

Base Erosion and Profit Shifting (BEPS)

Public Discussion Draft

BEPS ACTIONS 8-10

Revised Guidance on Profit Splits

4 July - 5 September 2016



DISCUSSION DRAFT ON THE REVISED GUIDANCE ON PROFIT SPLITS

4 July 2016

Public comments are invited on this discussion draft which deals with the clarification and strengthening of the guidance on the transactional profit split method, as set out in the BEPS Actions 8-10, 2015 Final Report.¹

This draft sets out the text of proposed revised guidance on the application of the transactional profit split method, together with a number of questions. The questions are intended to elicit responses which will then be taken into account by Working Party No. 6 in considering revisions to the relevant guidance in Chapter II of the Transfer Pricing Guidelines. The discussion draft necessarily concentrates on the guidance proposed to be included in Chapter II, but respondents are reminded that such guidance is provided within a framework of other relevant guidance. In particular the revisions to Chapter I set out guidance on how accurately to delineate the actual transaction between the associated enterprises, including an understanding of the broader 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 which underpins the discussion of transfer pricing methods in Chapter II. In addition, the revisions to Chapter VI include relevant guidance on identifying and evaluating intangibles. The discussion of the transactional profit split method in this discussion draft should not be taken to imply any change to this wider framework.

Responses are invited to the questions included in the text, but commentators should feel able to comment on points that may not be specifically covered by those questions.

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. Therefore, to the extent the approaches discussed herein differ from the established guidance set out in the OECD Transfer Pricing Guidelines, they should not be relied upon by taxpayers or tax administrations. Moreover, all examples used herein are for illustrative purposes only and are necessarily presented with limited facts. The examples do not have applicability beyond the purpose of seeking comments on the approaches they serve to illustrate and should not be used by taxpayers or tax administrations to interpret superficially similar cases.

This discussion draft is submitted for comment by interested parties. Comments should be submitted by **5 September 2016 (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 the Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA. Comments in excess of ten pages should attach an executive summary limited to two pages.

¹ OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

The OECD intends to hold a public consultation on the proposed guidance on 11-12 October 2016 at the OECD Conference Centre in Paris, France. Registration details for the public consultation will be published on the OECD website in September. Speakers and other participants at the public consultation will be selected from among those providing timely written comments on the discussion draft.

Please note that all comments on this discussion 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 group, or the person(s) on whose behalf the commentator(s) are acting.

REVISED GUIDANCE ON TRANSACTIONAL PROFIT SPLITS (TO REPLACE PART III SECTION C OF CHAPTER II OF THE 2010 TRANSFER PRICING GUIDELINES)

C. Transactional profit split method

C.1 *In general*

1. [2.108]² This section provides guidance on the selection and application of the transactional profit split method as the most appropriate method (see paragraph 2.2). 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 section C.4.2 for guidance on how to determine 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 section C.4.4 for guidance on how to split the combined profits.

2. [New] Splitting profits on an economically valid basis can be described in two broad ways. One approach to splitting profits is to combine and split anticipated profits. The second approach involves combining and splitting actual profits. Although some considerations surrounding transactional profit splits of anticipated profits will be presented in this section, the focus will be on the application of the transactional profit split of actual profits as the “most appropriate method” for evaluating pricing of an accurately delineated transaction. References to a transactional profit split method cover both applications of the method.

3. [2.130] When applying the transactional profit split method, care should be exercised to ensure that its application is performed in a context which is similar to that 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. That is, irrespective of whether a transactional profit split of anticipated or actual profits is used, the basis upon which those profits are to be split between the associated enterprises, including the profit splitting factors and the way in which combined profits are calculated, must be determined *ex ante* on the basis of information known or reasonably foreseeable by the parties at the time the transactions were entered into.

4. [New] A transactional profit split of anticipated profits is a type of pricing arrangement whereby the principles of splitting profits on an economically valid basis are applied to the anticipated profits of an enterprise resulting from its own contributions and also from those made by an associated enterprise in order to determine a price for the contributions from that associated enterprise. As an example, consider

² Square bracketed paragraph references are to assist the reader in identifying the derivation of the paragraph in the 2010 Guidelines and in identifying new guidance.

the following scenario involving the transfer of rights in an intangible by Company A to an associated enterprise, Company B, in circumstances where Company B combines that intangible with its own intangible to commercialise a product using the intangibles in combination. Assuming that the facts of this case lead to the conclusions that a transactional profit split of anticipated profits is the most appropriate method to apply, the profits anticipated to be generated by Company B from commercialising products using its own intangible and the rights to an intangible contributed by Company A over an appropriate period are determined. The respective contributions made by each of the associated enterprises (both Company A and Company B contribute intangibles, and Company B makes additional inputs to commercialise the product using both intangibles) are then used to determine a pricing arrangement at the time of the transfer based on the anticipated profits of Company B resulting from the combined contributions of the enterprises that seeks appropriately to reward each company for its contribution to those anticipated profits at the time of the transfer. Further guidance on the potential application of transactional profit split methods to transactions involving intangibles is provided at Section D.2.6.2 of Chapter VI. Typically a transactional profit split of anticipated profits will be used in conjunction with a discounted cash flow valuation technique as described in Sections D.2.6.3 to D.2.6.4 of Chapter VI and discussed further in paragraph 20 of this Section.

5. [New] In a transactional profit split of actual profits, the profits of the enterprises are combined and the respective contributions of each enterprise are used to split the actual profits derived in each taxable period from commercialising products using the intangibles. In a transactional profit split of actual profits, although the basis for the split of combined profits is established *ex ante*, it is applied to actual, combined profits resulting from the transaction. As an example, consider the following scenario involving the transfer of rights in an intangible by Company A to an associated enterprise, Company B and the transfer of rights in an intangible by Company B to Company A, in circumstances where each company commercialises a product using the intangibles in combination. Assuming that the facts of this case lead to the conclusions that a transactional profit split of actual profits is the most appropriate method to apply, the respective contributions made by each company are determined *ex ante* and used to split the combined actual profits of both Company A and Company B from commercialising the product in each taxable period covered by the arrangement.

6. [New] A significant difference between the two approaches to the application of the transactional profit split method is that combining the profits of each associated enterprise under a transactional profit split of actual profits requires a high level of integration of activities. This is discussed in Section C.3.1. A further difference between the two approaches is that there is a greater sharing of uncertain outcomes resulting from risks associated with the transaction under a transactional profit split of actual profits, than under a transactional profit split of anticipated profits. The difference between the effect of uncertain outcomes on the two approaches may be less significant in practice where a contingent price is determined under a transactional profit split of anticipated profits. For example, where the price set takes the form of a royalty rate based on actual sales, the amount of the royalty payment will adjust to reflect higher or lower sales than anticipated. However, under a transactional profit split of actual profits there is a greater sharing of the effect of uncertainty resulting from risks, since the profits or losses that are split are the actual profits or losses, and since additional risks are likely to be shared depending on the level at which the profits are split. For example, in the scenario outlined above where both Company A and Company B combine their profits from commercialisation of the product, then if either company varies its marketing spend, this may affect the resulting profits to be split between the enterprises where the profits are split at the net rather than the gross level. Variations in the costs of production may affect the resulting profits to be split at both the gross profit and the net profit level. This aspect is discussed further in Section C.4.3. The implication for risk assumption by the parties to a profit split of actual profits is discussed further in paragraphs 7-10.

7. [New] The reference to division of profits in paragraph 1 has a specific meaning and application in the context of the transactional profit split of actual profits. In any transaction the price set by the parties

affects the allocation of available profits or losses from that transaction. For example, the price a reseller pays for its supplies of bars of chocolate from a producer will affect the available profits for the producer and for the reseller. In this sense, any price setting, irrespective of how the price is determined, does have an impact on how potential profits are divided. Pricing negotiations by an uncontrolled party will typically take into account the profits it expects to derive from the transaction, and those it estimates the other party may be likely to obtain. For example, uncontrolled parties may negotiate a price discount for additional volume of products by reference to anticipated additional profits, and will make assumptions about how the anticipated additional profits may be divided between them, and how much of those profits they might be prepared to share with the other party as a result of setting the discount at a particular level. However, both parties will generally continue to run their separate business activities, including the assumption of the associated risks in their individual activities, to maximise their individual profits within the parameters set by the terms of the price discount.

8. [New] Although in some cases an uncontrolled party may mitigate its individual risks through agreed variations in prices, this generally does not result in the other party sharing in the outcomes of its business activities or sharing in its risks. Thus, when setting the price for bars of chocolate, the producer may take into account, among other things, the anticipated impact of future changes in cocoa prices on available profits, but the reseller is not expected when buying the products at the agreed price to share in the actual outcomes of the business activities and risks of the producer.

9. [New] In contrast, the division of combined actual profits under a transactional profit split of actual profits requires that the parties share in the outcomes of the business activities and risks associated with those outcomes, in accordance with the accurate delineation of the actual transaction. In such cases, the activities and associated risks of the parties are integrated such that they can often be considered as a single, cohesive business. If the reseller of chocolate bars were to agree to combine its profits with those of the producer and to split those profits between them, then the reseller would share in the impact of, among other factors influencing that profit, changes in cocoa prices and other costs of production.³ In addition, the producer would share in the outcomes of the business activities and risks of the reseller, and would share in the impact of, among other factors influencing that profit, marketing costs and the consumer selling prices achieved. Each of the parties involved remains exposed to the effects of the risks associated with business activities of the other. The outcome for each party will depend on the overall performance of the businesses (i.e. including the performance of each party) in relation to those risks. Transactional profit splits sharing the combined actual profits of the parties contributing to the arrangement have the effect of sharing the impact of the risks associated with the business activities of the parties. In accordance with the guidance in Section D of Chapter I, such an outcome would only be consistent with the accurate delineation of the actual transaction in cases where the economically significant risks associated with the outcomes of the business activities are controlled, either separately or collectively, by the parties sharing in the actual profits, and each party has the financial capacity to assume its share of the risks.

10. [New] These observations about the implication of sharing in profits are particularly important to take into account following the determination of the nature of the commercial or financial relations of the parties under the guidance in Section D of Chapter I. Businesses can adopt different arrangements involving similar commercial activities and assets. For example, in a telecoms business an asset owner can rent out the asset for a fee or can split network income with the other asset owners; in the pharmaceutical business, a sales company can obtain services from a marketer for a fee, or can enter into a co-promotion agreement and split the combined profits. The differences between the arrangements can give rise to very

³ Note that this example is intended simply to provide an illustration of the effect on the parties of applying the transactional profit split method. No inferences should be drawn that the transactional profit split method would be the most appropriate method in these particular circumstances.

different outcomes in terms of profits or losses. Sometimes, the same business can be seen at arm's length to adopt both arrangements; for example, a pharmaceutical business may enter into co-promotion agreements for certain markets or products as well as entering into fee-based marketing services arrangements for other markets or products. In examining arrangements between associated enterprises, it may be difficult for a tax administration to determine whether the accurately delineated transaction represents, for example, a fee arrangement, or is an arrangement in which two or more associated enterprises share economically significant risks, such that they should split the unanticipated, actual profits arising from their combined activities. However, a key indicator for the appropriateness of a profit split of actual profits is that the parties continue to share in the outcomes of the business activities and the risks associated with those subsequent outcomes. It would be contrary to the guidance in Section D of Chapter I to apply a transactional profit split of actual profits where the functional analysis demonstrates that one party does not exercise any degree of control over those risks, since to do so would assign to that party the impact of risks it does not control. As has been noted in paragraph 3, while a transactional profit split of actual profits can only be applied once actual profits, being the outcomes of risks, are known, the basis upon which combined profits are to be calculated and split must be determined *ex ante*, that is, before risk outcomes are known. Otherwise there is in fact no longer any risk. See paragraphs 1.47 and 1.78.

Questions to commentators

The guidance in the 2010 Transfer Pricing Guidelines on the application of the transactional profit split method envisages its application to either projected or actual profits (see 2.127). This discussion draft proposes to explore these distinctions further and provide clearer guidance on the different applications of the two approaches.

1. Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular:
 1. Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear?
 2. Is the distinction between the two profit split approaches described useful?
2. Comments are also invited on the link between integration of business activities (and thus the sharing of risks) and the appropriate application of a transactional profit split of actual profits.
3. Examples of scenarios where each approach to splitting profits would be the most appropriate (together with a brief explanation as to why) are also requested.

C.2 *Summary of strengths and weaknesses*

11. [2.109] In determining the most appropriate method to apply to a controlled transaction, the main strength of the transactional profit split of actual profits is that it can offer a pricing solution in circumstances in which the accurate delineation of the actual transaction shows that two or more associated enterprises undertake activities involving the sharing of economically significant risks. This may happen in highly integrated operations in which the parties each perform similar functions, and in some instances share core assets used to produce the income stream. 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.⁴ This may happen also in cases where both parties to a transaction make unique and valuable contributions (e.g. contribute unique intangibles), because in such a case independent parties might wish to share the profits of the transaction in proportion to their respective contributions. On the other hand, the sharing of economically significant risks is less likely to occur 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). In such cases where the accurate delineation of the actual transaction confirms that the parties do not share in the risks associated with subsequent outcomes, a transactional profit split of actual profits would not be appropriate because it would inappropriately have the effect of assigning the impact of significant risks to a party which in fact does not exercise control over such risks.

12. [2.112] A strength of the transactional profit split method generally 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.

13. [2.113] A further strength of the transactional profit split of actual profits is that it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result, which does not appropriately reflect the contributions made in terms of functions, assets, and risks by each party. This is because the value contributed by both parties to the transaction is assessed, and also because the profits being divided are the actual profits arising rather than a benchmarked profit for one of the parties. This aspect can be particularly important when analysing the contributions by the parties in respect of the intangibles employed and economically significant risks assumed in the controlled transactions.

14. [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 identifying from the financial records of the parties to the transaction the revenues, costs, and profits arising from the transaction and separating them from the parties' other activities.

15. [2.114] The way in which profits are split may also require detailed analysis of past, current, and expected expenditure relating to the combined profits from the transaction or transactions concerned. For example, a profit split between a global manufacturer and a regional distributor, in circumstances where both enterprises contribute intangibles, will require the combined profits for the products manufactured by the global manufacturer to be identified and separated from its other activities, and where the regional distributor sells other products or performs additional activities, similar separation will be required. If the way in which the profits are split depends on respective costs, then analysis of past expenditure may be necessary and appropriate allocation made to the products sold by the regional distributor. The required financial information may be difficult to access, the required interpretation of the data can be difficult for the taxpayer to perform, the analysis of the data may require reasonable assumptions to be made based on knowledge of the business, and in most cases a tax administration will not be able to perform the analysis or verify the information without full co-operation from the taxpayer.

⁴ See the 2010 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.

Question to commentators

4. Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarised?
5. Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses? If so, what are they?

C.3 *Most appropriate method*

16. [New] The application of a transactional profit split of actual profits reflects a relationship where the parties either share the same economically significant risks associated with the business opportunity or separately assume closely related risks associated with the business opportunity and consequently should share in the resulting profits or losses. The selection under the guidance in paragraph 2.2 of a transactional profit split of actual profits as the most appropriate method in a particular case will depend on accurately delineating the actual transaction, through a functional analysis as set out in Section D of Chapter I and, in so doing, determining the shared assumption of economically significant risks. The application of a transactional profit split of actual profits when not supported by the features derived from the functional analysis, for example in cases where other methods are difficult to apply because reliable comparables are scarce, is unlikely to produce an arm's length outcome since the appropriate use of a profit split is determined by the existence of a specific commercial relationship between the parties.

17. [New] The accurate delineation of the actual transaction will be important in determining whether a transactional profit split of actual profits is potentially applicable. For example, if the accurate delineation of the actual transaction supports non-contingent remuneration to one of the parties, then the party receiving the non-contingent remuneration would not be sharing in the outcomes of the business activities and the risks associated with those outcomes, which is required for the transactional profit split of actual profits to be the most appropriate method. Example 1 in Section D.1 of Chapter I (paragraph 1.83) illustrates such a case. In the example, illustrating a contract R&D arrangement, Company A assumes the development risk (that is, Company A meets the control and other requirements of Section D.1.2). Company B assumes the risks (and similarly meets the requirements of Section D.1.2) associated with competently performing the research activities. Notwithstanding that the risks assumed by Company B might be economically significant, especially in relation to Company B's business, the critical aspect in the example is that it is the entity assuming development risk, Company A, that will bear the consequences associated with the success or failure of the intangible to be developed. This is reflected in the accurate delineation of the actual transaction. Accordingly, a transactional profit split would not be the most appropriate method to apply.

18. [New] A lack of comparables alone is insufficient to warrant the use of a transactional profit split of actual profits under the arm's length principle. In cases where the accurate delineation of the actual transaction indicates that one of the parties to the transaction assumes only limited risks, but reliable comparables data is scarce, it is likely that a more reliable arm's length outcome can be reached through the adjustment (under Step 8 of a typical process for performing a comparability analysis in paragraph 3.4) and interpretation (under Step 9 of a typical process for performing a comparability analysis in paragraph 3.4) of inexact comparables data rather than through the inappropriate application of the transactional profit split method. Using a transactional profit split of actual profits in such a case would result in a fundamentally different economic outcome to the one supported by the accurate delineation of the actual transaction.

19. [New] A sharing of risks by parties to a transaction may be accompanied by a high degree of integration of functions or the making of unique and valuable contributions by each of the parties. Highly integrated business operations may involve the sharing of functions, where the outcome of the transaction is dependent on two or more parties making contributions which are interlinked and thus cannot reliably be evaluated in isolation. In such a case, a transactional profit split of actual profits may be appropriate. However, the contribution alone of an intangible or rights in an intangible by one of the parties is not sufficient to justify the splitting of combined actual profits of the parties to the transaction under a transactional profit split of actual profits. Integration and unique and valuable contributions are discussed further in Sections C.3.1 and C.3.2.

Question to commentators

6. The discussion draft introduces the sharing of economically significant risks as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method.
1. Do commentators have any suggestions for clarifying the notion of risk sharing in this context?
 2. Do commentators find the draft helps to clarify the circumstances where the transactional profit split method is the most appropriate method? Please provide explanations and/or examples supporting your views.

20. [New] However, as discussed in paragraph 6, a transactional profit split of anticipated profits does not require the level of integration or risk sharing required for a transactional profit split of actual profits. For example, in circumstances where it is determined that a transactional profit split of anticipated profits is the most appropriate method, the value of a party's contribution for which reliable comparables cannot be found may be derived from the splitting of appropriate projected income or cash flows of the transferee based on a splitting factor that reflects the respective contributions of the transferor and transferee to those projected income or cash flows. The contribution can then be valued using valuation techniques discussed in sections D.2.6.3 and D.2.6.4 of Chapter VI. The amount so derived can then be used to set a single price or a series of recurring payments. Where the contribution takes the form of an intangible or rights to an intangible the guidance on intangibles for which valuation is highly uncertain at the time of the transaction in Section D.3 and D.4 of Chapter VI will be relevant.

Question to commentators

7. The discussion draft notes that a transactional profit split of anticipated profits can be used in conjunction with certain valuation techniques. Examples showing the application of a transactional profit split of anticipated profits are sought.

C.3.1 *Highly integrated operations*

21. [New] The accurate delineation of the actual transaction may determine that multiple parties share significant risks in relation to a transaction in cases in which the transaction is part of highly integrated business operations of the parties. Although most business operations undertaken by an MNE group are integrated to some degree, a high degree of integration means that the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with, and cannot reliably be evaluated in isolation from, the way in which another party to the transaction performs functions, uses assets and assumes risks. Indeed, in some cases there will be a high degree of commonality in the

functions performed, the assets used, and risks assumed. This commonality is more likely to be the case where there is parallel integration by the associated enterprises in the value chain, rather than sequential integration. In the case of sequential integration, in which parties perform discrete functions in an integrated value chain, it will often be the case that it is possible to find reliable comparables for each stage or element in the value chain since the functions, assets, and risks involved in each discrete stage may be comparable to those involved in uncontrolled arrangements. In contrast, where parallel integration occurs, multiple parties to the transaction are involved in the same stage of the value chain. For example, the parties may each contribute intangibles, share functions in jointly developing products, and exploit the marketing of those products together. In cases of parallel integration, it may be the case that the accurate delineation of the actual transaction determines that each party shares economically significant risks, and a transactional profit split, using an approach which splits actual profits, may be found to be the most appropriate method.

Questions to commentators

8. Is the distinction between parallel and sequential integration of business operations a useful refinement in determining when the transactional profit split method is likely to be the most appropriate method?
9. If so, how should the concept of parallel integration be further defined?

C.3.2 Unique and valuable contributions

22. [New] Another situation in which the transactional profit split method may be the most appropriate method is where multiple parties to the transaction make unique and valuable contributions, such as unique and valuable intangibles (see paragraph 6.17). Contributions, whether in the form of functions performed, assets used, or risks assumed, will be “unique and valuable” in cases where (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) their use in business operations represents a key source of actual or potential economic benefits. The two factors are often linked: comparables for such contributions are seldom found *because* they are a key source of economic advantage. In such cases, it may be that the risks associated with the respective unique and valuable contribution of each of the parties cannot be controlled by the other party or parties. For example, the developer and manufacturer of a key component together with the developer and manufacturer of the rest of the product both make unique and valuable contributions in terms of functions and intangibles that represent a key source of economic benefits. In practice, neither of them may be able to control the development risk and to take on the key source of economic benefits from the other, but instead they together control the development risks and share in the combined profits resulting from their contributions.

Questions to commentators

10. Comments are invited on the relationship between the making of unique and valuable contributions by both (all) parties to a transaction, and the sharing of economically significant risks.
11. Are there situations where all the parties make unique and valuable contributions to a transaction, but they do not share the economically significant risks associated with the outcomes of that transaction? If so, what guidance on the appropriate use of profit splits in such a situation should be provided?

C.3.3 Group synergies

23. [New] As has been noted in paragraph 1.162, the benefits of important group synergies attributable to deliberate concerted group actions should be shared by members of the group in proportion to their contribution to the creation of the synergy. This sharing of benefits (or negative costs) can be achieved through the use of appropriate allocation keys similar to the way in which allocation keys can be used to apportion costs of shared services. There is no need to combine the total profits of the parties and use the transactional profit split method simply on account of group synergies alone. It is merely necessary to apply an appropriate allocation key to the marginal system profits arising from those synergies.

Question to commentators

12. The Final BEPS Report on Actions 8-10 noted that group synergies were to be addressed in the guidance on profit splits. The approach taken in this discussion draft is to make reference to the incremental or marginal system profits arising from the group synergy, which would then be shared amongst the relevant associated enterprises. The analytical framework suggested in the draft, based on an accurate delineation of the actual transaction, would not support the combining and splitting of total system profits on the basis of group synergies alone. Comments on this point are invited.

C.3.4 Value chain analyses

24. [New] A value chain analysis, undertaken as part of the broad-based analysis of the taxpayer's circumstances (see 1.34), may be useful in helping to identify when the transactional profit split method may be appropriate. Such an analysis may also assist in determining how the method, if indeed it is the most appropriate method, should be applied, including the profits to be split and the relevant splitting factors. It should be emphasised however, that such a value chain analysis is merely a tool to assist in delineating the controlled transactions, in particular in respect of the functional analysis, and thereby determining the most appropriate transfer pricing methodology.

25. [New] All business operations can be expressed through a value chain and many MNE groups operate through a global value chain. This alone does not imply that the transactional profit split should be applied. If that were the case, then a profit split would apply in almost every case and risk producing results contrary to the arm's length principle. Instead, the purpose of the value chain analysis is to identify the features of the commercial or financial relations between the parties described in the paragraphs below which are indicators that the transactional profit split method may be the most appropriate method for a particular case under the guidance in paragraph 2.2. For a transactional profit split of actual profits those features include a sharing in the outcomes of the business activities and associated risks involving highly integrated operations or unique and valuable contributions by the parties.

26. [New] A value chain analysis should consider where and how value is created in the business operations, including in particular: (i) consideration of the economically significant functions, assets and risks, which party or parties perform the functions, contribute the assets and assume the risks, as well as whether and how the functions, assets, and risks of the parties may be interdependent or otherwise interlinked; and (ii) how the economic circumstances may create opportunities to capture profits in excess of what the market would otherwise allow, such as those associated with unique intangibles, first mover advantages, or other unique contributions. In considering where and how value is created, the analysis should also consider whether such value-creation is sustainable, for instance, whether market advantages are protected due to barriers to entry to potential competitors or the impact of valuable intangibles. The analysis thus both contributes to the process of accurately delineating the transaction, and also determines the level of integration (which may determine the level at which profits or revenues should be split), and the economically relevant contributions (which may determine the factors to use to split the profits). It is

important to note, however, that the value chain analysis is simply a tool to assist in accurately delineating the transaction. Moreover, it does not, of itself, indicate that the transactional profit split is the most appropriate method, even where the value chain analysis shows that there are factors which contribute to the creation of value in multiple places, since all parties to a transaction can be expected to make some contributions to value creation.

27. [New] A value chain analysis might usefully provide information about the following aspects of the business activity, relevant to determining whether the transactional profit split is the most appropriate method:

- The key value drivers in relation to the transaction, including how the associated enterprises differentiate themselves from others in the market;
- The nature of the contributions of assets, functions, and risks by the associated enterprises to the key value drivers, including consideration of which contributions are unique and valuable;
- Which parties can protect and retain value through performance of important functions relating to the development, enhancement, maintenance, protection and exploitation of intangibles;
- Which parties assume economically significant risks or perform control functions relating to the economically significant risks associated with value creation;
- How parties operate in combination in the value chain, and share functions and assets in parallel integration as described in paragraph [21].

Question to commentators

13. Does this section properly describe a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit split method is appropriate?
14. If commentators see a value chain analysis as serving a greater purpose in relation to profit splits, then please provide an explanation for that view together with examples.

C.4 Guidance for application

28. [2.115] These Guidelines provide guidance on applying the transactional profit split method, but they do not seek to provide an exhaustive catalogue of economically significant risks, contributions, or other factors that will impact how this method may be applied reliably in a given case. Application of the method will depend on the accurate delineation of the actual transaction, including the assumption of economically significant risks, the nature of the contributions of the parties, how those contributions drive profit outcomes, and the identification of the profits to be split, 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. If the economically significant risks have not been specified, if the nature of the contributions of the parties has not been accurately determined, if an evaluation of how those contribution drive profit outcomes has not been made, if the profits to be split have not been reliably identified, or if the basis for splitting the profits has not been reliably determined (as discussed below), then it is doubtful that the overriding objective can be achieved and the application of the transactional profit split method would be unreliable.

29. [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 occurred in comparable circumstances at arm's length based on the accurate delineation of the actual transaction under Section D.1 of Chapter 1. In general, the determination of the combined profits to be split and of the splitting factors should:

- Be consistent with the accurate delineation of the actual transaction as set out in Section D.1 of Chapter I, and in particular reflect the contributions of the parties in terms of functions performed, assets used, and risks assumed;
- 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 in comparable circumstances; and
- Be capable of being measured in a reliable and verifiable manner.

30. [2.117] In addition,

- If a transactional profit split of anticipated profits is used to set transfer pricing in controlled transactions, it would be reasonable to expect the life-time of the arrangement, the assumptions made, and the assessment of respective contributions to be determined in advance of the transaction;
- The person using the 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 used to evaluate respective contributions to split the combined profits; and
- Irrespective of whether anticipated or actual profits are used, the basis for calculating the combined profits to be split and the determination of the splitting factors should be made without the use of hindsight and should generally be used consistently over the life-time of the arrangement.

C.4.1 Various approaches for splitting profits

31. [New] Two commonly used approaches to splitting profits include the use of a contribution analysis, and its variation, a residual analysis. These two approaches can be used to apply both transactional profit splits of anticipated profits and transactional profit splits of actual profits.

C.4.1.1 Contribution analysis

32. [2.119] Under a contribution analysis, the combined profits, which are the total profits from the controlled transactions under examination, are divided between the associated enterprises based upon a reasonable approximation of the division of profits that independent enterprises would have expected to realise 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.

C.4.1.2 Residual analyses

33. [2.12] A residual analysis is appropriate where the contributions of the parties to the combined profits resulting from the transaction or transactions can be separated in two categories and applied in two stages. Where the contributions of the parties are such that some can be directly and reliably valued by reference to comparables (*e.g.* because the risks assumed in relation to these contributions are not shared, and the integration in relation to these transactions is low, and the contributions are not unique and valuable), while others cannot, the application of a residual analysis may be appropriate. A residual analysis divides the combined profits from the controlled transactions under examination in two stages. In the first stage, each party engaged in the controlled transactions is allocated an arm's length remuneration for those categories of contributions which can be directly valued, typically routine contributions for which reliable comparables can be found. Ordinarily this initial remuneration would be determined by applying one of the traditional transaction methods or a transactional net margin method to identify the remuneration of comparable transactions between independent enterprises. Thus, it would generally not account for the return that would be generated by a second category of contributions through the sharing of risk involving a high level of integration and unique and valuable contributions by the parties. In the second stage, any residual profit (or loss) remaining would be allocated among the parties. Typically, this allocation will be based on the relative value of the second category of contributions of the parties in a manner similar to the contribution analysis outlined above and in accordance with the guidance as described in section C.3.4.

34. [New] In applying a residual analysis in a transactional profit split of anticipated profits to set a price for the contribution made by the transferor, it is likely that projected income or cash flows of the transferee resulting from the transaction will be estimated over an appropriate period, deducting the income or cash flows associated with the activities that can be reliably benchmarked. This will leave estimated income or cash flows arising from the second category of contributions made by both parties described in the preceding paragraph. These income or cash flows can be discounted to a net present value and split between the parties to determine a price for the contribution made by the transferor. For a discussion of the application of valuation techniques that estimate the discounted value of projected future income or cash flows see sections D.2.6.3 and D.2.6.4 of Chapter VI.

C.4.2 Determining the profits to be split

35. [New] Irrespective of the type of transactional profit split approach that might be applied in a given case, the first step in performing any transactional profit split is to determine the pool of profits to be divided amongst the parties to the transaction.

36. [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 or transactions 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.

37. [2.125] In order to determine the combined profits to be split, the relevant financial data 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. Differences in accounting standards may affect the timing of revenue recognition as well as the treatment of expenses

in arriving at profits. Material differences between the accounting standards used by the parties should be identified and aligned.

38. [2.126] Financial accounting may provide the starting point for determining the profit to be split in the absence of harmonised 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.

39. [New] However, except in circumstances where the total activities of each of the parties are the subject of the profit split, the financial data will need to be segregated and allocations made so that the profits solely relating to the combined contributions made by the parties are identified. For example, a product supplier in a profit split with an associated enterprise engaged in European marketing would need to identify the profits arising from its production of goods for the European market, and exclude the profits arising from the production of goods for, for example, the Asian market. The exercise may be relatively simple if the same goods are supplied to both markets, but will be more complex if different goods with different production costs or with different embedded technology, for example, are supplied to each market. Similarly, if the associated enterprise engaged in European marketing buys products from other sources, it will need to segregate its financial data in a way that reflects the revenues, costs, and profits solely relating to the goods purchased from the product supplier in the profit split. Experience suggests that this initial stage in performing a profit split can in some circumstances be extremely complex, and the method of identifying the profits relevant to the transaction and any assumptions made in doing so need to be documented.

C.4.3 Different measures of profits

40. [New] The measure of profits used as the basis for the profit split will depend on the nature of the integrated operations and the sharing of risks as determined when accurately delineating the actual transaction. If gross profits are used as the basis of the split, then this should reflect the findings of the functional analysis that the parties share not only market risk, which affects the volume of sales and prices charged, but also risks associated with producing or otherwise acquiring goods and services, including any relevant costs of intangibles, which affect the level of gross profit. This may mean that the parties have integrated or joint functions and assets relating to the production or acquisition of goods and services. If operating profits are used as the basis of the split, then this should reflect the findings of the functional analysis that the parties share, in addition to market and production risks, a further range of risks that affect the level of operating expenses that may include investment in intangibles. This may mean that the parties have integrated or joint functions relating to the entire value chain.

41. [New, second example from 2.131] Therefore, the choice of the measure of profits to be split will depend on the nature of the transactions and the extent to which the associated enterprises are integrated, and the nature of the significant risks they share. For example, two associated enterprises, each with its own manufacturing specialisation and unique and valuable intangibles, agree to contribute the intangibles to produce innovative, complex products. The enterprises in this example will share in the profits associated with production and the risks associated with the success or otherwise of the products in the marketplace. However, they do not share risks associated with their selling and other expenses, which are largely unintegrated. Using a profit split based on combined operating profits after all expenses of both parties would have the potential result of sharing the consequences of risks that are controlled by only one of the parties. In such cases, a splitting of gross profits may be more appropriate and reliable since this level of profits captures the outcomes of market and production activities that the parties share together with the associated risks. Similarly, in the case of associated enterprises that engage in highly integrated worldwide trading operations, if the accurate delineation of the actual transaction determines that the

sharing of risks and level of integration does not extend to operating costs, it may be appropriate to split the gross profits from each trading activity then deduct from the resulting share of the overall gross profits allocated to each enterprise its own operating expenses incurred.

Question to commentators

15. What further guidance or clarification of existing guidance would be helpful in these sections? Please provide practical examples in support of the response.

C.4.4 *Splitting profits*

42. [2.13] 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, and in particular on the identification of the drivers of profit determined in the value chain analysis. The criteria or profit splitting factors 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),
- Be verifiable, and
- Be supported by comparables data, internal data, or both.

43. [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.

44. [2.110 and 2.111] However, it is rare to find reliable comparables data that can be used in this manner. Nevertheless, external market data can be relevant in the profit split analysis to assess the value of contributions that each associated enterprise makes to the transactions. In effect, the assumption is that independent parties would have split combined profits in proportion to the value of their respective contributions to the generation of profit in the transaction. Thus, 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 relative contributions of the parties, as measured by their functions, taking into account the assets used and risks assumed.

45. [New] More commonly, comparables data can be relevant in the residual profit split analysis to assess the value of certain categories of contributions, typically routine contributions for which reliable comparables can be found, that each associated enterprise makes to the transactions.

C.4.5 *Profit splitting factors*

46. [2.134] The division of the combined profits under the transactional profit split method is generally achieved using one or more profit splitting factors. Depending on the facts and circumstances of

the case, the factor 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 factors as discussed below). Where more than one profit splitting factor is used, it will also be necessary to weight the factors used to determine the relative contribution that each factor represents to the earning of the combined profits.

47. [2.13] In practice, profit splitting factors based on assets/capital (operating assets, fixed assets (for examples, production assets, retail assets, IT assets), intangibles, capital employed) or costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) are often used where these capture the relative contributions of the parties to the level of profits being split. Other profit splitting factors that may capture the relative contributions of the parties to the level of profit being split may be based in the circumstances of the case on incremental sales, headcounts (number of individuals involved in the key functions that generate value to the transaction), or 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.

48. [New] As noted above, arm's length parties can be assumed to split combined profits on the basis of their relative contributions to the creation of those profits. The determination of an appropriate profit splitting factor should, therefore, reflect the key value drivers in relation to the transaction. The value chain analysis may be helpful in the process of determining the relevant factors to use in splitting profits, including determining the weighting of applicable profit splitting factors, in cases where more than one factor is used.

C.4.5.1 Examples of profit splitting factors

Asset-based factors

49. [2.136] Asset-based or capital-based factors can be used where there is a strong correlation between tangible assets or intangibles or capital employed and creation of value in the context of the controlled transaction. In order for a profit splitting factor 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.

50. [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. Intangibles pose difficult issues in relation both to their identification and to their valuation. Identification of intangibles can be difficult because not all valuable intangibles are legally protected and registered and not all valuable intangibles are recorded in the accounts. An essential part of a functional analysis is to identify what intangibles are contributed by each associated enterprise to the controlled transaction. Guidance on the identification and valuation of intangibles is found at Chapter VI of these Guidelines. See also the examples in the Annex to Chapter VI "Examples to illustrate the guidance on intangibles."

Cost-based profit splitting factors

51. [2.138] A profit splitting factor based on expenses may be appropriate where it is possible to identify a strong correlation between relative expenses incurred and relative value contributed. For example, marketing expenses may be an appropriate factor 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 intangibles such as patents. However, if, for instance, each party contributes different valuable intangibles, then it is not appropriate to use a cost-based factor unless cost is a reliable measure of the relative value of those intangibles or costs can be risk-weighted to achieve a reliable measure of relative value. Even where each party contributes the same kind of intangibles, risk-weighting will be an appropriate consideration. For example, where the risk of failure at an early stage of development is several times higher than the risk of failure at a later stage or in the development of incremental improvements to an already proven concept, then the costs incurred in that early stage will have a higher risk weighting than the costs incurred at a later stage or on incremental improvements. Employee remuneration is likely to be relevant in situations where people functions are the primary factor in generating the combined profits.

52. [New and 2.139] Cost-based profit splitting factors may need to consider a number of issues. One is differences between the parties in the timing of expenditure. For example, research and development costs that are relevant to the value of a party's contributions may have been incurred several years in the past, whereas the expenditure for another party may be current. As a result, it may be necessary to bring historic costs to current values, as discussed further below. The relevant costs may be part of a larger cost pool that needs to be analysed and allocated to the contributions made to the profit split transaction. For example, marketing costs may be incurred and recorded across several product lines, whereas only one product line is the subject of the profit split transaction. In some instances costs, particularly employee compensation costs, are relatively higher for one party to the profit split transaction, not because the functions are more extensive or more valuable than those of another party, but because the location is more expensive. In such circumstances it may be appropriate to consider whether a more reliable outcome can be achieved by adjusting the costs so that the relative share of unadjusted costs does not result in a greater or lower share of value being allocated to a location simply because of a higher or lower cost of living. Where location savings are a significant contributor to profits, and such costs are included in the profits to be split, then the manner in which independent parties would allocate retained location savings would need to be reflected in the profit split, taking into account the guidance in section D.6 of Chapter I. Cost-based profit splitting factors can be very sensitive to differences and changes in 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 factor and to determine the factor consistently among the parties.

Timing issues

53. [2.140] In some cases, a significant issue for the reliability of cost-based splitting factors 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 factor, 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 29-30 above, the selection of the profit splitting factor 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.5 Reliance on data from a taxpayer's own operations (internal data)

54. [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.

55. [2.142] For instance, where an asset-based profit splitting factor 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 profit splitting factors 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 profit splitting factor. 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 profit splitting factor is used.

56. [2.143] Internal data may also be helpful where the profit splitting factor is based on a cost accounting system, e.g. headcounts involved in some aspects of the transaction, or time spent by a certain group of employees on certain tasks.

57. [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.

Questions to commentators

16. The discussion of profit splitting factors sets a requirement that the factors must be capable of being measured in a reliable and verifiable manner. Do commentators believe that useful ways of splitting profits have been excluded? If so, please describe these factors and explain how they meet the requirement of reliable and verifiable measurement.
17. What further guidance would be useful in this section relating to identifying and measuring profit splitting factors? Please illustrate your response with examples.
18. More generally, examples are requested of scenarios where a transactional profit split of actual profits or of anticipated profits are applied, together with a brief explanation as to why the method and the approach to applying the method, is considered to be the most appropriate in the circumstances of the case.