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Profit Split Method – An Overview
Profit Split Method (‘PSM’)

• PSM evaluates whether the allocation of the combined profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined profit or loss.

• PSM typically is applied where each party to the transaction under evaluation makes unique and valuable contributions and/or the operations of the parties to the transaction are highly integrated and cannot be evaluated on a separate basis.

• PSM is typically applied in complex situations when other available methods (such as the CUP or the TNMM) are not sufficient to price the functions performed.
Profit Split Method (‘PSM’)

- PSM are usually appropriate when:
  - Operations are highly **integrated** for which a one-sided method would not be appropriate
  - Parties to the transaction make unique and valuable contributions and profit arising to the group cannot be assigned to one of the entities of the group
  - Adequate **comparables are unavailable** to set margins for all the entities

**PSM is contribution analysis, rather than comparability analysis**
PSM – Indian Regulations and OECD Guidelines
Diagrammatic representation - PSM

Comparable Profit Split Method / Contribution Method

Aggregate profits in the controlled transaction based on contribution made by both parties

Profit share for Related Party X

Aggregate profits split based on market’s valuation of each party’s contribution

Profit share for Related Party Y

Entity A

Profits split by A and B (unrelated parties) based on their relative contribution forms the basis for splitting profits / losses in the controlled transaction

Entity B
Residual Profit Split Method (RPSM)

Aggregate profits in the controlled transaction based on contribution made by both parties

\[ \text{Residual Profit} \]

\[ \text{Residual Profit Share for Related Party X} \]

\[ \text{Residual Profit Share for Related Party Y} \]

\[ \text{Residual profits / losses split based on their relative contribution} \]

\[ \text{Minus functional returns to each party based on external benchmarks} \]
How to apply Residual Profit Split Method?

<table>
<thead>
<tr>
<th>Particulars</th>
<th>INR.</th>
<th>INR.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Combined Group Profits</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Assign basic return to each entity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Entity A</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>• Entity B</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>• Entity C</td>
<td>10</td>
<td>60</td>
</tr>
<tr>
<td>Residual Profit</td>
<td>40</td>
<td></td>
</tr>
<tr>
<td>Contribution analysis (based on relative contribution of the entities)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Entity A</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>• Entity B</td>
<td>10</td>
<td></td>
</tr>
</tbody>
</table>

Contribution Analysis – Element of subjectivity
Indian Transfer Pricing Regulations

Rule 10B(1)(d) of Income-tax Rules, 1962

It is worthwhile to first iterate the tenets of Rule 10B(1)(d), which prescribe that a taxpayer can adopt:

• Either a **contribution PSM** → where the entire system profits are split amongst various Associated Enterprise (‘AEs’), who are parties to the transactions in question; or

• A **residual PSM (‘RPSM’)** → where each of the AEs, who are parties to the transactions in question, are first assigned routine/ basic returns for the routine functions performed by them; and thereafter, a contribution PSM is applied.
OECD Guidelines*

Contribution Analysis

Para 2.119:

• Under a contribution analysis, the combined profits, which are the total profits from the controlled transactions under examination, would be divided between the associated enterprises based upon a reasonable approximation of the division of profits that independent enterprises would have expected to realize from engaging in comparable transactions.

• This division can be supported by comparable data where available.

• In the absence thereof, it is often based on the relative value of the functions performed by each of the AE 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.

OECD Guidelines…

Contribution Analysis

Para 2.120:

• It can be difficult to determine the relative value of the contribution that each of the AE makes to the controlled transactions, and the approach will often depend on the facts and circumstances of each case.

• The determination might be made by comparing the nature and degree of each party’s contribution of differing types (for example, provision of services, development expenses incurred, capital invested) and assigning a percentage based upon the relative comparison and external market data.
Residual Analysis

Para 2.121:

• A residual analysis divides the combined profits from the controlled transactions under examination in **two stages**:

• **First stage**
  - Each participant is allocated an arm’s length remuneration for its non-unique contributions in relation to the controlled transactions in which it is engaged
  - Ordinarily this initial remuneration would be determined by applying one of the traditional transaction methods or a transactional net margin method, by reference to the remuneration of comparable transactions between independent enterprises
  - Thus, it would generally not account for the return that would be generated by any unique and valuable contribution by the participants
Residual Analysis

- **Second stage**
  - Any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances, for splitting the combined profits.
PSM – A Practical Perspective

• Typical example of Industries, where PSM can be applied:
  – Telecommunications
  – Pharmaceuticals
  – Courier/logistic

• Implementation Issues:
  – External market data
  – Identification of value drivers
  – Measurement of value drivers contributed by each entities in the group
  – Assignment of weight to value drivers
PSM – Understanding with an Example
Functional Analysis of India end Contract

Functions, Assets & Risks are spread across all the Group entities

<table>
<thead>
<tr>
<th>Functions *</th>
<th>Assets **</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Network Operations and</td>
<td>Undersea Cables</td>
<td>Large Investment Risk</td>
</tr>
<tr>
<td>Maintenance</td>
<td>Landing Stations</td>
<td>General Market Risk</td>
</tr>
<tr>
<td>Sales &amp; Marketing</td>
<td>Switches &amp; Routers</td>
<td>Foreign Exchange Risk</td>
</tr>
<tr>
<td>General &amp; Administrative</td>
<td>Routing &amp; Billing Software</td>
<td>Credit Risk</td>
</tr>
<tr>
<td></td>
<td>Earth Stations</td>
<td>Technology &amp; Product Obsolescence Risk</td>
</tr>
<tr>
<td></td>
<td>Infrastructure</td>
<td></td>
</tr>
</tbody>
</table>

* May be performed by all or one and may overlap

** May be owned by various entities in part or whole
Characterisation

<table>
<thead>
<tr>
<th>Indian entity</th>
<th>AE</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Indian Entity carries out sales and marketing activities, network maintenance and general and administration functions</td>
<td>- AE provides support services for the overseas geography as and when required by Indian entity</td>
</tr>
<tr>
<td>- It bears market risk, credit risk, etc.</td>
<td>- It does not bear market risk, nor does it carry out any sales and marketing activities with respect to the services provided to Indian entity</td>
</tr>
<tr>
<td>- It owns significant tangible and intangible assets</td>
<td>- It does own non routine intangible assets</td>
</tr>
<tr>
<td>- Indian entity performs routine functions as well as contributes uniquely by way of its intangibles/tangible assets and thus, eligible for share of residual profits along with routine returns</td>
<td>- It is only responsible for ensuring that adequate local assets and support services are available to enable the Indian company to provide international connectivity services to its customers.</td>
</tr>
<tr>
<td></td>
<td>- It performs routine functions and is entitled to routine returns</td>
</tr>
</tbody>
</table>
Remuneration Model

<table>
<thead>
<tr>
<th>Remuneration Model</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross Revenues</strong></td>
</tr>
<tr>
<td><strong>Less: Third Party Costs (as per regulatory regime)</strong></td>
</tr>
<tr>
<td><strong>Net Revenues</strong></td>
</tr>
<tr>
<td><strong>Assign routine return to each entity for its day-to-day functions</strong></td>
</tr>
<tr>
<td><strong>Divide residual profit / loss among entities providing unique contribution</strong></td>
</tr>
</tbody>
</table>

**Return for Routine functions**
(selling, network operations, use of assets and administration)

Routine function performed by group entities:

- Selling and marketing
- Network operations and maintenance
- General and administrative (billing, customer support, etc.)
- Use of the network assets

Arm’s length return provided to each entity for routine functions

**Return for Unique Contribution**
(capacity utilization, marketing efficiency and third party sales)

Residual profit / loss allocated among key of group members based on its unique contribution

Entities classified into category A and B based on:

1) total bandwidth capacity and
2) scale of selling and marketing function which are key for success in international telecommunication business, residual profits are shared only by category A companies.
Remuneration Model
Routine Returns

- **All Network Assets**
  - Assets deployed calculated on average book value of assets
  - Return percentage is determined based on the independent comparability analysis
  - Depreciation on these assets is also included

- **Selling & Marketing efforts**
  - Selling and marketing costs are considered for return
  - Return percentage is determined based on the independent comparability analysis

- **Network Operations**
  - Network maintenance costs are considered for return
  - Return percentage is determined based on the independent comparability analysis

- **Administration functions**
  - General and administrative costs are considered for return
  - Return percentage is determined based on the independent comparability analysis
  - Return on costs for all other functions not reflected above (e.g. invoicing, accounts, tax, etc.)
Remuneration Model
Non Routine Returns

• Measurement of the contribution of the Value Added Drivers (VAD) – this involved identification and assessing the relative importance of the key drivers for the Group.

• Identified drivers to be ranked on some rationale basis and accordingly assigning weights to each of the VAD

• Utilized Network Reach – Weight – e.g. 50%
  – Total available capacity x utilization%

• Efficiency of Selling and Marketing Expenses- Weight – e.g. 33%
  – Ratio of gross third party revenue and total selling & marketing expense (including third party payments)

• Third Party Revenue (Scale of Operations)- Weight – e.g. 17%
Application of Residual Profit Split Method (RPSM)

<table>
<thead>
<tr>
<th>Unique contribution</th>
<th>Weights (%) (A)</th>
<th>India Relative value (%) (B)</th>
<th>Group Entity 1 Relative value (%) (C)</th>
<th>Group Entity 2 Relative value (%) (D)</th>
<th>Total of relative value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Network reach</td>
<td>50</td>
<td>11*</td>
<td>6</td>
<td>40</td>
<td>20</td>
</tr>
<tr>
<td>Efficiency</td>
<td>33</td>
<td>24**</td>
<td>8</td>
<td>45</td>
<td>15</td>
</tr>
<tr>
<td>Third Party Revenue</td>
<td>17</td>
<td>12***</td>
<td>2</td>
<td>50</td>
<td>9</td>
</tr>
<tr>
<td>Total</td>
<td>15</td>
<td>44</td>
<td>41</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

Residual profit / loss to be divided in ratio of 15 : 44 : 41

* Network capacity utilized by India / Total Network capacity utilized by category A entities * 100
** Selling /marketing activity by India / Total selling and marketing activity performed by category A entities * 100
*** India’s gross third party sales / Total gross third party sales by category A entities * 100
Steps in application of RPSM

1. Revenues of the group (A)
2. Deduct all third party costs (B)
3. Provide for routine returns to all entities in the group (C)
4. Calculate residual profit or loss (D= A-B-C)
5. Identify entrepreneurial entities i.e. those entities in the group that play greater role in the global business, by using the following criteria:
   • Sales force greater than 10; or
   • Ownership of more than 5% of the total available network capacity
6. These entities are referred to as “Entrepreneurial entities” or category A entities and the remaining entities in the group are referred to as “Service Provider entities” or category B entities.
7. In the instant case, India is an Entrepreneur (category A) where as AE is a support service provider (category B)
8. Additional contribution made by the category A entities to the global business resulting in sharing greater burden of the overall group risk and are therefore entitled to share the residual profit / loss.
**Application of RPSM**

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Company A</th>
<th>Company B</th>
<th>Total</th>
</tr>
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<tbody>
<tr>
<td>Revenues</td>
<td>100</td>
<td>200</td>
<td>300</td>
</tr>
<tr>
<td>Costs</td>
<td>50</td>
<td>150</td>
<td>200</td>
</tr>
<tr>
<td><strong>Profit</strong></td>
<td><strong>50</strong></td>
<td><strong>50</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

**STEP 1 – Compensation for routine activities**

| % return on routine functions | 10% | 10% |
| Return on routine activities (A) | 5 | 15 | 20 |

**STEP 2 – Allocation of residual profit/ loss on value drivers**

| Residual group profit / (loss) | 80 |
| Value drivers (ratio)         | 50% | 50% |
| Allocation of residual profit/ loss (B) | 40 | 40 | 80 |

**Total Compensation (A+B)**

| 45 | 55 | 100 |

Settlement – Company A to pay Company B

| -5 | 5 | 2015 Deloitte Touche Tohmatsu India Private Limited |
Mechanics to apply PSM
Mechanics to apply PSM (Guidance)

Indian Transfer Pricing Regulations

• PSM can be applied as under:
  − Contribution analysis; or
  − Splitting the profits based on a residual analysis

• Contribution analysis steps:
  − Combined net profit of the AE arising from the international transaction in which they are engaged, is determined
  − Relative contribution made by each of the AE to the earning of such net combined profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances.
  − Combined net profit is then split amongst the enterprises in proportion to their relative contributions; and the profit thus apportioned to the assessee is taken into account to arrive at an arm’s length price in relation to the international transaction
Indian Transfer Pricing Regulations

- **Residual analysis steps:**
  - Residual analysis allocates the combined operating profit or loss from the relevant business activity between the parties to the controlled transaction in two steps
  - First, a market return is provided to each party’s routine contributions
  - Second, any “residual” profit attributable to intangibles is divided among the parties to the controlled transaction under evaluation based on the contribution analysis discussed above.
Mechanics to apply PSM (Guidance)...

OECD Guidelines

Para 2.116:
Under the transactional profit split method, the combined profits are to be split between the AEs on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm’s length.

In general, the determination of the combined profits to be split and of the splitting factors should:

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

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

• Be consistent with the type of profit split approach (e.g. contribution analysis, residual analysis), and

• Be capable of being measured in a reliable manner.
Mechanics to apply PSM (Guidance)...

OECD Para 2.117:

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

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

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

**OECD Para 2.132:**

- The relevance of comparable uncontrolled transactions or internal data and the criteria used to achieve an arm’s length division of the profits depend on the **facts and circumstances** of the case.
- It is therefore not desirable to establish a prescriptive list of criteria or allocation keys.
- **In addition, the criteria or allocation keys used to split the profit should:**
  - Be reasonably independent of transfer pricing policy formulation, i.e. they should be **based on objective data** (e.g. sales to independent parties), not on data relating to the remuneration of controlled transactions (e.g. sales to associated enterprises), and
  - Be **supported by comparables data, internal data, or both**
Reliance on data from comparable uncontrolled transactions

OECD Para 2.133:

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

**OECD Para 2.134 - 2.135:**

- In practice, the division of the combined profits under a transactional profit split method is generally achieved using one or more allocation keys.

- Depending on the facts and circumstances of the case, the *allocation key can be a figure* (e.g. a 30%-70% split based on evidence of a similar split achieved between independent parties in comparable transactions), or a *variable* (e.g. relative value of participant’s marketing expenditure or other possible keys as discussed below).

- In practice, allocation keys based on assets/capital (operating assets, fixed assets, intangible assets, capital employed) or costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) are often used.

- Other allocation keys based for instance on incremental sales, headcounts (number of individuals involved in the key functions that generate value to the transaction), time spent by a certain group of employees if there is a strong correlation between the time spent and the creation of the combined profits, number of servers, data storage, floor area of retail points, etc. may be appropriate depending on the facts and circumstances of the transactions.
Mechanics to apply PSM (Guidance)...

Cost-based allocation keys

**OECD Para 2.138 - 2.139:**

- An allocation key based on expenses may be appropriate where it is possible to identify a strong correlation between relative expenses incurred and relative value added.
- Cost-based allocation keys have the advantage of simplicity.
- It is however not always the case that a strong correlation exists between relative expenses and relative value. One possible issue with cost-based allocation keys is that they can be very sensitive to accounting classification of costs.
- It is therefore necessary to clearly identify in advance what costs will be taken into account in the determination of the allocation key and to determine the allocation key consistently among the parties.
Reliance on data from the taxpayer’s own operations (“internal data”)

**OECD Para 2.141 - 2.144:**

- 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.

- They will frequently be extracted from the taxpayers’ cost accounting or financial accounting.

- For instance, where an asset-based allocation key is used, it may be based on data extracted from the balance sheets of the parties to the transaction. It will often be the case that not all the assets of the taxpayers relate to the transaction at hand and that accordingly some analytical work is needed for the taxpayer to draw a “transactional” balance sheet that will be used for the application of the transactional profit split method.
Reliance on data from the taxpayer’s own operations ("internal data")

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

- 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.
PSM – Case Study
PSM – Case Study

• Value Drivers – (i) Marketing and Customer relationship; and (ii) Technical support
• Internal data is used to assign the weightages.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Y1 (in 000)</th>
<th>% of TC</th>
<th>Y2 (in 000)</th>
<th>% of TC</th>
<th>Y3 (in 000)</th>
<th>% of TC*</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>36,000</td>
<td></td>
<td>62,000</td>
<td></td>
<td>98,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td>24,500</td>
<td></td>
<td>37,820</td>
<td></td>
<td>56,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Profit (‘GP’)</td>
<td>11,500</td>
<td></td>
<td>24,180</td>
<td></td>
<td>42,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advertising Costs*</td>
<td>1,800</td>
<td></td>
<td>4,900</td>
<td></td>
<td>7,850</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GP after Ad cost</td>
<td>9,700</td>
<td></td>
<td>19,280</td>
<td></td>
<td>34,150</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Technical Support (a)</td>
<td>2,275</td>
<td>32.97%</td>
<td>3,600</td>
<td>33.96%</td>
<td>4,900</td>
<td>33.68%</td>
<td>33.54%</td>
</tr>
<tr>
<td>Sales And Marketing (b)</td>
<td>2,555</td>
<td>37.03%</td>
<td>3,920</td>
<td>36.98%</td>
<td>5,250</td>
<td>36.08%</td>
<td>36.70%</td>
</tr>
<tr>
<td>Others (c)</td>
<td>2,070</td>
<td>30.00%</td>
<td>3,080</td>
<td>29.06%</td>
<td>4,400</td>
<td>30.24%</td>
<td>29.76%</td>
</tr>
<tr>
<td>Total Cost (‘TC’) – (a) + (b) + (c)</td>
<td>6,900</td>
<td>100%</td>
<td>10,600</td>
<td>100%</td>
<td>14,550</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>2,800</td>
<td></td>
<td>8,680</td>
<td></td>
<td>19,600</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Advertisement costs has been excluded while computing total costs since proportion of various *functions* needs to be worked out. As expenditure incurred on advertisement costs is the outcome of sale and marketing function, the same has been excluded from total costs.

• It is noted from the above table that there is a reasonable proportion of costs (30% of total costs) pertaining to routine activities viz., administration, facilities, HR.
• The key strategic functions - sales and marketing, and technical support constitute 33% and 37% respectively (approximately 50% each among these two functions).
PSM - Judicial precedents
Judicial precedent – Global One India Pvt. Ltd.

• Assessee, a WOS of Netherlands Company, was engaged in providing internet and related network services to the group’s customers in India

• In order to provide service to customers, the network connectivity of other operating entities of the group, was used

• Operations are highly integrated, interconnected and intrinsically linked → one group entity recorded the revenues generated, whereas another group entity incurred the expenditure for providing the services and that multiple entities are involved in the transaction

• Assessee had applied residual PSM
  – Routine return through benchmarks
  – Residual profits/ losses allocated based on relative contribution by group entities
  – Key drivers → sales and marketing operations/ network operations and field operations; with equal weight based on detailed FAR
Hon’ble Delhi ITAT upheld assessee's residual PSM over TPO's TNMM for determining arm's length profit

Assessee's activities are highly integrated & interrelated where transaction passes through multiple AEs and each entity makes contribution by deploying its assets, performing functions & using manpower.

TNMM not suitable for benchmarking returns earned by number of entities/entrepreneurs, where each makes valuable contribution

Use of unique intangible not 'must' for adopting PSM

Assessee not a simple email operator, but offers unique services which is its intangible

Though Rule 10B(1)(d) suggests benchmarking under PSM based on uncontrolled transaction, impossible to find comparable for benchmarking of allocation of residual profits in assessee's case

Allocation of residuary profits to be done based on contribution from each entity as stated in UN TP Manual & OECD TP Guidelines
Judicial precedent – Net Freight (India) Pvt. Ltd.

- Assessee provides freight forwarding and other logistic services → had applied PSM in TP documentation
- No benchmarking used to split residual profits
- Hon’ble Delhi ITAT acknowledged that for splitting residual profits, no benchmarking was necessary, as it was not practical to do
- The relevant extract of the Tribunal’s decision is reproduced below (emphasis supplied in bold text):

  “9.5. The profits need to be split among the AEs on the basis of reliable external market data, which indicate how unrelated parties have split the profits in similar circumstances. For practical application, we are of the view that, benchmarking with reliable external market data is to be done, in case of residual profit split method, at the first stage, where the combined net profits are practically allocated to each enterprise so as to provide it with an appropriate base returns keeping in view the nature of the transaction.

  The residual profits may be split as per relative contribution of the Associated Enterprise.

  In our view at this stage of splitting of residual profits, no benchmarking is necessary, as it is not practicable. Nevertheless, for splitting the residuary profits a scientific basis for allocation may be applied.”
Judicial precedent - Net Freight (India) Pvt. Ltd.

• The Tribunal in case of Net Freight (India) P. Ltd. (supra), quoted the decision of Aztek Software, wherein the following was held regarding PSM (*emphasis supplied in bold text*):

> “...The contribution of each enterprise is based upon a functional analysis and valued to the extent possible by any available reliable external market data. The functional analysis is an analysis of the functions performed (taking into account assets used and risks assumed) by each enterprise. The external market criteria may include, for example, profit split percentages or returns observed among independent enterprises with comparable functions....”

• Clearly, both the above judicial precedents have not mandated the use of external market data

• From a reading of the ruling in the case of Aztec Software (supra), the Special Bench has allowed flexibility with regard to use of external market data. *ITAT in the case of Net Freight (supra) has gone a step further, i.e., having appreciated the difficulties in obtaining external market data to split residual profits, the Tribunal has held that benchmarking with external data is therefore not necessary*

• Quite evidently, *the Special Bench and the Delhi Tribunal have read the “and” in Rule 10B(1)(d)(ii) as an “or”, if external market data is not available*
BEPS Action plan 10
Use of Profit Splits in Global Value Chains
Profit Splits: Overview

• Action 10 proposal to review application of profit split in the context of global value chain
  – Recognition that one-sided methods may not be applicable in all scenarios
  – Presents ten situations (with nine example scenarios) whereby the profit split method could potentially be applicable

• Discussion draft does not contain specific proposed modifications to the OECD’s transfer pricing guidelines

• Solicits comments from interested parties to elaborate on these scenarios regarding the relative reliability of such methods

• Not a consensus document
Profit Splits: Guidance on when to consider

- Global value chains
- Multisided, integrated business models
- Unique and valuable contributions’ to intangibles
- Highly integrated and enterprises share and jointly manage strategic risks
- Fragmentation
- Lack of comparable
- Aligning taxation with value creation
- ‘Hard-to-value’ intangibles
- Dealing with unanticipated results
- Dealing with losses
**Facts**

- Three controlled OEM manufacturers located in the same region with similar capabilities coordinate their product offerings and investments through a Leadership Board on which all three are represented.

- It has a Leadership Board which represents all three OEMs, and makes decisions for the entire business (e.g. new products, new plant investments, strategic marketing, etc.) due to integrated nature of the European market.

**Considerations**

- One sided approach – Management charges for Board activities

- The contribution by the Board to the activities of the OEMs – key value drivers?
  - Identification of profit attributable to the activities of the Board and allocation to each of the OEMs
  - Allocation key and weightage – 1) production capacity, 2) headcount and 3) value of production

- AOP or partnership issues
Profit Splits: Scenario 2 - Multisided Business Models

Company R: Developer /Parent entity within the RCo group

Function II
- Provide inputs on technology for adaptation to local market features

Local Subsidiaries
- Advertising Services through an online platform

Function I
- Free online services to end-user customers

End user customer

Clients
- Fees based on number of users who click on each advertisement

Facts
- MNE R on one side of business model, offers advertising services and related technologies, such as targeting and user interfaces to clients, charging a fee to the client per click on hosted advertisements
- On the other side, it offers free online services to end-user customers and gathers information on their behavior, location, and personal information, which is used to enhance the value of the advertising sold

Transfer Pricing Considerations
- Are the activities of local subsidiaries fundamentally different than the activities of comparable companies?
  - What is the extent of integration of functions?
  - How critical are the suggestions from subsidiaries in the value chain?
- Role of IP/risks in the framework
- Linkage with Action 1 – Digital Economy
Questions