



THE RESIDUAL PROFIT SPLIT METHOD AND ITS NEW ACCEPTANCE IN EUROPE RELATED TO PLATFORM CONCEPTS

September 2020





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PRICING

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The OECD's Base Erosion and Profit Shifting (BEPS) effort has resulted in many changes in global transfer pricing systems. Rapid developments in the business world, generally and currently caused by the corona crisis, make it necessary to constantly review and, if necessary, adjust transfer pricing systems. As a result, multinational enterprises more and more opt for transfer pricing methods such as the Profit Split Method using a residual analysis (RPSM). In the context of cross-border transfer pricing and the ongoing digitalisation process emphasis is placed on platform concepts.

NEW ACCEPTANCE?

With the recent focus on profit shifting around the world, in June 2018 the OECD published a Report containing Revised Guidelines on the application of RPSM under BEPS[1] project to clarify and notably expand the Guidelines on when a residual profit split may be the most appropriate method.[2] This has led to a wider acceptance of RPSM in Europe.

In line with the arm's length principle, the RPSM measures the net operating profits realized from controlled transactions and compares the detected profit level to the profit level realized by comparable independent enterprises that are engaged in comparable transactions.

[1] OECD, Addressing Base Erosion and Profit Shifting, 2013.

[2] OECD, Revised Guidance on the Application of the Transactional Profit Split Method, 2018.

ROLE OF PLATFORM CONCEPTS?

The profit-based RPSM is becoming an obvious choice for the use of platform concepts in connection with intangible assets, such as product-know-how and intellectual property.

As a result of the crisis, value-added processes are being rethought and platform concepts no longer solely focus on product sales. Digitalisation favours new business models regarding intangibles, which are

Platform concepts enable multinational companies to improve the sustainability of life cycles and recycling processes and to prevent sunk costs. Through platform concepts, it is possible to produce in one country what has been conceived and developed in another location around the world. Companies all over Europe exploit the potential of these intelligent processes. The local company uses the platform developed by an entrepreneur as well as the data and information (intellectual property) provided therein. In the age of globalisation, the movement towards more sustainability also leads to changes in price setting along the value chains and thus the transfer pricing system itself.



INDICATORS FOR RPSM?

The most appropriate cross-border transfer pricing method has to be selected for each particular case, taking into account the respective strengths and weaknesses of each approach. There are several indicators for the consideration of the RPSM (OECD, Revised Guidance on the Application of the Transactional Profit Split Method, 2018, para. 2.125 f). The clearest indicator are unique and valuable contributions made by each entity. It may not be appropriate to use the RPSM, if one of the transaction partners performs only simple functions. Furthermore, the business operations shall be highly integrated such that the contributions of the parties cannot be reliably evaluated in isolation from each other. The last indicator is the shared assumption of economically significant risks and simultaneously the separate assumption of closely related risks. Besides, the lack of external comparables per se should not lead to default use of RPSM (OECD, Revised Guidance on the Application of the Transactional Profit Split Method, 2018, para 2.128 and 2.143).

The first step involved in the RPSM is the identification of the relevant profit with regard to the respective transactions. Secondly, the residual profit is divided between the companies involved in the cross-border transaction on the basis of the relative value of their contributions. Thus, the allocation is based on a measurement of each party's investment in intangible assets or their specific contributions to value drivers. Transfer pricing experts determine appropriate profit splitting factor(s), which can be based on e.g. assets or capital (like intangibles) or costs. During the application, the objective is to approximate as closely as possible the split of profits that would have been realised by third independent companies.

DOWNSIDERS?

Albeit the increased popularity of RPSM, its drawbacks should be pointed out. Due to the high degree of subjectivity, it offers tax authorities the possibility to allocate a disproportionate amount of profits to a related enterprise engaging in the respective transaction. This may lead to disputes and therefore increases the risk of litigation, which can be prevented by the ongoing support of transfer pricing experts. Furthermore, the number of mutual agreement procedures (MAP) might increase.

LICENSEE'S SYSTEM AS A CLASSIC EXAMPLE?

An example of a transaction for which the RPSM is the most appropriate method is a cross-border licensee's system. A licensor (enterprise "A") develops and owns technology and provides the use of these intangibles and possibly guidance to a licensee. The licensee (enterprise "B") uses the intangible through a platform concept, owns certain market intangibles itself and is responsible for all aspects of the supply chain in its defined market. Both companies bear high risks and carry out complex functions, while A owns crucial remarkable assets and makes strategic decisions. Therefore, A is a so-called entrepreneur, whereas B can be classified as a so-called hybrid entity (also "local entrepreneur"). A local entrepreneur is a company which, taking into account the functions it performs, the assets it uses and the risks it assumes, is neither a company with routine functions nor an entrepreneur.^[3] A will provide the corresponding platform to enable B to use the intangibles in its local market, such as know-how regarding the customer base.

[3] German Verwaltungsgrundsätze-Verfahren, 2005, para. 3.4.10.2.

DEMPE-FUNCTIONS?

In determining the most appropriate method, B's functions must be observed. The remaining profit should be divided between the two entrepreneurs of the group. Regarding the development and application of intangible assets the so-called DEMPE-functions (development, enhancement, maintenance, protection and exploitation) are associated with the application of the RPSM (OCED, Addressing the tax challenges of the digitalisation of the economy, 2019, para 1.3). In particular, concerning sharing of platforms, the DEMPE-functions shall be used in accordance with the company's contribution to value creation.

The forecasted profit rates must be within the interquartile range developed through a benchmark study. The receiving company (B) of the intangible assets transferred must still be in a position to make an adequate profit despite the user fee. A third party would not enter into a contract which would force it to permanently enter into losses (see German IDW Standard S5, 2015, para. 127).

The RPSM is likely to conform with the arm's length principle in relatively high-profit systems, where constant positive residual profits can be expected. Generally speaking, this applies to multinational companies that are expanding their future sustainability by using platform concepts. Until recently, (R)PSM has not been acknowledged as a transfer pricing method by the German tax authorities. Therefore, the DEMPE-concept in using the RPSM is new for them and might create obstacles and hurdles. In practice, we see that some German tax authorities tend to review DEMPE/RPSM-models by the Transactional Net Margin Method as a second testing model.

IMPACTS OF COVID-19?

The COVID-19 economic crisis will put the decision to select a certain transfer pricing method to the test. On the one hand side, the crisis can be the restart for the expansion of digitalisation in Europe. On the other hand, the pandemic might lead to loss situations for non-routine entities (and even in so-called routine entities). Regarding platform concepts and typical license agreements the question arises how such a loss shall be allocated between the licensor and licensee of multinational companies. Open to debate in the example above is how much of the expected loss the licensee should bear for taking on the market risks concerning customer acquisition as opposed to the licensor as the provider of intangible assets.

Due to the emergence of new business models, it is to be assumed that the RPSM is going to be applied more often in the future. To meet the challenges of platform concepts a forward-looking and proactive policy is needed. The uncertainty of the economic future makes the choice of the most appropriate transfer pricing method more challenging and simultaneously more important than ever.





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