where a lack of comparables is such that it poses a serious impediment to the reliable application of one-sided methods, transactional profit split methods may be useful in circumstances where they can be reliably applied to determine an arm's length outcome in accordance with the functions of the parties.

30. The following scenario relates to the potential lack of reliable comparables, but the other scenarios in this section also illustrate the concept.

Scenario 5

31. An MNE group operates as a supplier of office stationery in a region. The group has operations in several countries, and each operating company supplies stationery products to its local customers. Some of the MNE's larger customers also operate across the region, and increasingly those larger customers co-ordinate their procurement activities and want to deal with suppliers who can operate regionally. As a result, the activities of each operating company of the MNE involve (1) selling to local customers, (2) agreeing terms and taking orders from local customers buying on behalf of their regional organisation, and (3) fulfilling orders placed with other group companies. All orders are invoiced and fulfilled locally in accordance with the terms agreed. In effect each operating company has a purely local business, together with a regional business in which each company generates business for the other. The mix of local and regional business varies from year to year and from operating company to operating company.

Questions

17. How can comparables be found and applied in scenario 5? What method is likely to be appropriate for determining an arm's length remuneration for the activities of the group companies?

18. How can comparables be found and applied in scenario 3 (or to any other relevant scenario in this discussion draft)?

19. What aspects of scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?

32. In cases where available comparables for the application of a one-sided method may not reliably reflect the level of functions or risk in the tested party, concepts of a transactional profit split approach may sometimes offer the means to vary or flex the results under a one-sided method. For example, application of a one-sided method may result in establishing a range of operating margins of 4-10% for one of the parties to the transaction: a baseline return of 7% is adopted which would vary in accordance with a pre-determined computation upwards to 10% and downwards to 4% depending on the levels of consolidated profits or sales achieved by the parties to the transaction.

Questions

20. In what circumstances, if any, might an approach described in the last sentence of paragraph 32 be appropriate?

21. More generally, in what circumstances would a transactional profit split approach be useful in supporting the application of other transfer pricing methods, and what guidance would be useful to develop for the supporting use of such approaches?

Aligning taxation with value creation

33. The BEPS Action Plan has as one of its three pillars ensuring that taxation is aligned with substance, and Action 10 covering profit splits falls under the heading of assuring that transfer pricing outcomes are in line with value creation. The Plan notes that "the rules should be improved to put more emphasis on value creation in highly integrated groups".

34. Transactional profit split methods may be viewed as one means of achieving this closer alignment between profits and value creation. In practice, transactional profit split methods are typically applied using one or more allocation keys or factors to split the profits, based on the outcome of a functional analysis that determines how value is created in the MNE group. As the Guidelines note, it is important that factors are used in an economically valid way that approximates the division of profits that would have been agreed at arm's length (see paragraph 2.108)

35. While the Guidelines state at paragraph 2.135 that there should be a "strong correlation" between the allocation key and the creation of value, a common criticism of transactional profit split methods is their perceived subjectivity: allocation keys can be difficult to verify from objective evidence.

36. This section focusses on how to develop objectivity in profit split factors in order that transfer pricing outcomes are firmly aligned with value creation. Scenario 8 in a later part of this document contains a weighting approach relevant to the issues in this section.

37. Scenario 1 in this discussion draft sets out the integrated activities of three manufacturing OEMs. Assume further that the post-royalty residual profits or losses are split between the OEMs on the basis of three factors, production capacity, headcount, and value of production. Each factor is intended to reflect key value drivers in the business, deriving from the detailed functional analysis of the business. Production capacity intends to recognise the capital investment, headcount intends to recognise the key input of labour, and value of production intends to recognise the contribution to actual output. These factors are also then given a weighting.

Questions

22. In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?

23. What guidance is needed on weighting of factors?

38. In the following scenario a RACI[5] responsibility assignment matrix is used to weight the contributions of the parties to value creation.

Scenario 6

39. Company A located in country A purchases technological goods from its associated manufacturer, Company B located in country B. Company A determines and controls the business and development strategy of the group, deciding which markets to operate in and the product range and pricing within each market. It licenses relevant IP from another group entity (Company C) which has developed and legally owns it. The licence fee payable to Company C was subject to a separate transfer pricing analysis and an arm's length amount determined based on comparable, independent transactions. Company A on-sells the products to local distribution entities.

40. Company B determines and controls the global group manufacturing strategy including the procurement process and the structure of the supply chain. It develops and owns IP related to the manufacturing processes for the group's products. The actual manufacturing is carried out on a contract basis by another group entity (Company D) also located in country B.

41. After undertaking a thorough analysis of the commercial and financial relations between the enterprises in the group, including the functions, assets and risks of the parties, and considering the availability of potential comparables, the MNE group adopted a transfer pricing methodology based on a split of the total system profit between Company A and Company B. Those companies then provided arm's length remuneration from their shares to Company C and the local distributors, and the manufacturing entity in country B, respectively, using one-sided methods.

42. The allocation of the system profit between Company A and Company B was determined by an analysis of their respective contributions (including the contributions of those other entities that they separately compensate) to each of the group's key value drivers (undertaken as part of a thorough functional analysis). For each process contributing to a particular value driver it was considered which personnel were responsible for, accountable for, consulted in making or merely informed of relevant decisions. The analysis is reviewed and updated annually.

43. Risks and assets were not considered separately as they were considered by the MNE group to be embedded in the processes that managed them.

Questions

24. How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for example approaches based on concepts of bargaining power, options realistically available, or a RACI-type analysis of responsibilities and decision making)?

25. Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an MNE operates an integrated global value chain ? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate?

[5] The RACI model describes the roles of participants based on who is Responsible, Accountable, Consulted and Informed for each task in a business process, project, etc.

Hard-to-value intangibles

44. The interim guidance on Chapter VI suggests that transactional profit split methods may, in some cases, be applied to the valuation of partially developed intangibles. It goes on to caution that, in such cases, using transactional profit split approaches based on the cost of the contributions made by the parties may be unreliable as there may be little relationship between such costs and the value of the contributions (paragraphs 6.147- 6.148).

Question

26. What specific aspects of transactional profit split approaches may be particularly relevant in determining arm's length outcomes for transactions involving hard-to-value intangibles?

Dealing with *ex ante / ex post* results

45. Transactional profit split approaches have been suggested as a way to address significant differences between *ex ante* and *ex post* result, and may provide an appropriate way to deal with unanticipated events where strategic risks are effectively shared between associated enterprises.

46. The following scenario relates to how a transactional profit split method can determine from the outset how parties will determine the share of uncertain outcomes.

Scenario 7

47. Two associated enterprises jointly agree to share the development of a new product, and each associated enterprise will be responsible for developing and manufacturing one of the two key components. At the outset it is estimated by the enterprises that the development costs will be 100 in total, with 30 estimated to be incurred by one of the parties and 70 estimated to be incurred by the other. However, there is risk that the project will not produce the expected returns, and significant risk of cost overruns. Each party manages its own cost overrun risk. The parties agree that expected profits from the sale of the new product will first be allocated to provide each party with a routine return on its manufacturing functions; with the residual profit and loss split 30/70 notwithstanding that the actual development costs may vary from what was projected.

Questions

27. How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?

48. The following example illustrates the fact that transactional profit split methods do not always result in outcomes which report a split of actual profits. Sometimes profit splits are used to determine a price, such as a royalty. One advantage of the conversion of the profit split outcome to a royalty is a practical one: a royalty may be simpler to implement and avoids end of year calculations to true-up the profits to equate to the profit split ratio. The conversion of a profit split to a fixed royalty may, however, reduce the potential for the transactional profit split method to respond to unanticipated events.

Scenario 8

49. Parent Company P licenses patent rights relating to a potential pharmaceutical product to Subsidiary Company S. Company S is responsible for marketing the product. P performs all of the basic research and most of the development functions, with S contributing to late stage development and marketing. For the purposes of this scenario, both companies are understood to contribute to the development of the intangible. It is possible to risk-weight the expenditure based on reported industry data about success rates at each development stage for products in the same therapeutic category. The risk-weighted costs on a net present value basis, including anticipated further costs involved in bringing the product to market, are contributed by P and S in the ratio 80:20. At the time of the licence, projections are prepared on a net present value basis of the expected sales, production and sales costs (including a benchmarked return on those costs), and resulting profits. The respective contributions to product development are then used to split the anticipated profits in the ratio 80:20. At this point, however, P's expected profit from the expected sales is converted to a royalty rate on those sales. In this scenario, the transactional profit split method is used to calculate a royalty.

Questions

28. Is the application of a transactional profit split method to calculate the royalty in Scenario 8, or in other circumstances to set a price, helpful? What are the advantages and disadvantages?

Dealing with losses

50. The Guidelines note that references to 'profits' in the guidance should be taken as applying equally to losses (para 2.108). The guidance also states that generally the factors used to split profits should be applied consistently, including during loss years (para 2.117), unless independent parties would have agreed otherwise.

51. The following scenario relates to a situation in which it may be possible to consider that the transactional profit splits method may be applied in a different way when there are losses to be split than when there are profits.

Scenario 9

52. Three companies in a banking group carry on trading in a type of structured financial product through an integrated model. Each operates in one of the main time zones. Profits from this business are allocated between the three companies using a multi-factor profit split methodology that gives different weightings to each factor. The greatest weighting is given to the factor based on remuneration paid to the traders in each location, including bonuses based on performance.

53. However, the methodology recognises that this line of business may give rise to significant losses rather than profits over a period and the correlation between bonus compensation and such losses will not be the same as that between bonuses and profits. In order to ensure that the allocation of losses is consistent with arrangements that would have been made up-front by independent enterprises the methodology incorporates principles for the adjustment of the remuneration based factor where losses are incurred. This is based on an analysis of the group's compensation policy in such circumstances as well as a careful consideration of the types of circumstance in which losses may be incurred in the particular business.

Questions

29. In what circumstances might it be appropriate under the arm's length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss?

30. Are there circumstances under the arm's length principle where parties which would share combined profits, would not be expected to take any share of combined losses?

Questions

31. Paragraph 2.114 of the Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?

32. Finally, what further points would respondents wish to make about the application of transactional profit split methods not covered by previous questions?

ANNEX

EXTRACT FROM TRANSFER PRICING GUIDELINES (2010) CHAPTER II, PART III: TRANSACTIONAL PROFIT METHODS

C. Transactional profit split method

C.1 In general

2.108 The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12) by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions. The transactional profit split method first identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged (the "combined profits"). References to "profits" should be taken as applying equally to losses. See paragraphs 2.124-2.131 for a discussion of how to measure the profits to be split. It then splits those combined profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. See paragraphs 2.132–2.145 for a discussion of how to split the combined profits.

C.2 Strengths and weaknesses

2.109 The main strength of the transactional profit split method is that it can offer a solution for highly integrated operations for which a one-sided method would not be appropriate. For example, see the discussion of the appropriateness and application of profit split methods to the global trading of financial instruments between associated enterprises in Part III, Section C of the Report on the Attribution of Profits to Permanent Establishments.[6] A transactional profit split method may also be found to be the most appropriate method in cases where both parties to a transaction make unique and valuable contributions (*e.g.* contribute unique intangibles) to the transaction, because in such a case independent parties might wish to share the profits of the transaction in proportion to their respective contributions and a two-sided method might be more appropriate in these circumstances than a one-sided method. In addition, in the presence of unique and valuable contributions, reliable comparables information might be insufficient to apply another method. On the other hand, a transactional profit split method would ordinarily not be used in cases where one party to the transaction performs only simple functions and does not make any significant unique contribution (*e.g.* contract manufacturing or contract service activities in relevant circumstances), as in such cases a transactional profit split method typically would not be appropriate in

[6] See Report on the Attribution of Profits to Permanent Establishments, approved by the Committee on Fiscal Affairs on 24 June 2008 and by the Council for publication on 17 July 2008 and the 2010 Sanitised Version of the Report on the Attribution of Profits to Permanent Establishments, approved by the Committee on Fiscal Affairs on 22 June 2010 and by the Council for publication on 22 July 2010.

view of the functional analysis of that party. See paragraphs 3.38-3.39 for a discussion of limitations in available comparables.

2.110 Where comparables data are available, they can be relevant in the profit split analysis to support the division of profits that would have been achieved between independent parties in comparable circumstances. Comparables data can also be relevant in the profit split analysis to assess the value of the contributions that each associated enterprise makes to the transactions. In effect, the assumption is that independent parties would have split the combined profits in proportion to the value of their respective contributions to the generation of profit in the transaction. On the other hand, the external market data considered in valuing the contribution each associated enterprise makes to the controlled transactions will be less closely connected to those transactions than is the case with the other available methods.

2.111 However, in those cases where there is no more direct evidence of how independent parties in comparable circumstances would have split the profit in comparable transactions, the allocation of profits may be based on the division of functions (taking account of the assets used and risks assumed) between the associated enterprises themselves.

2.112 Another strength of the transactional profit split method is that it offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises, while still constituting an arm's length approach to the extent that it reflects what independent enterprises reasonably would have done if faced with the same circumstances.

2.113 A further strength of the transactional profit split method is that it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result, since both parties to the transaction are evaluated. This aspect can be particularly important when analysing the contributions by the parties in respect of the intangible property employed in the controlled transactions. This two-sided approach may also be used to achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administrations.

2.114 A weakness of the transactional profit split method relates to difficulties in its application. On first review, the transactional profit split method may appear readily accessible to both taxpayers and tax administrations because it tends to rely less on information about independent enterprises. However, associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates. In addition, it may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies. Further, when the transactional profit split method is applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises' other activities.

C.3 Guidance for application

C.3.1 In general

2.115 These Guidelines do not seek to provide an exhaustive catalogue of ways in which the transactional profit split method may be applied. Application of the method will depend on the circumstances of the case and the information available, but the overriding objective should be to approximate as closely as possible the split of profits that would have been realised had the parties been independent enterprises.

2.116 Under the transactional profit split method, the combined profits are to be split between the associated enterprises on an economically valid basis that approximates the division of profits that would

have been anticipated and reflected in an agreement made at arm's length. In general, the determination of the combined profits to be split and of the splitting factors should:

- Be consistent with the functional analysis of the controlled transaction under review, and in particular reflect the allocation of risks among the parties,

- Be consistent with the determination of the combined profits to be split and of the splitting factors which would have been agreed between independent parties,

- Be consistent with the type of profit split approach (*e.g.* contribution analysis, residual analysis, or other; *ex ante* or *ex post* approach, as discussed at paragraphs 2.118-2.145 below), and

- Be capable of being measured in a reliable manner.

2.117 In addition,

- If a transactional profit split method is used to set transfer pricing in controlled transactions (*ex ante* approach), it would be reasonable to expect the life-time of the arrangement and the criteria or allocation keys to be agreed in advance of the transaction,

- The person using a transactional profit split method (taxpayer or tax administration) should be prepared to explain why it is regarded as the most appropriate method to the circumstances of the case, as well as the way it is implemented, and in particular the criteria or allocation keys used to split the combined profits, and

- The determination of the combined profits to be split and of the splitting factors should generally be used consistently over the life-time of the arrangement, including during loss years, unless independent parties in comparable circumstances would have agreed otherwise and the rationale for using differing criteria or allocation keys is documented, or if specific circumstances would have justified a re-negotiation between independent parties.

C.3.2 Various approaches for splitting the profits

2.118 There are a number of approaches for estimating the division of profits, based on either projected or actual profits, as may be appropriate, to which independent enterprises would have agreed, two of which are discussed in the following paragraphs. These approaches – contribution analysis and residual analysis – are not necessarily exhaustive or mutually exclusive.

C.3.2.1 Contribution analysis

2.119 Under a contribution analysis, the combined profits, which are the total profits from the controlled transactions under examination, would be divided between the associated enterprises based upon a reasonable approximation of the division of profits that independent enterprises would have expected to realize from engaging in comparable transactions. This division can be supported by comparables data where available. In the absence thereof, it is often based on the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions, taking account of their assets used and risks assumed. In cases where the relative value of the contributions can be measured directly, it may not be necessary to estimate the actual market value of each participant's contributions.

2.120 It can be difficult to determine the relative value of the contribution that each of the associated enterprises makes to the controlled transactions, and the approach will often depend on the facts and

circumstances of each case. The determination might be made by comparing the nature and degree of each party's contribution of differing types (for example, provision of services, development expenses incurred, capital invested) and assigning a percentage based upon the relative comparison and external market data. See paragraphs 2.132-2.145 for a discussion of how to split the combined profits.

C.3.2.2 Residual analyses[7]

2.121 A residual analysis divides the combined profits from the controlled transactions under examination in two stages. In the first stage, each participant is allocated an arm's length remuneration for its non-unique contributions in relation to the controlled transactions in which it is engaged. Ordinarily this initial remuneration would be determined by applying one of the traditional transaction methods or a transactional net margin method, by reference to the remuneration of comparable transactions between independent enterprises. Thus, it would generally not account for the return that would be generated by any unique and valuable contribution by the participants. In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances, following the guidance as described at paragraphs 2.132-2.145 for splitting the combined profits.

2.122 An alternative approach to how to apply a residual analysis could seek to replicate the outcome of bargaining between independent enterprises in the free market. In this context, in the first stage, the initial remuneration provided to each participant would correspond to the lowest price an independent seller reasonably would accept in the circumstances and the highest price that the buyer would be reasonably willing to pay. Any discrepancy between these two figures could result in the residual profit over which independent enterprises would bargain. In the second stage, the residual analysis therefore could divide this pool of profit based on an analysis of any factors relevant to the associated enterprises that would indicate how independent enterprises might have split the difference between the seller's minimum price and the buyer's maximum price.

2.123 In some cases an analysis could be performed, perhaps as part of a residual profit split or as a method of splitting profits in its own right, by taking into account the discounted cash flow to the parties to the controlled transactions over the anticipated life of the business. One of the situations in which this may be an effective method could be where a start-up is involved, cash flow projections were carried out as part of assessing the viability of the project, and capital investment and sales could be estimated with a reasonable degree of certainty. However, the reliability of such an approach will depend on the use of an appropriate discount rate, which should be based on market benchmarks. In this regard, it should be noted that industry-wide risk premiums used to calculate the discount do not distinguish between particular companies let alone segments of businesses, and estimates of the relative timing of receipts can be problematic. Such an approach, therefore, would require considerable caution and should be supplemented where possible by information derived from other methods.

C.3.3 Determining the combined profits to be split

2.124 The combined profits to be split in a transactional profit split method are the profits of the associated enterprises from the controlled transactions in which the associated enterprises are engaged. The combined profits to be split should only be those arising from the controlled transaction(s) under review. In determining those profits, it is essential to first identify the relevant transactions to be covered by the transactional profit split. It is also essential to identify the level of aggregation, see paragraphs 3.9-3.12. Where a taxpayer has controlled transactions with more than one associated enterprise, it is also necessary to identify the parties in relation to those transactions and the profits to be split among them.

7 An example illustrating the application of the residual profit split is found in Annex II to Chapter II.

2.125 In order to determine the combined profits to be split, the accounts of the parties to the transaction to which a transactional profit split is applied need to be put on a common basis as to accounting practice and currency, and then combined. Because accounting standards can have significant effects on the determination of the profits to be split, accounting standards should be selected in advance of applying the method and applied consistently over the lifetime of the arrangement. See paragraphs 2.115-2.117 for general guidance on the consistency of the determination of the combined profits to be split.

2.126 Financial accounting may provide the starting point for determining the profit to be split in the absence of harmonized tax accounting standards. The use of other financial data (*e.g.* cost accounting) should be permitted where such accounts exist, are reliable, auditable and sufficiently transactional. In this context, product-line income statements or divisional accounts may prove to be the most useful accounting records.

C.3.3.1 Actual or projected profits

2.127 If the profit split method were to be used by associated enterprises to set transfer pricing in controlled transactions (*i.e.* an *ex ante* approach), then each associated enterprise would seek to achieve the division of profits that independent enterprises would have expected to realize from engaging in comparable transactions. Depending on the facts and circumstances, profit splits using either actual or projected profits are observed in practice.

2.128 When a tax administration examines the application of the method used *ex ante* to evaluate whether the method has reliably approximated arm's length transfer pricing, it is critical for the tax administration to acknowledge that the taxpayer could not have known what the actual profit experience of the business activity would be at the time that the conditions of the controlled transaction were established. Without such an acknowledgement, the application of the transactional profit split method could penalize or reward a taxpayer by focusing on circumstances that the taxpayer could not reasonably have foreseen. Such an application would be contrary to the arm's length principle, because independent enterprises in similar circumstances could only have relied upon projections and could not have known the actual profit experience. See also paragraph 3.74.

2.129 In using the transactional profit split method to establish the conditions of controlled transactions, the associated enterprises would seek to achieve the division of profit that independent enterprises would have realized. The evaluation of the conditions of the controlled transactions of associated enterprises using a transactional profit split method will be easiest for a tax administration where the associated enterprises have originally determined such conditions on the same basis. The evaluation may then begin on the same basis to verify whether the division of actual profits is in accordance with the arm's length principle.

2.130 Where the associated enterprises have determined the conditions in their controlled transactions on a basis other than the transactional profit split method, the tax administration would evaluate such conditions on the basis of the actual profit experience of the enterprise. However, care would need to be exercised to ensure that the application of a transactional profit split method is performed in a context that is similar to what the associated enterprises would have experienced, *i.e.* on the basis of information known or reasonably foreseeable by the associated enterprises at the time the transactions were entered into, in order to avoid the use of hindsight. See paragraphs 2.11 and 3.74.

C.3.3.2 Different measures of profits[8]

[8] An example illustrating different measures of profits when applying a transactional profit split method can be found in Annex III to Chapter II.

2.131 Generally, the combined profits to be split in a transactional profit split method are operating profits. Applying the transactional profit split in this manner ensures that both income and expenses of the MNE are attributed to the relevant associated enterprise on a consistent basis. However, occasionally, it may be appropriate to carry out a split of gross profits and then deduct the expenses incurred in or attributable to each relevant enterprise (and excluding expenses taken into account in computing gross profits). In such cases, where different analyses are being applied to divide the gross income and the deductions of the MNE among associated enterprises, care must be taken to ensure that the expenses incurred in or attributable to each enterprise are consistent with the activities and risks undertaken there, and that the allocation of gross profits is likewise consistent with the placement of activities and risks. For example, in the case of an MNE that engages in highly integrated worldwide trading operations, involving various types of property, it may be possible to determine the enterprises in which expenses are incurred (or attributed), but not to accurately determine the particular trading activities to which those expenses relate. In such a case, it may be appropriate to split the gross profits from each trading activity and then deduct from the resulting overall gross profits the expenses incurred in or attributable to each enterprise, bearing in mind the caution noted above.

C.3.4 How to split the combined profits

C.3.4.1 In general

2.132 The relevance of comparable uncontrolled transactions or internal data and the criteria used to achieve an arm's length division of the profits depend on the facts and circumstances of the case. It is therefore not desirable to establish a prescriptive list of criteria or allocation keys. See paragraphs 2.115-2.117 for general guidance on the consistency of the determination of the splitting factors. In addition, the criteria or allocation keys used to split the profit should:

- Be reasonably independent of transfer pricing policy formulation, *i.e.* they should be based on objective data (*e.g.* sales to independent parties), not on data relating to the remuneration of controlled transactions (*e.g.* sales to associated enterprises), and

- Be supported by comparables data, internal data, or both.

C.3.4.2 Reliance on data from comparable uncontrolled transactions

2.133 One possible approach is to split the combined profits based on the division of profits that actually results from comparable uncontrolled transactions. Examples of possible sources of information on uncontrolled transactions that might usefully assist the determination of criteria to split the profits, depending on the facts and circumstances of the case, include joint-venture arrangements between independent parties under which profits are shared, such as development projects in the oil and gas industry; pharmaceutical collaborations, co-marketing or co-promotion agreements; arrangements between independent music record labels and music artists; uncontrolled arrangements in the financial services sector; etc.

C.3.4.3 Allocation keys

2.134 In practice, the division of the combined profits under a transactional profit split method is generally achieved using one or more allocation keys. Depending on the facts and circumstances of the case, the allocation key can be a figure (*e.g.* a 30%-70% split based on evidence of a similar split achieved between independent parties in comparable transactions), or a variable (*e.g.* relative value of participant's marketing expenditure or other possible keys as discussed below). Where more than one allocation key is

used, it will also be necessary to weight the allocation keys used to determine the relative contribution that each allocation key represents to the earning of the combined profits.

2.135 In practice, allocation keys based on assets/capital (operating assets, fixed assets, intangible assets, capital employed) or costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) are often used. Other allocation keys based for instance on incremental sales, headcounts (number of individuals involved in the key functions that generate value to the transaction), time spent by a certain group of employees if there is a strong correlation between the time spent and the creation of the combined profits, number of servers, data storage, floor area of retail points, etc. may be appropriate depending on the facts and circumstances of the transactions.

Asset-based allocation keys

2.136 Asset-based or capital-based allocation keys can be used where there is a strong correlation between tangible or intangible assets or capital employed and creation of value in the context of the controlled transaction. See paragraph 2.145 for a brief discussion of splitting the combined profits by reference to capital employed. In order for an allocation key to be meaningful, it should be applied consistently to all the parties to the transaction. See paragraph 2.98 for a discussion of comparability issues in relation to asset valuation in the context of the transactional net margin method, which is also valid in the context of the transactional profit split method.

2.137 One particular circumstance where the transactional profit split method may be found to be the most appropriate method is the case where each party to the transaction contributes valuable, unique intangibles. Intangible assets pose difficult issues in relation both to their identification and to their valuation. Identification of intangibles can be difficult because not all valuable intangible assets are legally protected and registered and not all valuable intangible assets are recorded in the accounts. An essential part of a transactional profit split analysis is to identify what intangible assets are contributed by each associated enterprise to the controlled transaction and their relative value. Guidance on intangible property is found at Chapter VI of these Guidelines. See also the examples in the Annex to Chapter VI "Examples to illustrate the Transfer Pricing Guidelines on intangible property and highly uncertain valuation".

Cost-based allocation keys

2.138 An allocation key based on expenses may be appropriate where it is possible to identify a strong correlation between relative expenses incurred and relative value added. For example, marketing expenses may be an appropriate key for distributors-marketers if advertising generates material marketing intangibles, *e.g.* in consumer goods where the value of marketing intangibles is affected by advertising. Research and development expenses may be suitable for manufacturers if they relate to the development of significant trade intangibles such as patents. However, if, for instance, each party contributes different valuable intangibles, then it is not appropriate to use a cost-based allocation key unless cost is a reliable measure of the relative value of those intangibles. Remuneration is frequently used in situations where people functions are the primary factor in generating the combined profits.

2.139 Cost-based allocation keys have the advantage of simplicity. It is however not always the case that a strong correlation exists between relative expenses and relative value, as discussed in paragraph 6.27. One possible issue with cost-based allocation keys is that they can be very sensitive to accounting classification of costs. It is therefore necessary to clearly identify in advance what costs will be taken into account in the determination of the allocation key and to determine the allocation key consistently among the parties.

Timing issues

2.140 Another important issue is the determination of the relevant period of time from which the elements of determination of the allocation key (*e.g.* assets, costs, or others) should be taken into account. A difficulty arises because there can be a time lag between the time when expenses are incurred and the time when value is created, and it is sometimes difficult to decide which period's expenses should be used. For example, in the case of a cost-based allocation key, using the expenditure on a single-year basis may be suitable for some cases, while in some other cases it may be more suitable to use accumulated expenditure (net of depreciation or amortization, where appropriate in the circumstances) incurred in the previous as well as the current years. Depending on the facts and circumstances of the case, this determination may have a significant effect on the allocation of profits amongst the parties. As noted at paragraphs 2.116-2.117 above, the selection of the allocation key should be appropriate to the particular circumstances of the case and provide a reliable approximation of the division of profits that would have been agreed between independent parties.

C.3.4.4 Reliance on data from the taxpayer's own operations ("internal data")

2.141 Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the combined profits, consideration should be given to internal data, which may provide a reliable means of establishing or testing the arm's length nature of the division of profits. The types of such internal data that are relevant will depend on the facts and circumstances of the case and should satisfy the conditions outlined in this Section and in particular at paragraphs 2.116-2.117 and 2.132. They will frequently be extracted from the taxpayers' cost accounting or financial accounting.

2.142 For instance, where an asset-based allocation key is used, it may be based on data extracted from the balance sheets of the parties to the transaction. It will often be the case that not all the assets of the taxpayers relate to the transaction at hand and that accordingly some analytical work is needed for the taxpayer to draw a "transactional" balance sheet that will be used for the application of the transactional profit split method. Similarly, where cost-based allocation keys are used that are based on data extracted from the taxpayers' profit and loss accounts, it may be necessary to draw transactional accounts that identify those expenses that are related to the controlled transaction at hand and those that should be excluded from the determination of the allocation key. The type of expenditure that is taken into account (*e.g.* salaries, depreciation, etc.) as well as the criteria used to determine whether a given expense is related to the transaction at hand or is rather related to other transactions of the taxpayer (*e.g.* to other lines of products not subject to this profit split determination) should be applied consistently to all the parties to the transaction. See also paragraph 2.98 for a discussion of valuation of assets in the context of the transactional net margin method where the net profit is weighted to assets, which is also relevant to the valuation of assets in the context of a transactional profit split where an asset-based allocation key is used.

2.143 Internal data may also be helpful where the allocation key is based on a cost accounting system, *e.g.* headcounts involved in some aspects of the transaction, time spent by a certain group of employees on certain tasks, number of servers, data storage, floor area of retail points, etc.

2.144 Internal data are essential to assess the values of the respective contributions of the parties to the controlled transaction. The determination of such values should rely on a functional analysis that takes into account all the economically significant functions, assets and risks contributed by the parties to the controlled transaction. In those cases where the profit is split on the basis of an evaluation of the relative importance of the functions, assets and risks to the value added to the controlled transaction, such evaluation should be supported by reliable objective data in order to limit arbitrariness. Particular attention should be given to the identification of the relevant contributions of valuable intangibles and the assumption of significant risks and the importance, relevance and measurement of the factors which gave rise to these valuable intangibles and significant risks.

2.145 One possible approach not discussed above is to split the combined profits so that each of the associated enterprises participating in the controlled transactions earns the same rate of return on the capital it employs in that transaction. This method assumes that each participant's capital investment in the transaction is subject to a similar level of risk, so that one might expect the participants to earn similar rates of return if they were operating in the open market. However, this assumption may not be realistic. For example, it would not account for conditions in capital markets and could ignore other relevant aspects that would be revealed by a functional analysis and that should be taken into account in a transactional profit split.

ANNEX II TO CHAPTER II

EXAMPLE TO ILLUSTRATE THE APPLICATION OF THE RESIDUAL PROFIT SPLIT METHOD

See Chapter II, Part III, Section C of these Guidelines for general guidance on the application of the profit split method.

The adjustments and assumptions about arm's length arrangements in the examples that follow are intended for illustrative purposes only and should not be taken as prescribing adjustments and arm's length arrangements in actual cases or particular industries. While they seek to demonstrate the principles of the Sections of the Guidelines to which they refer, those principles must be applied in each case according to the specific facts and circumstances of that case.

1. The success of an electronics product is linked to the innovative technological design both of its electronic processes and of its major component. That component is designed and manufactured by associated company A, is transferred to associated company B which designs and manufactures the rest of the product, and is distributed by associated company C. Information exists to verify by means of a resale price method that the distribution functions and risks of Company C are being appropriately rewarded by the transfer price of the finished product from B to C.

2. The most appropriate method to price the component transferred from A to B may be a CUP, if a sufficiently similar comparable could be found. See paragraph 2.14 of the Guidelines. However, since the component transferred from A to B reflects the innovative technological advance enjoyed by company A in this market, in this example it proves impossible (after the appropriate functional and comparability analyses have been carried out) to find a reliable CUP to estimate the correct price that A could command at arm's length for its product. Calculating a return on A's manufacturing costs could however provide an estimate of the profit element which would reward A's manufacturing functions, ignoring the profit element attributable to the intangible used therein. A similar calculation could be performed on company B's manufacturing costs, to give an estimate of B's profit derived from its manufacturing functions, ignoring the profit element attributable to its intangible. Since B's selling price to C is known and is accepted as an arm's length price, the amount of the residual profit accrued by A and B together from the exploitation of their respective intangible property can be determined. See paragraphs 2.108 and 2.121 of the Guidelines. At this stage the proportion of this residual profit properly attributable to each enterprise remains undetermined.

3. The residual profit may be split based on an analysis of the facts and circumstances that might indicate how the additional reward would have been allocated at arm's length. Paragraph 2.121 of the Guidelines. The R&D activity of each company is directed towards technological design relating to the same class of item, and it is established for the purposes of this example that the relative amounts of R&D expenditure reliably measure the relative value of the companies' contributions. See paragraph 2.120 of the Guidelines. This means that each company's contribution to the product's technological innovation may reliably be measured by their relative expenditure on research and development, so that, if A's R&D expenditure is 15 and B's 10, the residual could be split 3/5 for A and 2/5 for B.

4. Some figures may assist in following the example:

a) Profit & Loss of A and B

	A		B	
Sales		50		100
Less:				
Purchases		(10)		(50)
Manufacturing costs		(15)		(20)
Gross profits		25		30
Less:				
R&D	15		10	
Operating expenses	10	(25)	10	(20)
Net profit		**0**		**10**

b) Determine routine profit on manufacturing by A and B, and calculate total residual profit

5. It is established, for both jurisdictions, that third-party comparable manufacturers without innovative intangible property earn a return on manufacturing costs (excluding purchases) of 10% (ratio of net profit to the direct and indirect costs of manufacturing).[9] See paragraph 2.121 of the Guidelines. A's manufacturing costs are 15, and so the return on costs would attribute to A a manufacturing profit of 1.5. B's equivalent costs are 20, and so the return on costs would attribute to B a manufacturing profit of 2.0. The residual profit is therefore 6.5, arrived at by deducting from the combined net profit of 10 the combined manufacturing profit of 3.5.

c) Allocate residual profit

6. The initial allocation of profit (1.5 to A and 2.0 to B) rewards the manufacturing functions of A and B, but does not recognise the value of their respective R&D that has resulted in a technologically advanced product. That residual can, therefore, be split between A and B based on their share of total R&D costs, since, for the purposes of this example[10], it can reliably be assumed that the companies' relative expenditure on R&D accurately reflects their relative contributions to the value of the product's technological innovation. A's R&D expenditure is 15 and B's 10, giving combined R&D expenditure of 25. The residual is 6.5 which may be allocated 15/25 to A and 10/25 to B, resulting in a share of 3.9 and 2.6 respectively, as below:

A's share 6.5 x 15/25= 3.9
B's share 6.5 x 10/25= 2.6.

d) Recalculate Profits

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9 This 10% return does not technically correspond to a cost plus mark-up in its strictest sense because it yields net profit rather than gross profit. But neither does the 10% return correspond to a TNMM margin in its strictest sense, since the cost base does not include operating expenses. The net return on manufacturing costs is being used as a convenient and practical first stage of the profit split method, because it simplifies the determination of the amount of residual net profit attributable to intangible property.

10 But see paragraph 6.27 of the Guidelines.

7. A's net profits would thus become 1.5 + 3.9 = 5.4.

B's net profits would thus become 2.0 + 2.6 = 4.6.

The revised P & L for tax purposes would appear as:

	A		B	
Sales		55.4		100
Less:				
Purchases		(10)		(55.4)
Manufacturing costs		(15)		(20)
Gross profit		30.4		24.6
Less:				
R& D	15		10	
Operating expenses	10	(25)	10	(20)
Net profit		**5.4**		**4.6**

Note

8. The example is intended to exemplify in a simple manner the mechanisms of a residual profit split and should not be interpreted as providing general guidance as to how the arm's length principle should apply in identifying arm's length comparables and determining an appropriate split. It is important that the principles that it seeks to illustrate are applied in each case taking into account the specific facts and circumstances of the case. In particular, it should be noted that the allocation of the residual split may need considerable refinement in practice in order to identify and quantify the appropriate basis for the allocation. Where R&D expenditure is used, differences in the types of R&D conducted may need to be taken into account, *e.g.* because different types of R&D may have different levels of risk associated with them, which would lead to different levels of expected returns at arm's length. Relative levels of current R&D expenditure also may not adequately reflect the contribution to the earning of current profits that is attributable to intangible property developed or acquired in the past.

ANNEX III TO CHAPTER II

ILLUSTRATION OF DIFFERENT MEASURES OF PROFITS WHEN APPLYING A TRANSACTIONAL PROFIT SPLIT METHOD

See Chapter II, Part III, Section C of these Guidelines for general guidance on the application of the transactional profit split method.

The assumptions about arm's length arrangements in the following examples are intended for illustrative purposes only and should not be taken as prescribing adjustments and arm's length arrangements in actual cases of particular industries. While they seek to demonstrate the principles of the sections of the Guidelines to which they refer, those principles must be applied in each case according to the specific facts and circumstances of that case.

Furthermore, the comments below relate to the application of a transactional profit split method in the situations where, given the facts and circumstances of the case and in particular the comparability (including functional) analysis of the transaction and the review of the information available on uncontrolled comparables, such a method is found to be the most appropriate method to be used.

1. Below are some illustrations of the effect of choosing a measure of profits to determine the combined profits to be split when applying a transactional profit split method.

2. Assume A and B are two associated enterprises situated in two different tax jurisdictions. Both manufacture the same widgets and incur expenditure that results in the creation of an intangible asset which they can mutually use. For the purpose of this example, it is assumed that the nature of this particular asset is such that the value of the asset contribution attributable to each of A and B in the year in question is proportional to A and B's relative expenditure on the asset in that year. (It should be noted that this assumption will not always be true in practice. This is because there may be cases where the relative values of asset contributions attributable to each party would be based on accumulated expenditure from the prior, as well as current years.) Assume A and B exclusively sell products to third parties. Assume that it is determined that the most appropriate method to be used is a residual profit split method, that the manufacturing activities of A and B are simple, non-unique transactions that should be allocated an initial return of 10% of the Cost of Goods Sold and that the residual profit should be split in proportion to A's and B's intangible asset expenditure. The following figures are for illustration only:

	A	**B**	**Combined A + B**
Sales	100	300	400
Cost Of Goods Sold	60	170	230
Gross Profit	40	130	170
Overhead expenses	3	6	9
Other operating expenses	2	4	6
Intangible asset expenditure	30	40	70
Operating Profit	5	80	85

3. ***Step one: determining the initial return for the non-unique manufacturing transactions (Cost of Goods Sold + 10% in this example)***

A	60 + (60 * 10 %) = 66	→ Initial return for the manufacturing transactions of A =	6
B	170 + (170 * 10 %) = 187	→ Initial return for the manufacturing transactions of B =	17
		Total profit allocated through initial returns (6+17) =	23

4. ***Step two: determining the residual profit to be split***

a) In case it is determined as the operating profit:

Combined Operating Profit	85
Profit already allocated (initial returns for manufacturing transactions)	23
Residual profit to be split in proportion to A's and B's intangible asset expenditure	62

Residual profit allocated to A:	62 * 30/70	26.57
Residual profit allocated to B:	62 * 40/70	35.43
Total profits allocated to A:	6 (initial return) + 26.57 (residual)	32.57
Total profits allocated to B:	17 (initial return) + 35.43 (residual)	52.43
Total		85

b) In case it is determined as the operating profit before overhead expenses (assuming it is determined that the overhead expenses of A and B do not relate to the transaction examined and should be excluded from the determination of the combined profits to be split):

	A	**B**	**Combined A + B**
Sales	100	300	400
Cost Of Goods Sold	60	170	230
Gross Profit	40	130	170
Other operating expenses	2	4	6
Intangible asset expenditure	30	40	70
Operating Profit before overhead expenses	8	86	94
Overhead expenses	3	6	9
Operating Profit	5	80	85

Combined Operating Profit before overhead expenses	94
Profit already allocated (initial returns for manufacturing transactions)	23
Residual profit before overhead expenses to be split in proportion to A's and B's intangible asset expenditure	71

Residual profit allocated to A:	71 * 30/70	30.43
Residual profit allocated to B:	71 * 40/70	40.57

Total profits allocated to A:	6 (initial return) + 30.43 (residual) – 3 (overhead expenses)	33.43
Total profits allocated to B:	17 (initial return) + 40.57 (residual) – 6 (overhead expenses)	51.57
Total		85

5. As shown in the above example, excluding some specific items from the determination of the combined profits to be split implies that each party remains responsible for its own expenses in relation to it. As a consequence, the decision whether or not to exclude some specific items must be consistent with the comparability (including functional) analysis of the transaction.

6. As another example, in some cases it may be appropriate to back out a category of expenses to the extent that the allocation key used in the residual profit split analysis relies on those expenses. For example, in cases where relative expenditure contributing to the development of an intangible asset is determined to be the most appropriate profit split factor, residual profits can be based on operating profits *before* that expenditure. After determining the split of residual profits, each associated enterprise then subtracts its own expenditure. This can be illustrated as follows. Assume the facts are the same as in the example at paragraph 2 above and assume the overhead expenses are not excluded from the determination of the residual profit to be split.

7. ***Step one: determining the basic return for the manufacturing activities (Cost of Goods Sold + 10% in this example)***

Same as at paragraph 3.

8. ***Step two: determining the residual profit to be split***

a) In case it is determined as the operating profit after intangible asset expenditure:

Same as at paragraph 4, case a)

b) In case it is determined as the operating profit before intangible asset expenditure*:*

	A	B	Combined A + B
Sales	100	300	400
Cost Of Goods Sold	60	170	230
Gross Profit	40	130	170
Overhead expenses	3	6	9
Other operating expenses	2	4	6
Operating profit intangible asset expenditure	35	120	155
Intangible asset expenditure	30	40	70
Operating Profit	5	80	85

Combined Operating Profit before intangible asset expenditure		155
Profit already allocated (initial returns for manufacturing transactions)		23
Residual profit before intangible asset expenditure to be split in proportion to A's and B's intangible asset expenditure		132
Residual profit allocated to A:	132 * 30/70	56.57
Residual profit allocated to B:	132 * 40/70	75.43
Total profits allocated to A:	6 (initial return) + 56.57 (residual) – 30 (intangible asset expenditure)	32.57
Total profits allocated to B:	17 (initial return) + 75.43 (residual) – 40 (intangible asset expenditure)	52.43
Total		85

i.e. A and B are allocated the same profits as in the case where the profit to be split is determined as the operating profit after intangible asset expenditure, see case a) above.

9. This example illustrates the fact that, when the allocation key used to split the residual profit relies on a category of expenses incurred during the period, it is indifferent whether the residual profit to be split is determined before said expenses and the expenses are deducted by each party, or whether the residual profit to be split is determined after said expenses. The outcome can however be different in the case where the split factor is based on the accumulated expenditure of the prior as well as current years (see paragraph 2 above).

EXTRACT FROM GUIDANCE ON TRANSFER PRICING ASPECTS OF INTANGIBLES (2014)

Example 17

20. Shuyona is the parent company of an MNE group. Shuyona is organised in and operates exclusively in Country X. The Shuyona group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, ongoing research is carried out by the Shuyona group to improve existing products and develop new products. The Shuyona group maintains two R&D centres, one operated by Shuyona in country X, and the other operated by Company S, a subsidiary of Shuyona, operating in country Y. The relationships between the Shuyona R&D centre and the Company S R&D centre are as described in Example 15.

21. In Year 1, Shuyona sells all rights to patents and other technology related intangibles, including rights to use those intangibles in ongoing research, to a new subsidiary, Company T, organised in country Z. Company T establishes a manufacturing facility in country Z and begins to supply products to members of the Shuyona group around the world. For purposes of this example, it is assumed that the compensation paid by Company T in exchange for the transferred patents and related intangibles reflects the arm's length value of the transferred intangibles at the time of the transfer.

22. At the same time as the transfer of patents and other technology related intangibles, Company T enters into a contract research agreement with Shuyona and a separate contract research agreement with Company S. Pursuant to these agreements, Company T contractually agrees to bear the financial risk associated with possible failure of future R&D projects, agrees to assume the cost of all future R&D activity, and agrees to pay Shuyona and Company S a service fee based on the cost of the R&D activities undertaken plus a mark-up equivalent to the profit mark-up over cost earned by certain identified independent companies engaged in providing research services.

23. Company T has no technical personnel capable of conducting or supervising the research activities. Shuyona continues to develop and design the R&D programme related to further development of the transferred intangibles, to establish its own R&D budgets, to determine its own levels of R&D staffing, and to make decisions regarding whether to pursue or terminate particular R&D projects. Moreover, Shuyona continues to supervise and control the R&D activities in Company S in the manner described in Example 15.

24. The transfer pricing analysis of these facts begins by recognising that Company T is the legal owner of the intangibles following the transfer. Shuyona is entitled to compensation for the research functions it performs and for the functions it undertakes in managing and controlling that research. Company S should also be compensated for its research functions. Company T would be entitled to compensation for its manufacturing functions and for its investment in the acquired intangibles. Company T should also be compensated for funding ongoing R&D. It may be extremely difficult or impossible to identify comparable transactions with such a structure and use of profit split methods, valuation techniques, or other methods may be necessary to identify the appropriate level of compensation to Shuyona for its functions, assets and risks.

Example 18

25. Company A is a fully integrated pharmaceutical company engaged in the discovery, development, production and sale of pharmaceutical preparations. Company A conducts its operations in country X. In conducting its research activities, Company A regularly retains independent Contract Research Organizations to perform various R&D activities, including designing and conducting clinical trials with regard to products under development by Company A. However, such CRO's do not engage in the blue sky research required to identify new pharmaceutical compounds. Where Company A does retain a CRO to engage in clinical research activities, research personnel at Company A actively participate in designing the CRO's research studies, provide to the CRO results and information derived from earlier research, establish budgets and timelines for CRO projects, and conduct ongoing quality control with respect to the CRO's activities. In such arrangements, CRO's are paid a negotiated fee for services and do not have an ongoing interest in the profits derived from sales of products developed through their research.

26. Company A transfers patents and related intangibles related to Product M, an early stage pharmaceutical preparation believed to have potential as a treatment for Alzheimer's disease to Company S, a subsidiary of Company A operating in country Y (the transaction relates strictly to the existing intangibles and does not include compensation for future R & D services of Company A). It is assumed for purposes of this example that the payment of Company S for the transfer of intangibles related to Product M is arm's length. Company S has no technical personnel capable of designing, conducting or supervising required ongoing research activities related to Product M. Company S therefore contracts with Company A to carry on the research programme related to Product M in the same manner as before the transfer of intangibles to Company S. Company S agrees to fund all of the ongoing Product M research, assume the financial risk of potential failure of such research, and to pay for Company A's services based on the cost plus margins earned by CRO's like those with which Company A regularly transacts.

27. The transfer pricing analysis of these facts begins by recognising that, following the transfer, Company S is the legal owner of the Product M intangibles under relevant contracts and registrations. However, Company A continues to perform and control functions and to manage risks related to the intangibles owned by Company S, including the important functions described in paragraph 6.56, and is entitled to compensation for those contributions. Under these circumstances, Company A's transactions with CRO's are not comparable to the arrangements between Company S and Company A related to Product M and may not be used as a benchmark for the arm's length compensation required to be provided to Company A for its ongoing R&D activity with respect to the Product M intangibles. Company S does not perform or control the same functions or control the same risks in its transactions with Company A, as does Company A in its transactions with the CROs.

28. While Company S is the owner of the intangibles, it should not be entitled to all of the returns derived from the exploitation of the intangibles. Because Company S lacks the capability to control research related risks, Company A should be treated as bearing a substantial portion of the relevant risk and Company A should also be compensated for its functions, including the important functions described in paragraph 6.56. Company A should be entitled to larger returns than the CROs under these circumstances and if, as is likely, appropriate comparables cannot be identified, it may be necessary to apply profit split methods, valuation techniques, or other methods that do not directly rely on comparables to identify the appropriate compensation of Company A.[11]]

[11] Some country delegates believe that fact patterns like those reflected in Examples 17 and 18 could be appropriately addressed by disregarding or recharacterising transactions under paragraph 1.65 in some instances because such transactions would not normally occur between independent enterprises. The BEPS action plan calls for additional consideration to be given to the circumstances in which it is appropriate to disregard or recharacterise transactions. The analysis of these Examples will accordingly be discussed further in the context of the 2015 work on BEPS.