BEPS Action Plan 8-10 along with draft guidance on profit splits

WIRC |13 October, 2018
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Background

Background

- In order to curb a general perception that MNEs are not paying fair share of taxes by shifting profits, the G20 countries along with OECD decided to study the issues and make recommendations.
- Pursuant to this, the G20 and OECD has formulated a 15 point action plan under the base erosion and profit shifting [BEPS] project (final reports released in October 2015).
- The BEPS action plans are structured around three fundamental pillars:

Coherence	Substance	Transparency
Proposals relating to limitations on deductibility of interest, countering tax avoidance using hybrid mismatches, challenging harmful tax practices, etc.	Proposals relating to prevent tax treaty abuse (i.e. treaty shopping), strengthen rules relating to creation of a PE for taxation in the source country, **ensuring transfer pricing outcomes are in line with value creation**, etc.	Relates to disclosure of group information/tax positions – includes Acton 13 TP documentation, which will provide significant information to the revenue authorities in relation to global operations and financial information of companies.

The BEPS action plans also deal with the digital economy across all the three areas.

To implement the BEPS actions, the multilateral instrument is developed as part of the BEPS project

BEPS Action Plan 8-10

ACTION

8

Intangibles

"Develop rules to prevent BEPS by moving intangibles among group members. This will involve:

i. adopting a broad and clearly delineated definition of intangibles;

ii. ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation;

iii. developing transfer pricing rules in relation to hard-to-value intangibles; and

iv. updating the guidance on cost contribution arrangements."

ACTION

9

Risk and Capital

"Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules will require alignment of returns with value creation."

ACTION

10

Other high risk transactions

"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:

i. clarify the circumstances in which transactions will not be recognized;

ii. clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and

iii. provide protection against common types of base eroding payments, such as low value-add services."

Intangibles

Intangibles

Definition

Broad Definition

- Not a physical or financial asset
- Capable of being owned or controlled for use in commercial activities
- Transfer would be compensated between unrelated parties

Does not include

- Location savings / Market specific characteristics
- Group synergies
- Assembled workforce

OECD Para 6.6

"Something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances."

Intangibles

Exclusions

Location Savings

- Represents net cost saving as a result of shifting operations to a low cost location
- Sources of cost saving include
  - Labor
  - Raw material
  - Transportation
  - Rent
  - Capital etc.
- Important to evaluate the extent to which location savings are retained or passed on to customers or suppliers
- Where location savings are retained in the MNE group and where local market comparables are available, such comparables will provide the most reliable indication on how location savings should be allocated
- Where local market comparables are not available, allocation of location savings should be based on analysis of all relevant factors, including the FAR analysis

Intangibles

Exclusions

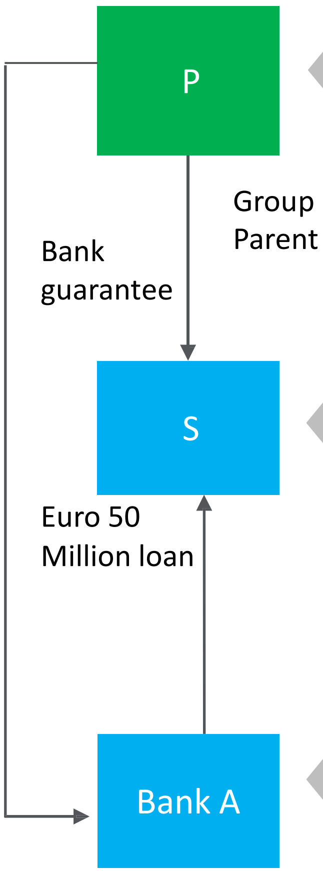
Assembled work force

- Some MNE’s use uniquely qualified or experienced cadre of employees in catering group entities,
- Efficiency of such employee group affects the transfer price of a product or service: A measure of arm’s length could be the payment of compensation to such employees
- Analyze whether such arrangement warrants separate compensation
- Indian TP regulations : Workforce intangibles

MNE Group Synergies

- MNE groups may benefit from interactions or synergies among group members
- It should be analyzed whether group synergies arise due to deliberate action – e.g. setting up centralized purchasing to avail volume discounts
- Synergistic benefits/burdens purely from MNE group membership without deliberate concerted action by group members need not be separately compensated
- Benefits of synergies should be shared in proportion to group members’ contribution

MNE group synergies



- Parent company of the MNE group
- Maintains AAA rating due to the strength of the group

- Part of the MNE group
- Maintains BAA rating on standalone basis
- Due to group synergy, credit standing is at A

- Lends at interest rate available for borrowers with A rating
- Post guarantee, rate of AAA credit rating applied

Example I

- P is the parent company of an MNE group
- Based on the group's strong financials, P is able to maintain AAA credit ratings
- S is part of the same MNE group
- S has a credit rating of BAA on standalone basis
- S's credit rating is increased to A, due to group synergy
- S borrows fifty million Euros from Bank A
- P provides a bank guarantee for the loan to enhance S's credit standing from A to AAA
- In calculating the arm's length guarantee fee, the fee should reflect the benefit of raising S's credit standing from A to AAA, as it is attributable to a deliberate concerted action, namely provision of guarantee and should therefore give rise to compensation

Intangibles
Classification

- The OECD guidance broadly discusses following intangibles:

Marketing intangible

"An intangible (within the meaning of paragraph 6.6) that relates to marketing activities, **aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned**. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers"

Dealership network | Brand Name | Goodwill

Customer relationship | Trademarks

Not all R&D a
expenses crea

Trade intangible

"An intangible other than a marketing intangible."

Know How | Trade secrets | Rights

Licenses

Should subsidiaries be charged for the use of corporate name and logo?

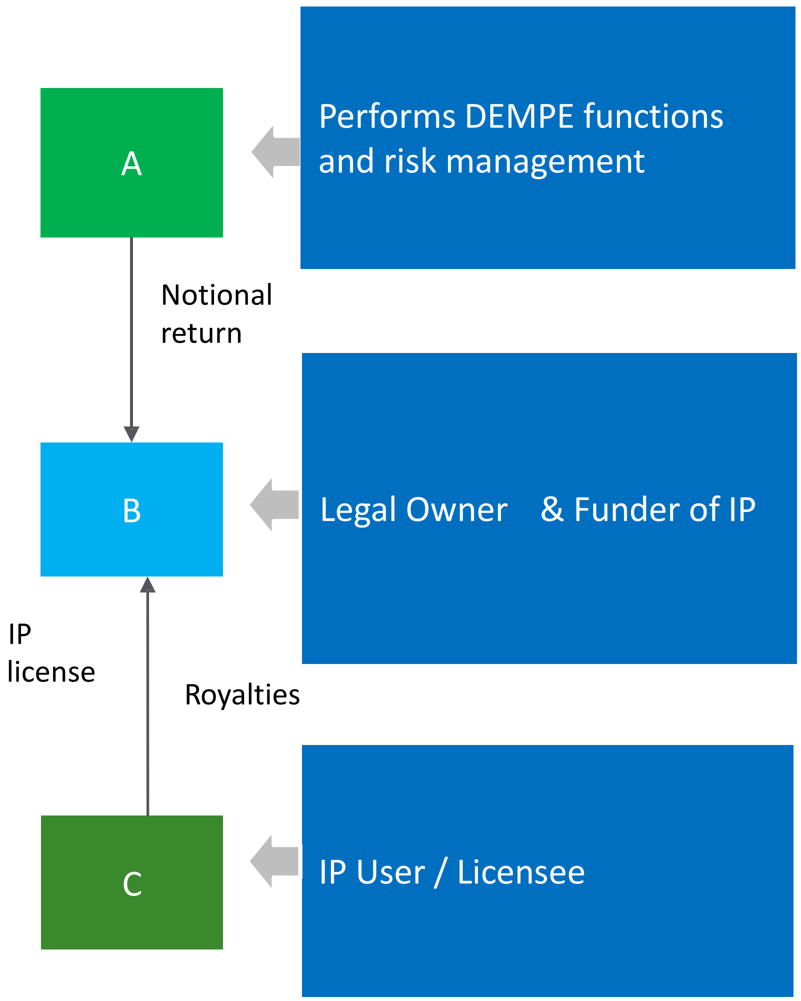
Intangibles

Six-step analytical framework for transactions involving use or transfer of intangibles

1. Identify the intangibles and economically significant risks with specificity
2. Analyze contractual arrangement to determine legal ownership, rights & obligations of entities in relation to intangibles
3. Undertake functional analysis (performance of important functions/assumptions of risks related to DEMPE) to determine actual conduct of parties
4. Confirm consistency between contractual arrangement and conduct on ground
5. Delineate the controlled transaction based on conduct of parties
6. Determination of arm's length price based on FAR of each entity

BEPS Action Plan 8

Example



TP outcomes from this example under the new TPG:

- As legal owner of the IP, B receives royalties from C, in return for granting C the right to use the IP
- A is entitled to a notional return from B – the legal owner – for the performance of DEMPE functions and risk management
- If B only funds the IP and assumes no control over A's DEMPE functions **or risk management (including funding risk),** B is only entitled to a risk-free return
- For transfer pricing purposes, A is entitled to all of the returns from exploitation of the IP above the risk free return

Intangibles

Entitlement for return

- Focus on ‘substance’ for conducting TP analysis of intangibles
- **The entities within an MNE group which are entitled to share in returns derived by the group from exploiting intangibles are those entities making the following contributions:**

Functions

The entity(ies) controlling / performing DEMPE functions in relation to the intangibles

Risks

The entity(ies) controlling risks and having the financial capacity to assume risks associated with the DEMPE of the intangibles

Funding

The entity(ies) providing funding for the intangibles and relevant DEMPE functions

- Important functions should be compensated with an appropriate share of the returns derived from the exploitation of intangibles
- Must consider options realistically available to both parties
- Consideration of the unique features of intangibles (viz. exclusivity, extent and duration of legal protection, useful life, stage of development etc.)

The provision of funding alone without control of the underlying risks does not entitle the funder to anything above a risk-free return

Intangibles

Key Functions

- DEMPE Functions:

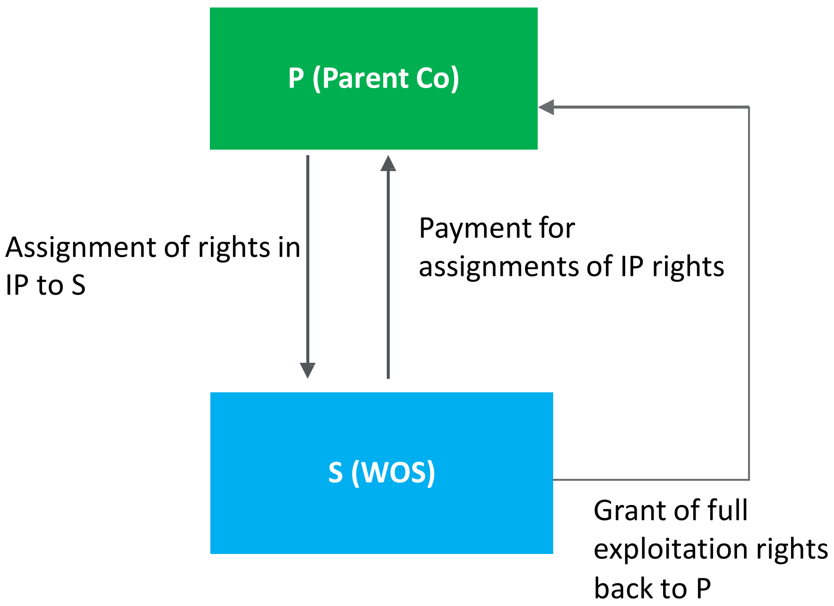
Development	Enhancement	Maintenance	Protection	Exploitation
• Development of intangible asset	• Enhancing value of Intangible asset	• Maintenance of intangible asset (e.g. quality control)	• Protection of intangible asset against infringement	• Use of an intangible asset to derive economic benefits

- **Design and control of research and marketing programs including control over strategic decisions regarding intangible development programs;**
- Management and **control of budgets;**
- Important decisions regarding defence and protection of intangibles **(patents, registrations etc.)**
- On going **quality control** over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.
- The legal owner can outsource such functions, provided it retains control of those functions **(control over risk).**

Legal ownership alone does not necessarily generate a right to all or any of the return generated by the intangibles' exploitation.

What are likely to be some sources of controversy related to DEMPE?

Situation 1

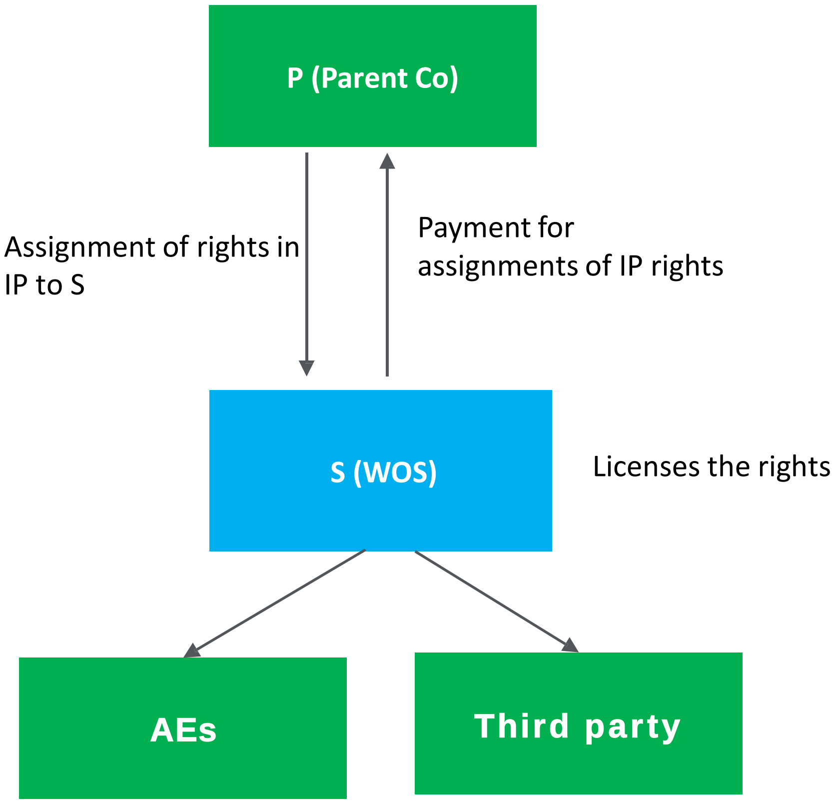


Key Facts

- P funds R&D and perform ongoing R&D activities
- S does not conduct or control any of the R&D activities, it has no technical personnel, it does not incur R&D expenses
- As a policy, all rights of IP are assigned to S to centralize and simplify the global patent administration
- S pays nominal fee to P for assignment of rights
- S grants to P and exclusive, royalty free patent license with right to sub-license, for full life of IP

Which entity is performing DEMPE functions?

Situation 2



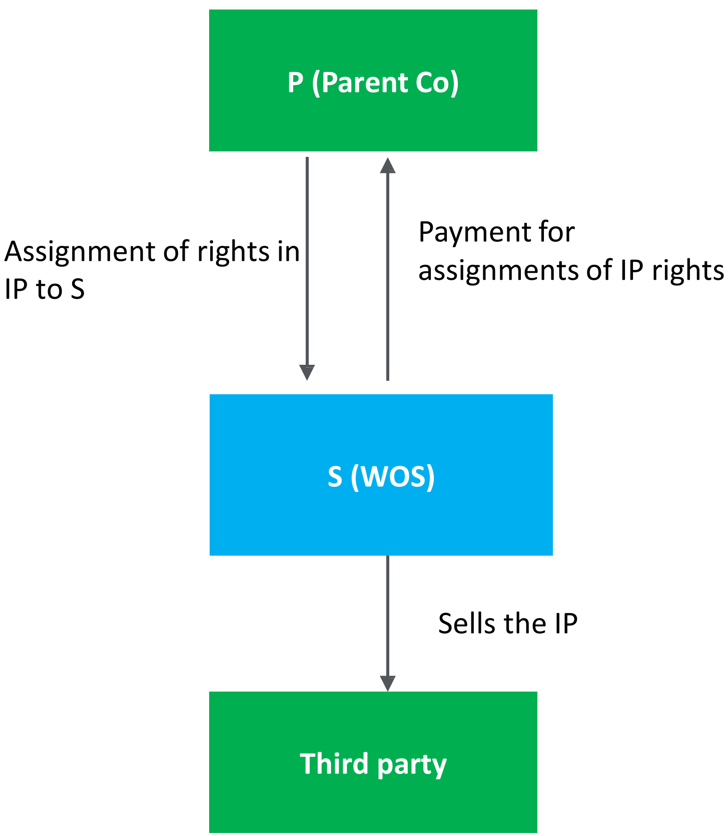
Key Facts

Same facts as in Situation 1 except:

- Instead of S granting exclusive, royalty free patent license with right to sub-license, for full life of IP to P, S under the control and direction of P sub-licenses it to AEs and third parties.

Which entity is performing DEMPE functions?

Situation 3



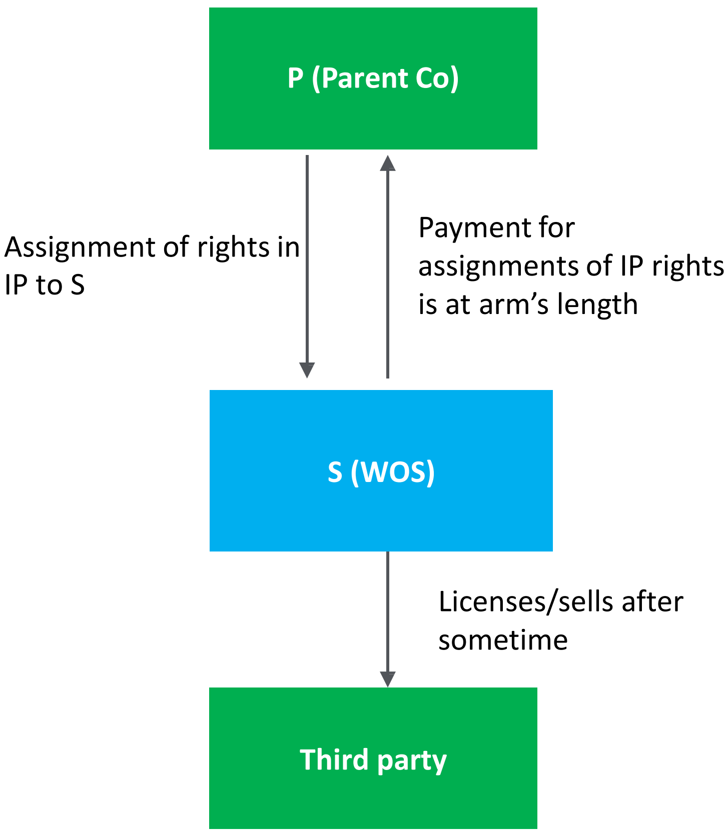
Key Facts

Same facts as in Situation 2 except:

- Instead of licensing the rights of IP to AEs and third parties, S sells IP to third parties under direction and control of P
- The increase in price of IP is attributable to the period when S was the legal owner

Which entity is performing DEMPE functions?

Situation 4



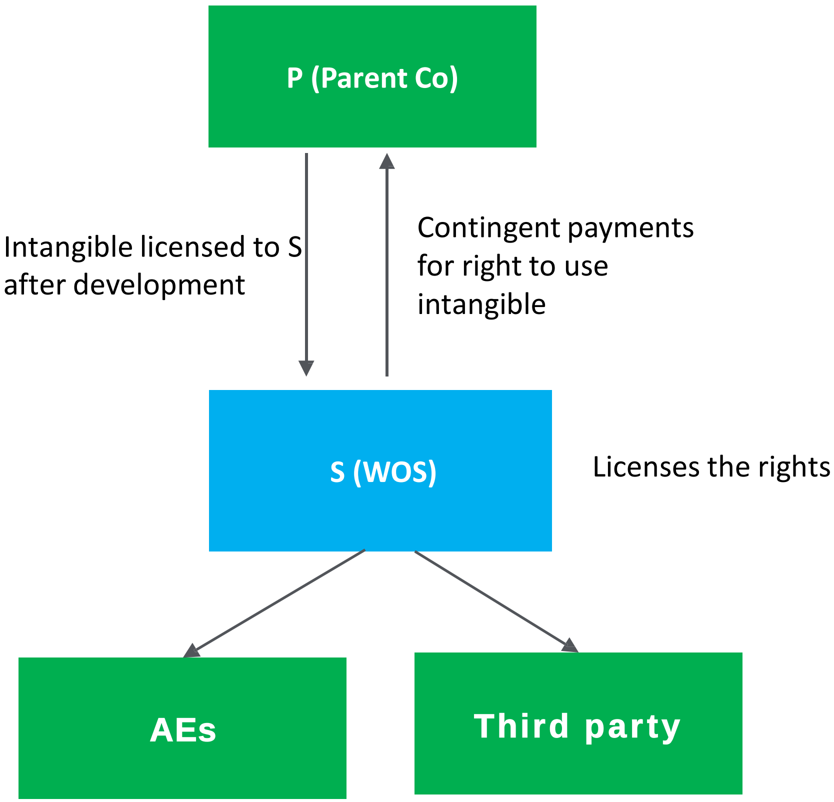
Key Facts

Same facts as in Situation 3 except:

- S has employees who make the decision to take on the patent portfolio and takes all decision relating to licensing programme, negotiation with licensees and monitoring compliance of third parties with term of licenses
- S licensed the IP to third party and thereafter sells it to another third party at a price far exceeding the price paid by S to P for original purchase as the value of the patent has increased due to external unforeseen circumstances
- S makes all decisions regarding sales. It manages and controls the disposition of the patents

Which entity is performing DEMPE functions?

Situation 5



Key Facts

P & S decide to develop an intangible

Functions of P

- Funds R&D and will be the legal owner of IP
- Contractually assumes and has the capacity to assume financial risk; and exercises control over the financial risk

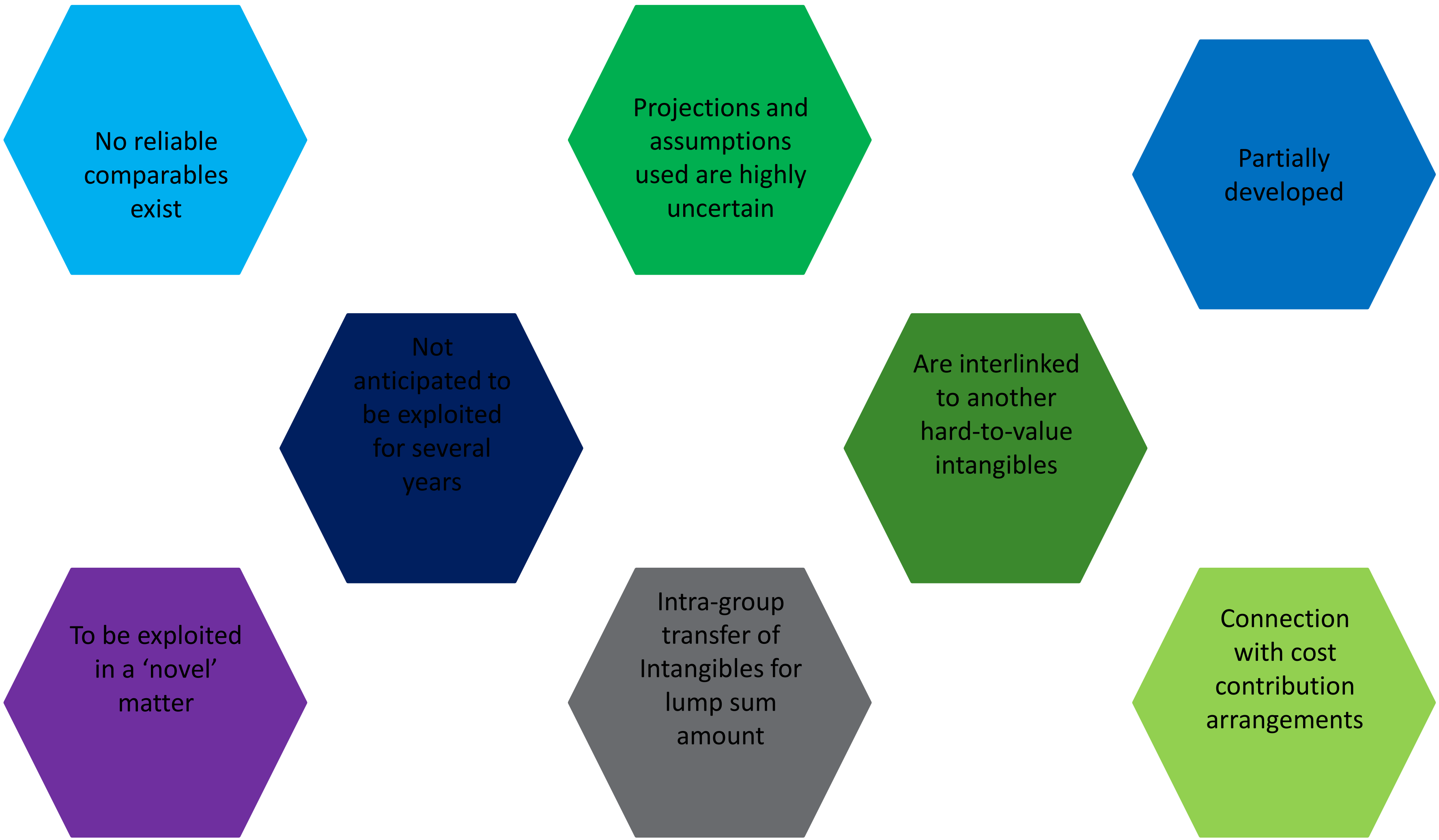
Functions of S

- S has existing IP which will benefit the R&D functions. It has track record and experienced employees
- Performs and control all R&D functions
- Key decision maker regarding development of IP

Which entity is performing DEMPE functions?

Hard to value intangibles : New concept added in Action 8

Description



Hard to value intangibles

Key considerations

Ex-post outcomes can be considered to assess the reliability of the information on which ex ante pricing is based

Information symmetry

Tax authorities have **lesser insight than businesses**, may use ex-post outcomes in later years to Impose price adjustments

Exemptions

Reliable evidence on *ex ante* calculations, including how risks were accounted for in calculations.

Bilateral or multilateral advanced pricing agreements

Ex-post outcome within 20% plus/ minus of *ex ante* calculations

5 year look-back period, with variation in actuals and projections not greater than 20% of projections

Can ex-post approach lead to economic double taxation?

Hard to value intangibles

Example

2010
Ex-ante value INR 100 Mil

Transfer of intangible

Assessment

2014
Ex-post value 500 Mil

Difference of valuation
Due to anticipated reasons?

No

No adjustment to be made

- Provide full details of ex ante projections
- Provide satisfactory evidence that significant difference are due to unforeseeable or extraordinary developments or subsequent events
- Mix jurisprudence

Yes

Adjustment can be made

Key application areas:

- Pharma drugs/chemical compounds under development
- Oil and Gas exploration
- Novel products/applications such as E-wallets, learning applications etc.
- *Price adjustments also observed in third party scenario*

Bilateral valuation methodology as best practice for intangibles?

Cost Contribution Arrangements ("CCA")

Definition

Old Definition	New Definition
"a framework agreed among business enterprises to **share the costs and risks** of **developing,** producing, or obtaining assets, services or rights and to determine the nature and extent of interests of each participant in those assets, services, or rights"	"contractual arrangement among business enterprises to **share the contributions and risks** involved in the **joint development,** production or the obtaining of intangibles, tangible assets or services **with the understanding that** such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants"

Key modification to definition of a CCA participant

01 Must have capabilities to and actually perform decision making related to taking a risk bearing opportunity and how to respond to risk associated with the opportunity

02 Would not be a participant if it does not exercise control over specific risks assumed under CCA and does have the financial capacity to assume those risks

Types of CCA

Development CCAs

- Joint development, production or the obtaining of intangibles or tangible assets
- Expected to create ongoing / future benefits
- Uncertain and involves significant risks

Services CCAs

- These CCAs are established for obtaining services
- Expected to create current benefits
- More certain and less risky

Risks and Capital

Overview

- Business transaction to reflect alignment between contractual arrangement and economic reality

Economic Reality

Risk vis-à-vis Actual Decision Making

- Contractual allocation of risk respected only if supported by actual decision making

- Capital without functionality will generate "risk free returns" : No premium returns to "Cash boxes"

Substance in Capital Funding

Guidance to Tax Authorities in peculiar situation

- Transaction can be disregarded for exceptional circumstances of commercial irrationality

Objectives of Action 9:

*-**strengthen** the guidance on arm's length principle (by considering contractual allocation of risks, value creation, allocation of profits, level of returns on funds provided by "cash boxes", etc.)*

Risks and Capital

Contractual terms

01 Contractual terms may be in the form of explicit written contracts, or may be in communications between the parties other than a written contract.

02 In the absence of a written contract, the conduct of the parties shall provide guidance.

03 The allocation of risks on paper (contracts) should not in itself determine outcome. Instead, the parties‘ conduct should serve as the basis for delineating the transaction when the conduct and contractual terms differ.

Contractual Arrangement

Executed written contract to license intellectual property by ABC Ltd. To XYZ Ltd.

XYZ Ltd. agrees to pay Royalty

ABC Ltd. – Characterized as licensor

ABC Ltd

XYZ Ltd (WOS)

Actual Conduct

Additionally, indicates that ABC Ltd negotiates with third party customers to achieve sales for XYZ Ltd, provides regular technical support services to customers of XYZ Ltd.

In substance, ABC Ltd. controls key functions/business risks

Licensor vs Principal?

ABC Ltd. should be compensated for other functions as well –identification of actual transaction should not be solely on the basis of terms of the written contract

Risks and Capital

Analysis of risks

Six step analytical framework to identify risks

Determine contractual allocation of risk

Identify control over risk

Identify financial capacity to absorb risk

Check conduct with contractual terms

Re-characterize risks, if appropriate

Pricing based on risk assumption and management

Risks and Capital

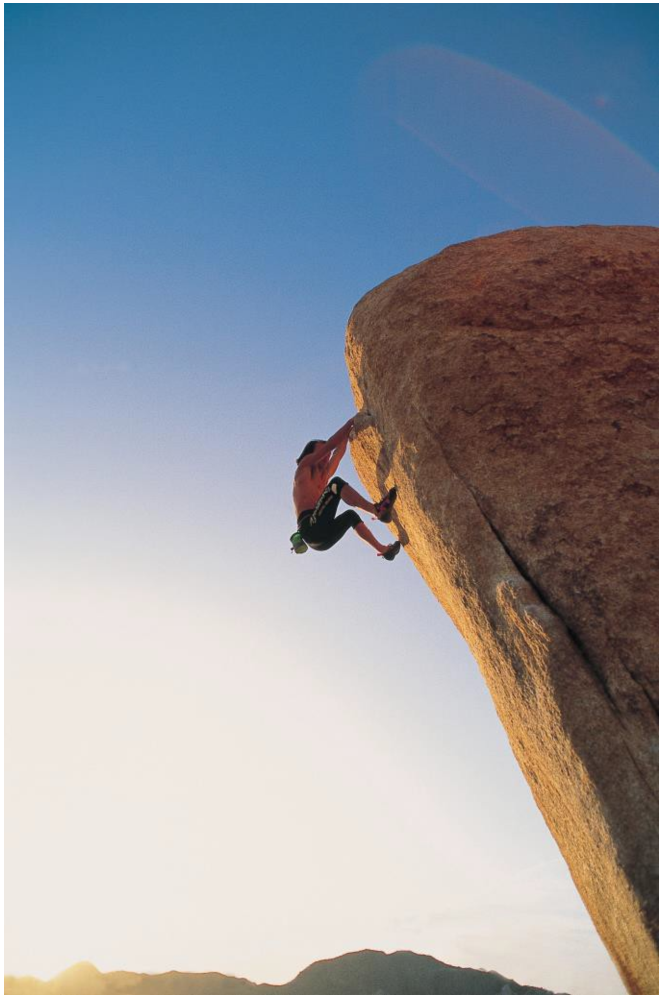
Analysis of risks

Management and control of Risks

- **Management and control of risks** involves Capability to **make decisions** to take on, lay off, or decline a risk-bearing opportunity and the performance of that decision-making function
- Capability to make decisions on **whether and how to respond** to the risks associated with an opportunity and the performance of that decision-making function
- **Capability to mitigate risk**, i.e. take measures that affect risk outcomes and the performance of this function
- **Day to day risk mitigation may be outsourced**, control over risk mitigation cannot be outsourced
- Control over risk does not mean **risk itself can always be influenced** (e.g. general business risk cannot generally be controlled)

Financial capacity to assume risk

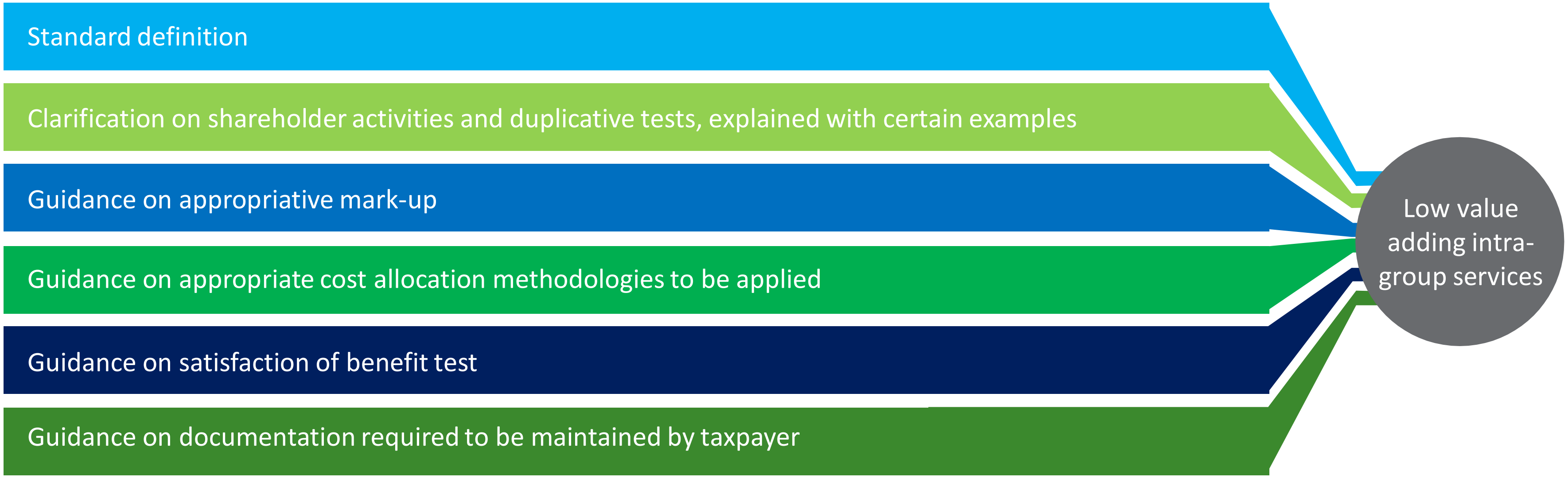
Access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materializes



Low value adding intra-group services

Overview

- Intra-group services could be a Base eroding payment and is matter of significant litigation across the globe
- Changes to Chapter VII of the OECD TPG by **adding a definition** of “low value-adding intra-group services” and provide an elective (optional) “simplified method” for such services.
- Provides guidance on achieving the necessary balance between appropriately allocating charges for intra-group services and the need to protect the tax base of payer countries
- Simplify and moderate the “benefit test”



Low value adding intra-group services

Definition

01 Characteristics

- Supportive in nature
- Not a part of core group business
- Can be principle business activity of the service provider – **appropriateness in Indian context?**
- Do not require unique/ valuable intangibles
- Do not lead to creating of unique/ valuable intangibles
- Do not involve assumption or control of or give rise to significant risk

02 Examples

- Accounting & auditing
- Processing and management of debtors/ creditors
- Activities in connection with human resources
- Information technology support services
- Internal and external communications and public relations support
- Legal, administrative, tax compliance/advisory and other clerical services

03 Exceptions

- Services constituting core group business
- Research & development
- Manufacturing and production
- Purchasing, sales, marketing and distribution
- Financial transactions
- Extraction, exploration or processing of natural resources
- Insurance/ reinsurance
- Services of Corporate Senior management

Cautions that if a company’s activities do not qualify for the simplified method, it should not be assumed that such activities should generate high returns

Low value adding intra-group services

Definition as per revised safe harbour rules

01

Characteristics

- Supportive in nature
- Not a part of core group business
- Not in nature of shareholder service or duplicate service
- Do not require unique/ valuable intangibles
- Do not lead to creating of unique/ valuable intangibles
- Do not involve assumption or control of or give rise to significant risk
- Do not have reliable external comparable services that can be used for determining ALP

02

Exceptions

- Research & development
- Manufacturing and production
- IT (software development services)
- KPO services
- BPO services
- Purchasing, sales, marketing and distribution
- Financial transactions
- Extraction, exploration or processing of natural resources
- Insurance/ reinsurance

Low value adding intra-group services

Documentation and reporting

- Electing MNE group to prepare following documentation and make it available upon request to tax administration:
  - Description of categories of low value-adding intra-group services provided, including
  - Justification that each category of service constitutes low value-adding service as per its definition
  - Rationale for provision of services within context of MNE's business
  - Description of expected benefits
  - Description of selected allocation keys and rationale behind its selection
  - Confirmation of mark-up applied
- Written contracts or agreements along with any modifications to them
- Calculations showing determination of cost pool
- Calculation showing application of the selected allocation keys
- Single annual invoice describing category of service should suffice
  - Any correspondence or other evidences for individual acts/ services not required

Simplified approach

Assumes that businesses are only willing to incur costs for business reasons	Assumes that businesses are only willing to incur costs for business reasons	Assumes that businesses are only willing to incur costs for business reasons	Assumes that businesses are only willing to incur costs for business reasons	Assumes that businesses are only willing to incur costs for business reasons	Assumes that businesses are only willing to incur costs for business reasons

OECD Guidance on Transactional PSM

Overview

1. The June 21 profit split report is the fourth and final round of proposed guidance relating to the transactional profit split method. It contains new provisions and examples that replace the current versions of Section C of Part III, Chapter II of the 2017 OECD TPG and Annex II to Chapter II of the 2017 OECD TPG, respectively.
2. The immediately preceding round of guidance was a non-consensus discussion draft released on June 22, 2017. The 2018 profit split report retains the same basic approach of the 2017 discussion draft, but expands upon that draft, especially in the examples.
3. Overall, the 2018 profit split report continues to focus squarely on the question of how the "risk control" framework of the revised Chapter I of the TPG might apply in the context of
   i. the selection of the transactional profit split as the most appropriate transfer pricing method, and
   ii. the application of a split factor that may reasonably result in an arm's length outcome.

OECD Guidance on Transactional PSM

The three profit split indicators

The 2018 final report sets forth three factors the presence of which indicate that the transactional profit split method may be the most appropriate method. Those three factors are:

- Whether each party is making unique and valuable contributions;
- Whether the business operations of the parties are so highly integrated that the parties' contributions cannot be reliably evaluated in isolation from each other; and
- Whether the parties share the assumption of economically significant risks or separately assume closely related risks.

Unique and valuable contributions

Contributions (for instance functions performed, or assets used or contributed) will be "unique and valuable" in cases where (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) they represent a key source of actual or potential economic benefits in the business operations.

Highly integrated business operations

Means the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with another party, and cannot reliably be evaluated in isolation

Shared assumption of economically significant risks, separate assumption of closely related risks

Each party to the controlled transaction shares the assumption of one or more of the economically significant risks in relation to that transaction" or "the various economically significant risks in relation to the transaction are separately assumed by the parties, but those risks are so closely inter-related and/or correlated that the playing out of the risks of each party cannot reliably be isolated.

OECD Guidance on Transactional PSM

Guidance on application

The determination of the relevant profits to be split and of the profit splitting factors should:

1. Be consistent with the functional analysis of the controlled transaction under review
2. Be capable of being measured in a reliable manner
3. The criteria or profit splitting factors to be agreed in advance of the transaction
4. Proper explanation on why PSM is the most appropriate method
5. The determination of the profits to be split and of the profit splitting factors should be consistent over the life-time of the arrangement, including for loss years. If there is any change, it should be properly documented

OECD Guidance on Transactional PSM

Approaches to splitting of profits

Contribution analysis

Under this, the relevant profits from controlled transactions are divided between the AEs based upon their relative value of contributions, supplemented by external market data (where possible) that indicate how independent enterprises would have divided profits in similar circumstances.

Residual analysis

A residual analysis divides the relevant profits from the controlled transactions into two categories. In the first category, profits are attributed to those functions which can be benchmarked and for which reliable comparables can be found. In the second category, profits which are left to be attributed will be splitted by using contribution analysis.

When internal or external market data is not available, a survey approach can be applied to gather information that will be used as a basis for contribution analysis

OECD Guidance on Transactional PSM

Determination of profits to be split

Important factors in determining the profits to be split

- Delineation of the transaction – may use segment results which will reflect accurate delineation of the transaction
- Usage of accounting standards consistently through out the lifetime of the arrangement
- Use of financial accounts that may provide the starting point for determining the profit to be split
- The use of other financial data (e.g. cost accounting) should be permitted where such accounts exist, are reliable, auditable and sufficiently transactional

Split of actual or anticipated profits

- Splitting of actual profits - when all the relevant parties share the assumption of the same economically significant risks
- Splitting of anticipated profits - Appropriate if one of the parties does not share in the assumption of all of the economically significant risks

The measure of profits to be split will depend on the risks that enterprises share.

Operating profit – If the enterprises share the risks of the entire business, then a split of operating profit may be appropriate

Gross profit - If the enterprises share only the risks associated with the volume of sales and production of the products, and they do not share the risks associated with selling the products in the marketplace, then a split of gross profit may be appropriate

OECD Guidance on Transactional PSM

Splitting the profits

- Profits should be split on an economically valid basis that reflects the relative contributions of the parties to the transaction. The criteria or splitting factors used to split the profit should:
- Be 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.

Profit splitting factors

Asset based	• Asset based profit splitting factors can be used when there is strong correlation between tangible assets, intangibles or capital employed with value creation • Operating assets, fixed assets (e.g. production assets, retail assets, IT assets), intangibles
Cost based	• Cost based factor is used when there is strong correlation between cost incurred and relative value created • Relative spending and/or investment in key areas such as research and development, engineering, marketing.
Others	• Incremental sales, or employee compensation (relating to the individuals involved in the key functions that generate value to the transaction; headcount or time spent by a certain group of similarly skilled employees with similar responsibilities

Strengths and weaknesses of profit split analysis

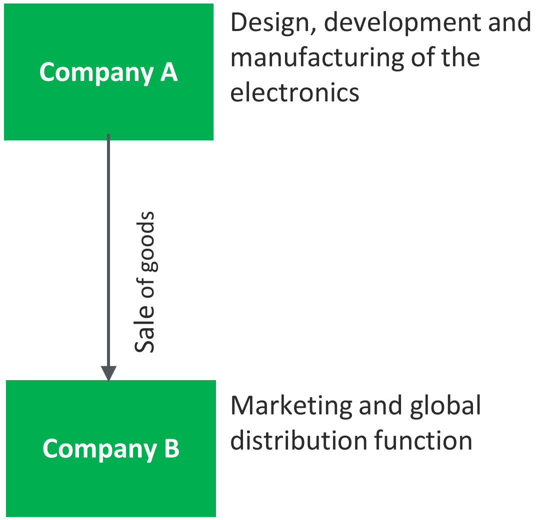
Strengths

- Can be used when no comparable transaction exists
- Offers flexibility
- Applicable when non-routine intangibles are developed or in case of complex transactions
- Allows direct evaluation of both parties to the transaction

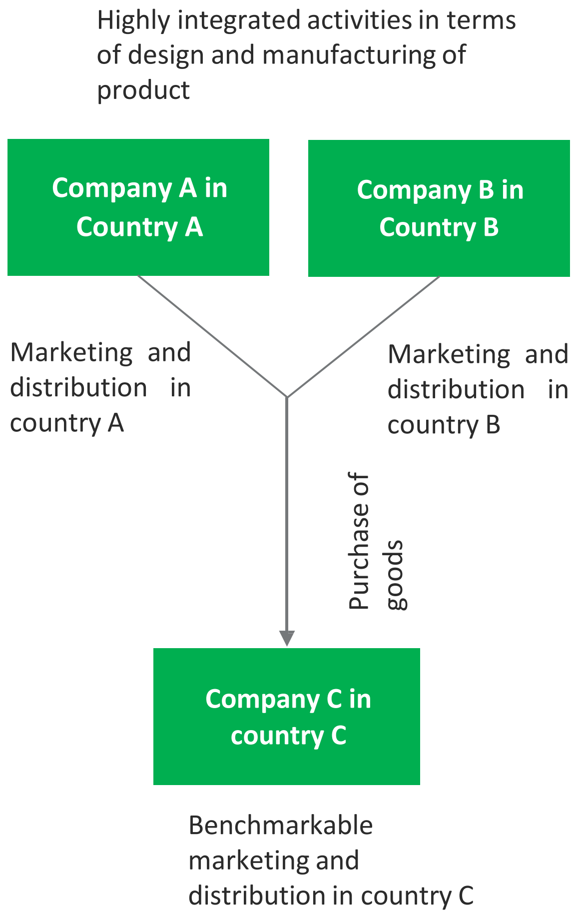
Weaknesses

- Complex and subjective analysis
- Difficult to obtain information from foreign affiliates
- Independent enterprises do not normally use the PSM to determine their transfer pricing (except in joint ventures)
- Need to apply local accounting criteria
- Difficult to identify appropriate expenses and carry out correct allocations

1. Company A and Company B are members of an MNE group that sells electronic appliances.
2. Company A - performs R&D, decides levels of production, performs quality controls. Company A uses its valuable know-how and expertise regarding the manufacturing of electronic appliances.
3. Once the products are manufactured, they are sold to Company B.
4. Company B - designs the marketing strategy, the level of marketing expenditure in each country, and validating the impact of the marketing campaigns on a monthly basis. The marketing activities performed by Company B result in a valuable trademark and associated goodwill by which the new line of products is favourably differentiated from competitors' alternatives in the market.
5. Company B is also responsible for the global distribution of the products. Company B has performed the R&D activities and assumed the risks associated with the development of a sophisticated proprietary algorithm to get feedback from customers on the performance of the products.
6. The accurate delineation of the transaction indicates that the contributions of Company A and Company B are unique and valuable to the potential success of the new line of products.
7. Under these circumstances, the transactional profit split method is likely to be the most appropriate method for determining the compensation for the products sold by Company A to Company B as both parties make unique and valuable contributions to the transaction.



1. Company A and Company B enter into an agreement to buy and sell pieces, moulds and components to manufacture the different models of the products.
2. Company A and Company B have each developed unique and valuable know-how and other intangibles in their respective design and manufacturing processes.
3. The accurate delineation of the transaction shows that Company C does not make any unique and valuable contribution. Instead, Company C performs benchmarkable marketing and distribution functions.
4. Under these circumstances, the transactional PSM is likely to be the MAM for determining the compensation for Companies A and B in relation to their intra-group transactions.
5. However, a one-sided transfer pricing method such as a RPM or a TNMM is likely to be the most appropriate to determine an arm's length return for Company C.
6. In applying the transactional PSM, the sales of products in Countries A, B and C should be taken into account in determining the relevant profits to be split.
7. In the case of Country C, this will be calculated by reference to the sales revenue of Company C, less the arm's length return to Company C (as established above) for its contributions.
8. An asset-based splitting factor may be appropriate, provided that the functional analysis concludes that there is a strong correlation between the assets of Company A and Company B and the creation of value in the context of their controlled transactions.



Scenario 1

1. Company A does not share any of the economically significant risks associated with the marketing and exploitation activities of Company B related to the licensed intangibles.
2. Under these circumstances, the application of the transactional PSM should be based on the profits anticipated to be generated by Company B from commercializing the products over an appropriate period (e.g. using a discounted cash flow valuation technique).
3. The relative value of the contributions made by Company A and Company B will be used to determine a split of the anticipated profits of Company B resulting from the combined contributions of the enterprises.

Scenario 2

1. In this scenario the accurately delineated transaction shows that:
   - Company A and Company B agree to a split of the actual profits from the sale of the products by Company B
   - Company A and Company B will jointly perform the marketing and distribution activities related to the trademarked products and
   - Both Company A and Company B assume risks associated with the success or otherwise of the marketing and commercialization of the products by Company B
2. Under these circumstances, the transactional profit split method applies to the actual profits achieved from the sales of the products and the relative value of the contributions made by Company A and Company B will be used to determine the split of those profits.

developed know-how and has enhanced the value of the trademark and associated goodwill of its business through intensive marketing activities

Company A in country A (parent company of Retail) Group

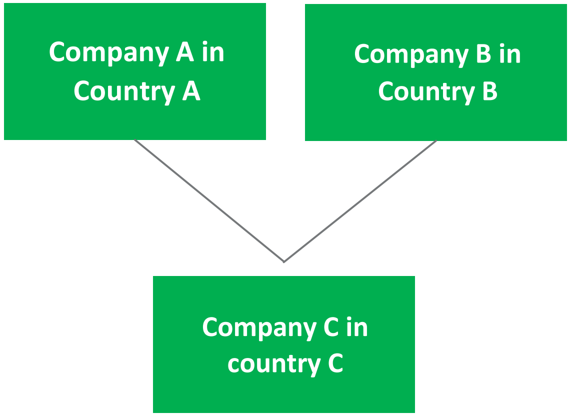
Company A grants to Company B the rights to utilize the know-how and to use the trademarks for the purpose of fashion retailing in Country B

Company B in country B

has extensive experience in retail fashion distribution and has a strong track record in building brand recognition and loyalty in Country B through its in-house team which develops and implements innovative marketing strategies and activities

1. Company A, Company B and Company C, members of the same MNE group, jointly agree to share the "greenfield" development of a new product
2. In this regard, none of the entities brings existing contributions of value such as pre-existing intangibles to the project. Each associated enterprise will be responsible for developing and manufacturing one of the three key components of the product
3. In this case, assume that the transactional profit split is found to be the most appropriate method for determining the profits of the three companies from the sale of the new product
4. The functional analysis concludes that the relative contributions of the parties may be measured by reference to the relative expenses incurred by each company in the development of the components as there is a direct correlation between these relative expenses and the relative value contributed by each company
5. Accordingly, the relevant profits (losses) in relation to the sales of the new product can be split based on the relative development costs incurred by each of the parties
6. In this example, the splitting of profits based on relative development costs will yield results similar to those which would have resulted under an analogous cost contribution arrangement, since parties performing activities with similar economic characteristics should receive similar expected returns, irrespective of whether the contractual arrangement in a particular case is termed as a CCA or not

Jointly agree to share the "greenfield" development of a new product



UN TP Manual guidance on PSM

Overview

1. The PSM is typically applied when both sides of the controlled transaction contribute significant intangible property. The profit is to be divided such as is expected in a joint venture relationship.
2. The PSM starts by identifying the profits to be divided between the associated enterprises from the controlled transactions.
3. Subsequently, these profits are divided between the associated enterprises based on the relative value of each enterprise's contribution, which should reflect the functions performed, risks incurred and assets used by each enterprise in the controlled transactions.
4. External market data (e.g. profit split percentages among independent enterprises performing comparable functions) should be used to value each enterprise's contribution, if possible, so that the division of combined profits between the associated enterprises is in accordance with that between independent enterprises performing functions comparable to the functions performed by the associated enterprises.
5. The PSM is applicable to transfer pricing issues involving tangible property, intangible property, trading activities or financial services.

Contribution Analysis

- The combined profits from the controlled transactions are allocated between the AEs on the basis of their relative value of functions performed
- External market data that reflect how independent enterprises allocate the profit in similar circumstances should complement the analysis to the extent possible.

Residual Analysis

- Allocation of sufficient profit to each enterprise to provide basic arm's length compensation for routine contributions.
- Allocation of residual profit between the associated enterprises based on the facts and circumstances. If the residual profit is attributable to intangible property then the allocation of this profit should be based on the relative value of each enterprise's contributions of intangible property

UN TP Manual guidance on PSM

Overview

Comparable Profit Split Method

1. The profit is split by comparing the allocation of operating profits between the associated enterprises to the allocation of operating profits between independent enterprises participating in similar activities under similar circumstances (Comparable Profit Split Method)
2. The major difference with the contribution analysis is that the Comparable PSM depends on the availability of external market data to measure directly the relative value of contributions, while the contribution analysis can still be applied even if such a direct measurement is not possible
3. The contribution analysis and the Comparable PSM are difficult to apply in practice and therefore not often used. This is especially the case because the reliable external market data necessary to split the combined profits between the associated enterprises are often not available

Strengths

- Suitable for highly integrated operations where the traditional methods prove inappropriate due to a lack of comparable transactions
- Avoids an extreme result for one of the associated Enterprises
- Able to deal with returns to synergies between intangible assets or profits arising from economies of scale

Weakness

- The relative theoretical weakness of the second step
- Its dependence on access to data from foreign affiliates
- Certain measurement problems exist in applying the PSM

- The PSM might be used in cases involving highly interrelated transactions that cannot be analyzed on a separate basis
- The (Residual) PSM is typically used in complex cases where both sides to the controlled transaction own valuable intangible property (e.g. patents, trademarks and trade names)

OECD Vs UNTP Manual Vs Indian Regulations on PSM

Comparison

OECD Guidelines	UN TP Manual	Indian TP Regulations
Not specific to intangibles. Refers “unique and valuable contributions” which is more about functions	Where both entities to transaction contribute own intangible properties	transfer of unique intangibles
Highly integrated & interdependent transactions	Highly interrelated transactions	so interrelated that they cannot be evaluated separately
all parties assume economically significant risks	No reference on assumption of risks	No reference on assumption of risks
Emphasis on significant economic functions considering the practical experience on business arrangements	No reference on importance of functions	No reference on importance of functions
Detailed guidance on approach on splitting of profits and factors for profit splitting	No such guidance	No such guidance

Points to ponder

1	Functional analysis to identify “unique and valuable contributions” in the context of Indian companies
2	Identification of economically significant risks and the parties assuming the same
3	Reliable data availability i.e. consistency in accounting treatment and appropriate segmentation
4	Identification of profit splitting factor
5	Awareness amongst clients on proactive approach required for application of PSM to the international transaction
6	Complexity in application of PSM and TNMM to a specific transaction
7	Tax authorities approach towards PSM
8	Approach towards documentation
9	Whether OECD BEPS project would increase the use of PSM?
10	Can CbCR serve as a starting point to ascertain whether PSM should be undertaken?
11	Number of APAs concluded by CBDT on PSM?
12	Impact of US tax reforms related to IP
13	Has India adopted BEPS Action Plan 8 – 10?