Base Erosion and Profit Shifting (BEPS)

Comments Received on Public Discussion Draft

BEPS ACTION 10

Revised Guidance on Profit Splits Part II

4 October 2017

OECD

BETTER POLICIES FOR BETTER LIVES

TABLE OF CONTENTS

Tax Treaties, Transfer Pricing and Financial Transactions Division

OECD/CTPA

RE: Comments to "BEPS Action 10 – Revised Guidance on Profit Split" by the Transfer Pricing Committee of the International Fiscal Association Chapter Mexico

---

1. The discussion draft addresses situations in which profits splits of anticipated profits or profit splits of actual profits are appropriate. Where it is established that the transactional profit split is the most appropriate method, please comment on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used.

In paragraph 32 of the Revised Guidance on Profit Split (Revised Guidance), it is stated that if the transactional profit split method is used in an *ex ante* approach, it would be reasonable to expect the life-time of the arrangement and the criteria or profit splitting factors to be agreed in advance of the transaction. Nevertheless, even when anticipated profits are applicable in cases where one of the parties does not share economically significant risks like the other party, changes in the industry like technology breakthroughs or external circumstances such as financial crises or political circumstances may affect directly the profits of the transaction and the unique and valuable contributions by each parties may change over time. External unrelated factors could lead to cases where even between third parties involved in these types of transactions could pursue a reevaluation of the terms and conditions, including the profit splitting factors.

Although we recommend the possibility of revaluating the terms and conditions as well as the profit key allocators ex post, in cases where extreme and uncontrollable situations occur, we feel that a general negotiation framework should be defined, i.e. the parties shall not be able to renegotiate ex post all profit key allocators decided ex ante, neither should they be able to implement another transfer pricing methodology should the result not be beneficial to either of the parties. Furthermore, the ex post alternative shall not be seen as an option to relocate profits to entities, in cases where the ex ante profit split resulted to zero profit allocation to entities that did not perform functions or assume their corresponding risks.

Paragraph 45 delimitates that if one of the parties involved in the transaction does not assume economically significant risks but contributes with unique and valuable contributions, it would be more appropriate to split anticipated profits. Nevertheless, in line with the Development, Enhancement, Maintenance, Protection and Exploitation of intangibles (DEMPE) functional analysis and the revision of the transaction that actually took place (*ex post*), a further analysis should be performed after the realization of the transaction to evaluate if splitting actual profits should be a more accurate manner to analyze the transaction instead of evaluating the anticipated profits to be shared.

Therefore, the information considered in an *ex post* and *ex ante* negotiation may differ. This observation raises the question on what type of information should be included in an *ex post* and *ex ante* negotiation in order to conclude that the outcome for the controlled transaction is arm's length.

In the case where the transaction involves highly integrated operations that cannot be benchmarked using a unilateral approach even though their contributions are not unique and valuable but the functions performed, assets used and risks assumed from one party cannot be isolated from the other party, it is likely that a split of actual profits will be the accurate methodology of profit sharing reflecting the distribution of the risk of each party. Furthermore, in the following paragraph the following question is raised: *"is it correct to use a one-sided approach when analyzing a transaction, when one party does not contribute a unique intangible/synergy"*.

> *Paragraph 19 "(…) In contrast, many instances of integration within an MNE result in situations in which the contribution of at least one party to the transaction can in fact be reliably evaluated by reference to comparable uncontrolled transactions."*

In all, as mentioned previously, over the expected life-time of the arrangement of the transaction, a reevaluation of the controlled transaction could be considered, but within a generic framework, meaning that the profit split shall not be redefined from the beginning (including totally new and different key profit allocators) or reevaluate its applicability, in order to obtain different results or accommodate profits or losses.

2. <u>A number of profit splitting factors are addressed in the discussion draft- Comments are particularly invited on:</u>

    a. <u>Whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained, and if so, what factors need to be taken into account for its selection and application as a reliable profit splitting factor.</u>

References to capital or capital employed as potential profit splitting factor should be retained, since it is important to evaluate first which party assumes the risk of this capital and not solely contemplate the entity that employs the contributed capital during the controlled transaction. In this case, if a related party does not bear the risk of the capital but is involved in the controlled transaction, should not receive profit just because of the simple fact that it employs capital used in the transaction. Although capital employed could be registered in the balance sheet of one or both related parties involved in the transaction, this single fact shall not be sufficient proof of the risk assumed neither of the value of such risk.

    b. <u>Should headcount of similarly skilled and competent employees be included as a potential profit splitting factor, and if so, in what circumstances would it be relevant?</u>

Using any profit splitting factor related to headcount of similarly skilled and competent employees or their compensation received (payroll) shall not be considered as reliable key profit allocators since significant differences can arise from the geographies and economies of where these employees live. Compensation policies from a Multinational Enterprises (MNE) may be different

between offices in developed economies to developing economies, even if the employees have similar qualifications. The headcount does not necessarily have a linear relation to the value creation during a controlled transaction. Furthermore, additional analysis should be performed in cases where there is a key employee or employees who can be easily identified as the ones who generate value to the transaction. Specific transactions may be applicable where given the characteristics of the industry, some employees can be key factors for the value of the transaction (for example, investment traders).

c. Given the existing guidance in Chapters I and IX of the Transfer Pricing Guidelines, should adjustments for purchasing power parity be made for profit splitting factor amounts, and if so, in what circumstances?

Applying adjustments for purchasing power parity for splitting factor may not be viable since there is not any clear and solid methodology available that could be applied in order to identify and adjust those elements/characteristics that differ from market to market.

As it is stated in paragraph 41 where a profit split needs to be put on a common basis as to accounting practice and currency, it is worth to including guidelines on how the purchasing power affects the profit that will be shared. Chapter III of the Transfer Pricing Guidelines states that adjustments can be performed as long as the information used is reliable and its applicability results to reasonable and reliable conclusions.

d. What other profit splitting factors should be included in the guidance, and in what circumstances?

Although different factors and profit allocators can be generally used in different transactions and industries, it is challenging to define just one factor or a set of factors that should be considered in order to assign profits. Therefore, we suggest to explore the possibility to create a portfolio of factors according to the industry core indicators of value creation, in order to quantify and measure how much value is created.

3. Additional example of scenarios in which a transactional profit split is found to be the most appropriated methods due to the high level of integration of the business operations are sought, together with an explanation as to the reasoning thereto.

Transactions that involve the use of government concessions or special permits to operate and where those permits are shared with a related party, for example in the telecommunications industry or energy.

The examples shown to illustrate the guidance on the transaction profit split method could be broader in terms of application of different profit splitting factors. Also an example of the application of the transactional profit split methods where synergies can be found during the controlled transaction, may clarify the application of the method.

Additional general observations to "BEPS Action 10 – Revised Guidance on Profit Split and comments to specific paragraphs

In general, we would suggest to provide a more detailed explanation and definition of unique and valuable intangibles, real examples and a list of specifications which an intangible must comply with in order to classify as unique and valuable. It would be beneficial to clearly define *unique* and *valuable*.

We also suggest to include in the guideline how to proceed if an intangible asset is *unique* but not *valuable* or *valuable* but not *unique*.

Where *unique* defines itself in circumstances where there are features or comparability elements which are not present or diverge in magnitude from the situation of the potential comparables, and *valuable* must be in line with the value drivers of the business, whether these value drivers are intangibles or not. In paragraph §16, there is a definition we will appreciate if it is clearly and directly referenced.

> *§16 "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) their use in business operations represents a key source of actual or potential economic benefits (…) It may be the case that in these situations, the risks associated with the respective unique and valuable contributions cannot be controlled by the other party or parties(…)"*

We would like to further understand if this suggests that a unique and valuable intangible is a result of certain functions and assets, or should there be a more "legal" definition behind it in order to support this characterization.

On the other hand, the following paragraph defines in cases where there is a lack of information of comparable companies, how the analysis should proceed:

> *Paragraph 14. "(…) A lack of information on closely comparable, uncontrolled transactions which would otherwise be used to benchmark an arm's length return for the party performing the simple functions should not per se lead to a conclusion that the transactional profit split is the most appropriate method(…)"*

In these circumstances, the question of, "is better to apply inexact comparables rather than rely on the transactional profit split method" arises so we require additional guidance as to in which cases an inexact comparable is preferable compared to a subjective profit split.

Additionally we also suggest to include that the lack of public comparable transactions or companies in a specific country should not automatically result to the implementation of a Profit Split Method. Comparable companies operating in other markets and geographies could also be considered.

We also suggest to provide a deeper and broader application of the residual profit split since in some circumstances where a reliable profit splitting factor may not be possible, the application of a residual analysis may provide a solution for the application of a two-sided analysis.

Paragraph 39. " The relevant profits to be split under the transactional profit split method are the profits of the associate enterprises relating to the controlled transactions in which the associate enterprise are engaged. (…)"

We consider important to specify how to address cases where the MNE as a whole presents excess earnings that can not be specifically attributed to the existence of an asset (intangible or not) or any other element or synergy within the supply chain of the group. In those cases, said profits could be attributed to specific market or country conditions; thus we would require some additional guidance as to how those profits should be allocated inbetween the markets/geographies.

IHG®

Tax Treaties, Transfer Pricing and Financial Transactions Division,
OECD/CTPA
(sent via email to TransferPricing@oecd.org)

2 August 2017

Dear Sir or Madam,

BEPS ACTIONS 8-10: REVISED GUIDANCE ON PROFIT SPLITS DISCUSSION DRAFT DATED 22 JUNE 2017

IHG welcomes the opportunity to submit comments on the proposed revised guidance on profit splits ('The Discussion Draft') issued on 22 June 2017.

About IHG

IHG® (InterContinental Hotels Group) [LON:IHG, NYSE:IHG (ADRs)] is a global organisation with a broad portfolio of hotel brands, including InterContinental® Hotels & Resorts, Kimpton® Hotels & Restaurants, HUALUXE™ Hotels and Resorts, Crowne Plaza® Hotels & Resorts, Hotel Indigo®, EVEN® Hotels, Holiday Inn® Hotels & Resorts, Holiday Inn Express®, Staybridge Suites® and Candlewood Suites®.

InterContinental Hotels Group PLC is the Group's holding company and is incorporated in Great Britain and registered in England and Wales. More than 350,000 people work across IHG's hotels and corporate offices globally.

Our General Comments on The Discussion Draft

1. Our comments focus on the first and third questions raised for commentators concerning the factors to be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used, and concerning additional scenarios in which a transactional profit split is found to be the most appropriate method due to the high level of integration of the business operations.

2. Our view concerning the first question is that an anticipated profit split methodology (interpreted as we have discussed below as the use of profit forecasts as a means of arriving at an arms-length basis for computing intra-group consideration) should have much broader application than might currently be assumed from The Discussion Draft. In particular, we beli.e.ve that, applying a number of the principles in the Discussion Draft, an anticipated profit split methodology can provide an appropriate and coherent bridge between a CUP approach using adjusted comparables as discussed in Chapters II and III of the Guidelines, and the rare cases where the use of a transactional profit split of actual profits may be appropriate.

3. We beli.e.ve that the broader use of an anticipated profit split approach (interpreted as described) is necessary and appropriate, particularly for modern service businesses, because:

(a) The flexible ability to contribute to an overall service provision from different locational centres means that the circumstance described in Example 7, paragraph 100, of The Discussion Draft, of there being internal or external comparables for the combined service but not for the segregated services provided from each location, will often arise;

(b) That may sometimes arise in circumstances where the functional analysis, and consideration of the updated Guidance in Chapter I concerning the allocation of risk, suggests that a two-sided approach leading to the sharing of risk, rather than a one-sided methodology, may be appropriate; but

(c) The broader functional and practical profile, considered in the context of the issues outlined in paragraph 10 of The Discussion Draft- but also in particular the general prevalence of fact patterns such as those touched on in paragraph 49 where there is not a sharing of risks with respect to costs- means that a profit share based on actual profits is not appropriate.

4. In phrasing our comments in 2. And 3. above we are interpreting 'profit share based on actual profits' as implying the use of an actual profit measure which has deducted more than just marginal transaction costs. Our view is that that form of actual profit split approach will only be appropriate in narrowly defined (and probably rare) circumstances. In contrast an approach which shares actual results with respect to a readily available marginal profit measure (or with respect to revenues where marginal costs are either small or not likely to produce distortion), based on consideration of appropriate contribution factors and the anticipated net profits of the parties, is appropriate in much more extensive circumstances. Indeed, in our view, that approach would mirror the approach which would be expected to be taken in comparable arms-length circumstances. After considering Example 9 in The Discussion Draft we have interpreted this latter type of approach as representing an anticipated profit share approach because it is a methodology for arriving at how to compute a revenue stream payable for services or rights provided by one of the parties based on anticipated net profit expectations -and is not a sharing of actual net or residual profits.

5. The approach we describe above as an anticipated profit split could alternatively be viewed as representing a share of actual profits if 'profits' within 'actual profits' can be 'marginal profits'. That interpretation is consistent with the principles set out in paragraphs 48 and 49 of The Discussion Draft that the measure of profits to be split should reflect the accurate delineation of the transaction -in particular that the level of integration and risk sharing must extend to any cost categories deducted in arriving at the given profit measure used in a transactional profit split. In our view Paragraph 47 is inaccurate however in suggesting that - if those principles are applied- the relevant profits to be split would 'generally' be operating

profits. We suggest that, to the contrary, it would be rare for the required level of integration to extend as far as to operating profits. In our view it would not generally extend past marginal profits.

6. Consider, for example, a two-centred service business case fitting the profile under points 3. (a) and (b) above but where, with respect to aspect (c), each of the two centres had its own people and premises/overheads involved in the provision of the services. In this circumstance, it is reasonable to assume that in an arms-length circumstance the two parties would negotiate to agree a division of marginal profits which reflected the parties' relative contributions and their anticipated profit expectations. Where there are negligible marginal costs, that may in practise be represented by an agreement to share revenues in either agreed proportions or in accordance with an agreed formula for a given future period- with that revenue share representing an adjusted comparable and each party bearing its own risks with respect to variations in costs from those reflected in the anticipated profit share.

7. Indeed it appears that Example 7 in The Discussion Draft fits this profile. Accordingly, in our view, Paragraph 99 should make additional comments concerning the nature of the transactional profit split (or revenue split) approaches which might be considered in that context -and should be explicit that a transactional profit split of actual net profits (i.e. after deducting non-marginal Country A and Country B costs) would not be appropriate.

8. For the type of business discussed in Example 7, we assume that marginal costs of investment transactions are readily identifiable but are comparatively small compared to the overhead base in each country. It may therefore reasonably be conjectured that in an arms-length circumstance the parties would agree a basis for sharing either gross or marginal net revenues (i.e.. actual revenues or marginal profits) for a given prospective period (e.g. 5 years). That sharing might, for example, be in set percentages negotiated up front which, based on the parties' respective profit forecasts, are anticipated to deliver each an acceptable net profit margin (but which -as in the Example 9 paragraph 108. type circumstances- may in practise produce either a higher or lower margin in any given year). Alternatively, an arms-length approach might allocate revenues by using some formula linked to future transaction levels or levels of investment in the respective countries- although that is perhaps less likely because it would risk creating dysfunctional incentives which would distort future investment discussions and decisions.

9. In accordance with our comments above we beli.e.ve that The Discussion Draft should consistently emphasise throughout the commentary and examples that the transactional profit split methodology chosen should not result in the sharing of realised risk with respect to overhead/non-marginal cost categories where that would be inconsistent with the functional analysis and the broader Guidelines concerning the application of arms-length principles, including those discussed in Chapter 1 concerning the allocation of risk. Whereas there are parts of The Discussion Draft -such as Paragraph 49 which make that point, the overall content of The Discussion Draft and examples may currently give the false impression that the sharing of cost related risks is the norm rather than rarely being consistent with the broader Guidelines. Correspondingly, we have a concern that a false impression may be given of the frequency of circumstances where a sharing of net profits (i.e.. an actual profit split) would be appropriate whereas, outside a functional and risk management context equivalent to a fully-fledged partnership, it is highly unlikely that such an approach would be acceptable in an arms-length context.

10. Linking this comment with Paragraph 11 of The Discussion Draft, we accept that a transfer pricing solution does not have to result in a solution, which is actually seen in an arms-length context- because in practise there may not always be direct third party comparables for all functional fact patterns prevailing between two or more locations within a multinational group. If the arms-length principle is to be respected however, then the transfer pricing solution arrived at must be one which it is reasonable to beli.e.ve would be capable of being accepted if such a comparable arms-length context were to arise. We beli.e.ve that that is what the second sentence of Paragraph 11 is intended to convey but we do have a concern that the current drafting might be misinterpreted as supporting approaches which are not consistent with the arms-length principle.

11. Our comments in Paragraphs 2 to 8 above focus on fairly straightforward circumstances where the degree of integration and risk management with respect to revenues (or marginal net revenues), and the broader functional analysis, supports a two sided approach with respect to those components, but -even though there are discretely identifiable cost bases for the project or service concerned- the degree of integration of risk with respect to that cost base means that a more extensive sharing of net profits is not appropriate. In practise there will often not be such discretely identifiable cost bases and so greater challenges may arise. For example, one party involved will often be a regional headquarters or similar centre which has functions and related overheads which either provide support for, or have more active involvement in the provision of services by, multiple jurisdictions.

12. In the past, the intra-group service charge for support provided by such a regional headquarters company would often have been computed by using a transactional net margin approach which involves first allocating costs in accordance with principles appropriate to the contribution context, and then adding a profit margin. Following the updated Chapter 1 Guidance concerning the allocation of risk the appropriateness of such a methodology may need to be reviewed although, depending on the precise functional and risk management facts, that type of one-sided approach which results in cost related risk being borne by the recipient of the charge may still be appropriate. Alternatively, a one-sided approach which leaves risk in the regional centre rather than in the recipient of the charge, may be. In some cases however- where the functional fact pattern is of a two-centred involvement in service delivery similar to that discussed in paragraph 3. Above a two-sided approach may be appropriate. Such an approach will however face the additional obstacle that a sharing of actual net profits may not only be inappropriate but close to impractical. That is because of the complexity (even before tax audit considerations) of integrating a multi-jurisdictional cost allocation within a jurisdiction specific net profit split.

13. We would suggest that in this circumstance an anticipated profit split approach, similar to that discussed above of arriving at an agreed basis for sharing either revenues or a readily measurable marginal profit figure based on an upfront consideration of contribution and anticipated attributable net profits, will often be appropriate. The challenge here is that with respect to that forecasting aspect- an additional layer of allocation/sharing is needed for the purpose of considering what proportion of the regional headquarters costs to include within the anticipated net profits forecasts. That raises a question concerning whether the second requirement set out in Paragraph 32. of The Discussion Draft can be met- i.e. that the relevant profits to be split, and the profit splitting factors to be used, be capable of measurement in a reliable manner. Provided that 'the relevant profits' can be interpreted as 'marginal profits' (or revenues) as we have argued they should be when applying an anticipated profit split method then the relevant profits can of course be measured in a reliable manner. Can it however be

said that the anticipated net profits which are used as a profit splitting factor can also be measured in a reliable manner- given that they are not only forecasts but forecasts which reflect the layers of assumptions and approximations inherent in any cost allocation?

14. We beli.e.ve that, if Paragraph 32. of The Discussion Draft is not to be interpreted too restrictively then it may require some further clarification and illustration- in particular concerning what is a sufficient level of reliability with respect to the factors concerned, not only when considering whether a profit split approach is appropriate, but if so, when considering what type of profit split approach is appropriate. In this context it seems to us that in order to use an actual profit split the relevant profit measure chosen must be capable of being measured with a very high level of precision-because by its nature an actual profit split is intended to be a precise calculation. Where an anticipated profit split approach is used the level of precision required will however depend on the context. For example, where the anticipated profit split approach is used as a means of arriving at an adjusted comparable (i.e. via a revenue split or marginal profit split) then the revenues or marginal profits which will in due course be split must be capable of being measured with precision. Where however -as in Example 9 Scenario 1 – an anticipated profit split is used to arrive at a form of payment which may either be a royalty or a lump sum, then the level of precision needed will depend on the form of the payment. For a royalty approach the relevant revenues to which the royalty rate is to be applied must be capable of measurement with precision. Where a lump sum is to be paid however then it will be calculated and paid based on net profit forecasts which should have appropriate sources and reference points but will by their nature be less precise.

15. Similarly, where profit splitting factors are concerned, we beli.e.ve that it is essential for the use of a profit split of actual net profits that the factors used to allocate relevant net profits are capable of measurement with precision i.e. the level of precision which would be expected in the arms-length comparable of a fully-fledged partnership. In the case of an anticipated profit split however the forecasts used as profit splitting factors, and the assumptions underlying them, merely need to be reasonable rather than precise. In this case the arms-length comparable is a fee negotiation rather than a partnership.

Comments on Specific Questions for Commentators

1. **'Where it is established that the transactional profit split is the most appropriate method, please comment on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used.'**

   As discussed in Paragraphs 4 and 5 above, in order to address this question, we beli.e.ve there is first a need for greater definitional clarity as to what constitutes an anticipated profits split and what constitutes an actual profit split i.e. what is the precise nature of the distinction between the two. The current or previous Discussion Drafts and Guidance unfortunately do not provide great clarity concerning the distinction.

   As set out in paragraph 4, on the basis of Example 9, we have interpreted an anticipated profit split methodology to mean a methodology whereby the anticipated attributable net profits of the two parties are used to arrive at a basis for computing a revenue stream to be payable by one of the parties to the other for the use -for example- of rights or for the provision of services in connection with the activity concerned. This is to be distinguished from an actual profit split whereby the parties each receive a computed share of a given

net profit measure and thus share risks with respect to all revenue and cost components included in that net profit measure in the same way as they would do if they were conducting that activity in a formal partnership.

Interpreted in these terms we consider that a profit split of actual profits should only be used where the functional and risk management profile is consistent with the view that, in substance, the parties are conducting the relevant activity in partnership. For that to be the case that must include active and continuous joint decision making concerning what relevant costs to incur e.g. re what people to employ and what to pay them] and concerning how to manage cost related risks. It requires more than just input where broader shareholder or group policy issues of funds allocation, strategic risk management, or consistency, impose parameters within which local decision making has to operate.

Our expectation is that that partnership type fact pattern will rarely be present -or would rarely be present without itself giving rise to the existence of an actual partnership where corresponding taxation results would more directly arise. We note in this context that Scenario 2 of Example 9 states that Company A and Company B will 'jointly perform' the marketing and distribution activities but does not elaborate on what 'jointly perform' means. It is thus unclear whether it really involves the degree of integration with respect to cost aspects which would justify inclusion of related costs within the profit measure to be shared and the adoption of an actual profit share approach.

Conversely however, we beli.e.ve that fact patterns which support an anticipated profit split approach (as we have interpreted it) will fairly frequently arise. Furthermore, we beli.e.ve that such an approach can appropriately be used as a means of adjusting an available revenue or other comparable for a combined activity, to provide adjusted comparables for the separate contributions of each party. This will be the case where there is a well integrated combined contribution to the earning of third party revenues, involving unique contributions (i.e. ones for which good separable comparables are not available), and revenue related risk sharing, but each party is predominantly responsible for risks relating to its component of the combined cost base.

We discuss in paragraphs 2. to 13. above the generic types of circumstances in which such an anticipated profit share approach may be appropriate. For example, as we have earlier commented, it seems to us that the approach may well be the most suitable one for circumstances such as those in Example 7 of The Discussion Draft. It would also seem to be the most suitable approach for dealing with the transfer from Webco to ScaleCo in Example 5, or the license from Company A to Company S in Example 1.

Indeed, to the extent that it is concluded that a transactional profit split approach is suitable for the examples given in The Discussion Draft, an anticipated profit split approach would seem to be much more appropriate than an actual profit split approach. The only examples where the level of apparent integration with respect to relevant cost components might lead to consideration of a profit split of actual profits (in the terms we have understood it) would be Scenario 2 of Example 9 (although as commented above that does not seem clear-cut), or Example 10 -which also seems to have been drafted so as to suggest a very high level of overall integration, but without the level of fine detail to be sure that an actual profit split would be appropriate. For example, it would seem surprising if the level of joint control with respect to Country A and Country B costs were

such as to justify an actual profit split- and if the reality is that Company A primarily controls Country A cost related risk and Company B controls Country B cost related risk then a profit split of anticipated profits would seem more appropriate.

2. **Comments are particularly invited on:**
   (a) Whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained and, if so, what factors need to be taken into account for its selection and application as a reliable profit splitting factor;
   (b) Should headcount of similarly skilled and competent employees be included as a potential profit splitting factor, and if so, in what circumstances would it be relevant?
   (c) Given the existing Guidance in Chapters I and IX of the Transfer Pricing Guidelines, should adjustments for purchasing power parity be made for profit splitting factor amounts, and if so, in what circumstances?
   (d) What other profit splitting factors should be included in the guidance, and in what circumstances?

With respect to questions (a) and (b), what are appropriate profit splitting factors will depend on the functional and contribution analysis which is appropriate to the specific fact pattern considered. Where there is a significant contribution in terms of capital employed then that should of course be remunerated appropriately- whether directly within the profit splitting factors or in arriving at the residual/relevant profits to be split. The form and nature of that remuneration will depend on the fact pattern but it is for example clear (and acknowledged) that Company A in Example 9 should be remunerated for permitting the capital assets (i.e. intangibles) which it has invested in developing over many years to be employed by Company B in Country B.

Similarly, where management or consultancy service businesses are concerned, and the most significant factors contributing to the generation of profits are the activities of the people involved, then people related allocation keys may be appropriate. It would however seem unusual for simple headcount measures to be appropriate as opposed to measures which reflect remuneration costs and thus some market indication of relative value expected to be generated. It may however also need to be considered whether (pursuant to the issues discussed under (a)) any prior charge or adjusting factor needs to be taken into account because the provision of the services makes use of intangibles (e.g. valuable know how) owned by one party to the transaction which could and would be reflected in the level of charges made in a third-party context.

People related factors might for example be relevant, if an anticipated profit split approach was being used and it was concluded from the functional analysis that the nature of the services supplied by each location was similar in value (i.e.. so, that each party would expect a similar profit margin). In that case revenues or marginal profits might be split on a percentage or other basis which was expected to achi.e.ve a similar net profit margin for each party -which for a people business might be pro-rata to the average forecast remuneration costs and attributable overhead.

With respect to question (c) it is difficult to conceive of a practical way of adjusting for purchasing power parity other than perhaps indirectly to the extent that the use of market

based exchange rate forecasts when translating to a common forecasting currency within an anticipated profit split approach indirectly encompasses such factors.

With respect to question (d) we think it is important that the Guidance is not too prescriptive, and thus in principle leaves open the possibility of using whatever profit splitting factors are most appropriate within the context of the functional and contribution analysis performed in the given case.

3. **Additional examples of scenarios in which a transactional profit split is found to be the most appropriate method due to the high level of integration of the business operations are sought, together with an explanation of the reasoning thereto.**

   We refer you to the comments made and examples given in our overall comments section, and in our response to question 1. above. We particularly refer you to paragraphs 2 to 13 of our overall comments section. These concern an integrated service business where the use of an anticipated profit split approach as a means for determining a basis for sharing third party revenues or identifiable marginal profits may sometimes provide the most appropriate method for approximating an arms-length outcome. We emphasise however that we do not consider that a profit split of actual profits (i.e. including non-marginal costs) would be likely to be either practical or appropriate to such cases.

We hope that these comments are helpful. We would be pleased to expand on them further as necessary.

Yours faithfully,

C.P. Garwood

C.P. Garwood
Head of Tax

Document No.133
September 15, 2017

The Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organization for Economic Cooperation and Development

Accounting & Tax Committee
Japan Foreign Trade Council, Inc.

Comments on Discussion Draft on Action 10 (Revised Guidance on Profit Splits)

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. ("JFTC") in response to the invitation to public comments by the OECD regarding the Public Discussion Draft on "BEPS Action 10: Revised Guidance on Profit Splits" released on June 22nd, 2017.

JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of the JFTC's Accounting & Tax Committee is to submit specific policy proposals and requests concerning tax matters. Member companies of the JFTC Accounting & Tax Committee are listed at the end of this document.

<General Comments>

We appreciate the OECD's efforts made in this Discussion Draft in terms of providing greater clarity to the appropriate application of the Transactional Profit Split Method (hereinafter "TPSM") .

Especially, we welcome that the OECD has clearly articulated its reservation about the inappropriate application of the TPSM in Para 14 of the Discussion Draft.

On the contrary, we would like to re-emphasize that the TPSM, in its application, inherently entails a great degree of subjectivity and uncertainty, which can easily be a source of disputes between taxpayers and tax administrations, or between tax administrations. We fear that this may not only lead to the increase in the compliance burden, but also raise the risk of double taxation, which could unduly undermine the competitiveness of companies. As such, should there be any

disagreement between taxpayers and tax authorities, we suggest the burden of proof to be placed on the tax authority, and the application of the TPSM and the contents of this Discussion Draft to be strictly subject to a binding mutual agreement between the relevant tax authorities.

<Specific Comments>

· Headcount of similarly skilled and competent employees as Potential Profit Split Factor

The definition of "similarly skilled and competent" is unclear and it is difficult to prove. Also, since personnel expenses and roles vary depending on a country where a company is located, it is generally not appropriate to use a headcount of similarly skilled and competent employees as a profit split factor.

· (Para13)

The language in Para 13 of the Discussion Draft states that "the existence of unique and valuable contributions by each party to the controlled transaction is perhaps the clearest indicator that a transactional profit split may be appropriate". However, even with referring to "Examples", it is still ambiguous on what makes contributions by each party "unique and valuable" so the decision could be subjective, which could lead to abuse the TPSM. Therefore, we request further clarification on "unique and valuable contributions", or limit the use of the TPSM in cases where "use of significant intangibles" is relevant, in addition to "unique and valuable contributions".

· (Para 28, 29)

We agree with the language in Para 28 of the Discussion Draft which states "However, a lack of comparables alone is insufficient to warrant the use of a transactional profit split". On the other hand, we would like you to reconsider the language in paragraph 29 of the Discussion Draft which states that "while the transactional profit split method can be applied in cases where there are no uncontrolled comparables" since it could lead to an misunderstanding that the TPSM could be applied automatically in cases where there are no uncontrolled comparables.

· (Para 67)

The language in Para 67 of the Discussion Draft states that "Where location

savings retained by member(s) of the MNE group 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 1". While the BEPS Final Report indicates that local market comparables will provide the most reliable indication, we are concerned that location saving could be mistakenly taken as unique and valuable contribution and therefore would like to delete the language.

· (Examples)

We believe the lack of clarity as to what constitutes "unique and valuable contribution" mentioned throughout the examples, may easily lead to the abuse of the TPSM and thus strongly demand a detailed depiction of the instances where a function can be characterized as "unique and valuable".

✧ (Example 3 and 4)

Though it seems practically difficult to identify and apply the unique and valuable contributions related to the marketing and distribution activities of company B, in example 3, from the facts that "(Paragraph 81) Company B assumes the risks relating to the marketing and distribution" and "(Paragraph 82) both parties to the transaction assume closely related risks that are economically significant for their business operations", it is concluded that "(Paragraph 82) transactional profit split method is likely to be the most appropriate method". On the other hand, in example 4, from the fact that "(Paragraph 85) the functional analysis determines that the risks assumed by Company B are not economically significant for the business operations", it is concluded that "(Paragraph 85) transactional profit split method may not be the most appropriate method". With regards to the above, we would like to be shown concrete examples of activities that actually make the conclusions differ between examples 3 and 4, and methods to identify the unique and valuable contributions.

✧ (Example 9)

– While the language in para 104 of the Discussion Draft states that "Under this agreement, Company A grants to Company B the rights to utlise the know-how and to use the trademarks for the purpose of fashion retailing in Country B.

Country B will distribute the products and introduce the trademark in the new market by performing innovative marketing activities. The contributions of both companies are determined to be unique and valuable to the Retail Group's business in Country B.", the language in para 103 of the Discussion Draft states that "Over the years, Company A has developed know-how and has enhanced the value of the trademark and associated goodwill of its business through innovative marketing activities.", which can be interpreted such as that the knowhow granted to Company B by Country A is for marketing activities. It is necessary to add more details regarding the background behind how it is determined that the innovative marketing activities conducted by Company B is unique and valuable contribution since the activities could be based on the knowhow created by Company A.

· (Example 9)

Scenario 1 of Example 9 (Para 106 -Para 108) provides the case for a profit split of anticipated profits. However, it is necessary to identify what types of transaction the anticipated profits should be used in. In the first place, it is too easy to conclude that a profit split of anticipated profits should be used when one party to the transaction does not assume economically significant risks. Further guidance and examples should be provided in order to prevent tax admissions from abusing a profit split of anticipated profits despite the intention of taxpayers.

Japan Foreign Trade Council, Inc.
World Trade Center Bldg. 6th Floor,
4-1, Hamamatsu-cho 2-chome,
Minato-ku, Tokyo 105-6106, Japan
URL. http://www.jftc.or.jp/

Members of the Accounting & Tax Committee of JFTC

CBC Co., Ltd.
Chori Co., Ltd.
Hanwa Co., Ltd.
Hitachi High-Technologies Corporation
Inabata & Co., Ltd.
ITOCHU Corporation
Iwatani Corporation
JFE Shoji Trade Corporation
Kanematsu Corporation
Kowa Company, Ltd.
Marubeni Corporation
Mitsubishi Corporation
Mitsui & Co., Ltd.
Nagase & Co., Ltd.
Nippon Steel & Sumikin Bussan Corporation
Nomura Trading Co., Ltd.
Shinyei Kaisha
Sojitz Corporation
Sumitomo Corporation
Toyota Tsusho Corporation
Yuasa Trading Co., Ltd.

Johann H. Müller
International tax professional

Tel. +45-6120 2911
Skype JohannHMuller
LinkedIn JohannHMuller
E. j.muller@quanteraglobal.com

OECD/CTPA
Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA
TransferPricing@oecd.org

Copenhagen, 15 September 2017

Dear madam, sir

Comments to the BEPS Action 10, Revised Guidance on Profit Splits,
Public Discussion Draft, 22 June – 15 September 2017

Thank you for continuing to allow public input into WP6's work; it is much appreciated. I am an international tax professional and the Danish managing director for Quantera Global, a transfer pricing boutique firm. My comments in this letter are made on personal title.

I will be brief on each point, but am happy to explain any point in further depth, should you wish me to.

Risk

1) As a general comment, I believe that there should be a closer link between the guidance on profit split and the new chapter I.D.1.2.1. Reasons include:
   - unrelated parties are unlikely to accept a high risk potential for a low profit potential: assuming equal bargaining power, they would insist on parity between risk and profit;
   - they are unlikely to accept risk over which they do not have control, but their partners do. Likewise, they are unlikely to insist on the rewards associated with the control of such risks. The details of chapter I.D.1.2.1.1. on risk control provides good guidance and could be referenced.
2) MNE's full value chains and vertical integration chains ought to be mentioned in response to Question 3, and could also be mentioned under C.2.2.2 and C.2.2.3 of the draft. These chains are generally highly integrated (unless the group is decentralised). More important is that not every link in the chain can be low/medium risk bearing. One or more links must be bearing / carrying the residual risk of the chain. Where there are more than one such link, it would be logical for such links to also split the residual profits of the chain in proportion to the residual risks they bear.

Chapter C.4.1 Actual profits or anticipated profits

3) Control over risk is another determining factor when choosing between splitting actual profits or anticipated profits. If ACo has control over a risk, then BCo is not going to accept paying for ACo's inadequate exercise of that control. Therefore, BCo will insist in splitting profits depending on that risk control on the basis of anticipated profits, not actual profits.
   Hence, one would expect that companies will split profits on the basis of anticipated profits, where those profits are more dependent on controllable risks, such as operational and transactional risks, but lean towards splitting actual profits where those profits are more dependent on less controllable risks which they wish to share, such as market risk.
4) However, even when parties agree on splitting profits based on actual profits, they are very likely to condition those splits on the basis of actual behaviour as well. This can best be illustrated by an example: Assume ACo and BCo decide to jointly produce a product (e.g. a liquor). The product is heavily dependent on uncontrollable risks and they agree on splitting actual profits. A widely published natural disaster greatly reduces for the next 2 – 3 years the supply of a key ingredient used by BCo.

In the weeks following the disaster, the ingredient's price becomes prohibitively high. As a result, the ACo-BCo product is brought to the market in diminished quantities and at higher cost, leading to lower profit despite the product demanding higher prices as a consequence of the product's shortage.

It turns out that BCo took no preventative actions: it had no backup inventory of the key ingredient and it did nothing to lock in prices of the ingredient before or immediately after the disaster. In such circumstances it is likely that ACo would use BCo's actual behaviour to justify a deviation of the original actual profit split in ACo's favour.

Chapter C.3.1 Approaches to splitting profits

5) I appreciate that the contribution analysis is widely used, and seems to be the profit split method of choice. I wonder though if a residual analysis should not be the only, or the default position.

   I believe that most profit split transactions will consist of (low) risk routine components and high value or residual risk bearing components. A residual split analysis would identify those components separately and price them separately, possibly applying a "contribution" approach to split profits from the high value / residual components.

   To me, this implies that most contribution-analysis-only approaches are simple aggregations of all the components of a profit split transaction, leading to a less accurate allocation of risks, a less accurate delineation of the actual transaction and hence a less accurate profit split.

Further examples

6) In response to question 3, I would like to propose freight forwarding companies as another example of highly integrated business operations. I have been the de facto head of tax of such a group for a few years.
   - There may, or may not be a principal in such a group, or a significant customer owner.
   - Besides such a company, there will always be a company at the beginning of the shipment, receiving the goods to be forwarded, clearing it with customs, containerising the goods, and finding a slot for the container on a ship.
   - On the other side there will always be another company doing the reverse: getting the container from the ship, decontainerising the goods, clearing it through customs and delivering the goods to their destination.
   - Both sides are interdependent and both sides do very much the same. Within a freight forwarding group, both companies and the sending and recipient customers will also follow the same IT tracking systems. It is not unusual for for the sending and the recipient companies to split their profits for these functions between them.
   - A separate part of the total profits are typically reserved for the customer owner, where larger, regular customers are concerned.

Yours sincerely,

Johann H. Müller

Johann H. Müller
Drosselvej 20
Frederiksberg 2000
DENMARK

Website www.johannmuller.net

September 15, 2017

Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development

Comments regarding the Public Discussion Draft on BEPS Action 10
Revised Guidance on Profit Splits

Thank you for the opportunity to provide comments on the OECD Public Discussion Draft on BEPS Action 10: Revised Guidance on Profit Splits dated June 22, 2017 (the **Discussion Draft**).

Keidanren has been concerned for some time about the increasingly broad ways in which the transactional profit split method is applied and believes that additional guidance is required for the method to be used appropriately. The Discussion Draft offers reorganized and expanded explanations on selecting the most appropriate method, provides more examples, and directly addresses issues involving profit split factors. These efforts are highly appreciated.

The Discussion Draft also includes many welcome statements, such as: "the selection of the 'most appropriate' method should take into account the *relative* appropriateness and reliability of the selected method" in paragraph 5; "an appropriate method using uncontrolled transactions that are comparable, but not identical to the controlled transaction is likely to be more reliable than an inappropriate use of the transactional profit split method" in paragraph 14; and "a lack of comparables alone is insufficient to warrant the use of a transactional profit split" in paragraph 28. We hope these statements will introduce new discipline to the application of the transactional profit split method.

On the other hand, the Discussion Draft may also be read as more broadly endorsing the application of the transactional profit split method when compared to the current OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (**Transfer Pricing Guidelines**) and the OECD Public Discussion Draft on BEPS Action 8-10: Revised Guidance on Profit Splits, dated July 4, 2016 (**July 2016 Discussion Draft**). For example, paragraph 11 states: "Transfer pricing methods are not necessarily intended to replicate arm's length behaviour, but rather to serve as a means of establishing and/or verifying arm's length outcomes for controlled transactions." This would seem to go beyond traditional guidance on the arm's length principle. We agree that transfer pricing methods do not necessarily replicate arm's length activities, but due respect should be given to the fact that the transactional profit split method is rarely considered when transaction prices are voluntarily negotiated at arm's length.

Another notable point in the Discussion Draft is the absence of references to sequential integration and parallel integration, which were included in the July 2016

Discussion Draft. In recent years, the businesses operated by multinational enterprises have become more complex and sophisticated. In this environment, these two concepts of integration are difficult to define. Nonetheless, we believed these concepts to be useful when examining the relationships between highly integrated business operations and the application of the transactional profit split method.

The transactional profit split method is inherently difficult to apply in practice. Where its use is increasingly accepted, or enforced arbitrarily by tax administrations, occurrences of double taxation are likely to increase, including cases that may not be resolvable via mutual agreement procedures. The final version of the guidance should therefore reiterate that the transactional profit split method is applicable only in very limited circumstances.

1. When is the Transactional Profit Split Method Likely to be the Most Appropriate Method?

The Discussion Draft includes three indicators that the transactional profit split method is likely to be most appropriate: the existence of unique and valuable contributions, highly integrated business operations, and shared assumption of economically significant risks. Of these, the existence of unique and valuable contributions is stated as perhaps the clearest indicator, in paragraph 13. We have commented on each of these indicators below.

(1) Unique and valuable contributions

In principle, when both parties to a transaction make unique and valuable contributions, we have no objection to concluding that the transactional profit split method is likely to be the most appropriate method (as already stated in the Transfer Pricing Guidelines). To be called “the clearest indicator,” though, The Discussion Draft should clarify how unique and valuable contributions differ from other contributions (such as contributions that are not unique but are valuable, or contributions that are unique but not valuable). Otherwise, the subjective interpretation of this indicator by tax administrations may lead to the wider application of the transactional profit split method.

Keidanren’s general view is that valuable contributions should not be identified unless the contribution of one party to the transaction has generated considerable value independently.

We would also like to emphasize that the existence of unique and valuable contributions alone does not always guarantee that the transactional profit split method is the most appropriate method. Cases exist that also require the shared assumption of economically significant risks; indeed, cases exist where much greater importance is attached to the shared assumption of risks than to unique and valuable contributions.

One example would be a value chain in which Company A, a parent company engaged

in R&D activities enters into a contract with Company B, a subsidiary of Company A, according to which Company B distributes products developed by Company A. Company A also enters into a contract with Company C, another subsidiary of Company A, according to which Company C manufactures products for Company A on a contract basis. In this case, even if Company C's cost-cutting efforts at its factories or Company B's advertising and promotion campaigns are determined to be unique and valuable contributions, many of the risks assumed by the Company A will differ in nature and significance from the risks assumed by Company B or Company C. The economically significant risks are primarily assumed by Company A and neither Company B nor Company C would typically share in the assumption of those risks. Consequently, we would not consider it appropriate to apply the transactional profit split method in this case.

Even where both parties to the transaction develop valuable intangibles, these parties should not be considered to share the assumption of economically significant risks if the development risk is assumed by one party only. Hence, in this case it would not be appropriate to apply the transactional profit split method.

(2) Highly integrated business operations

As the business operations of multinational enterprises have become more or less integrated, the issue here continues to be how to distinguish business operations that are highly integrated from those that are not highly integrated. It is possible that where there is sequential integration of business operations, as defined in the July 2016 Discussion Draft, these business operations may now be determined to be highly integrated. Such operations include the intragroup supply of a broad range of parts, as well as the relationships, among Company A, Company B and Company C in the aforementioned example. In order to discourage arbitrary use of this indicator, the same consideration should be made as in the case of unique and valuable contributions — the shared assumption of economically significant risks should also be requisite for the transactional profit split method to be selected as the most appropriate method.

(3) Shared assumption of economically significant risks

Given that risk is an abstract concept, the key to considering this indicator in practice is presumably to determine whether the economic risks are significant. We are concerned about the lack of detail in the Discussion Draft regarding the "separate assumption of closely related economically significant risks," despite this being treated as equivalent to the shared assumption of economically significant risks. Example 3, to which we will later refer, includes some additional explanation but may too readily allow the risks assumed by the parties to a transaction at each stage of the value chain to be determined to be closely related.

Paragraph 24 refers to the treatment of cases "where a party contributes to the control of economically significant risk, but that risk is assumed by the other party to the transaction." We agree with the statement that "[t]he mere fact that an entity

performs control functions in relation to a risk will not necessarily lead to the conclusion that the transactional profit split is the most appropriate method in the case." However, we ask that more detailed guidance and specific examples are provided regarding such cases.

2. Examples

We welcome the additional examples provided, including those where the use of the transactional profit split method is determined to be inappropriate. We hope that the finalized guidance will expand on the explanations accompanying these examples, in particular, regarding how unique and valuable contributions are determined to exist, whether the parties share in the assumption of economically significant risks, and the selection of appropriate profit splitting factors.

Example 1

This example in the pharmaceutical sector has a basic transaction structure resembling those of the similar examples presented in the Public Discussion Draft on BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles, dated May 23, 2017. Under the hard-to-value intangibles approach, a one-sided analysis is likely to be conducted as a rule. However, since Example 1 illustrates profit split methods, it may be helpful to explain how income should be calculated by applying both methods.

In addition, while Example 1 concludes that the transactional profit split method is likely to be the most appropriate method following the approval and commercialization of a new pharmaceutical product, an analysis of the product life cycle cannot be identified from the available information. Due attention should be given to the possibility that, depending on the timing of implementation, the analysis may fail to capture Company A's losses during the initial investment period by focusing only on the profit situation at the height of Company S's sales.

Furthermore, this example should explain whether Companies A and S share the assumption of economically significant risks.

Example 2

As with Example 1, our concern about Example 2 is that no mention is made of the shared assumption of economically significant risks and the conclusion that the transactional profit split method is the most appropriate method is based entirely on the basis of unique and valuable contributions.

Whereas Example 2 explains that B Co carries out extensive advertising campaigns that feature the tea grown and the unique blend developed by A Co, further explanation is required in order to clarify which of A Co or B Co is the principal. It seems unusual that these two companies would adopt a business model under which they divide the functions of tea-growing, blending, and advertising on equal terms. It is probably more natural that those functions are divided as one party being the principal and the other being the subcontractor, and that the principal assumes economically significant risks.

If that is the case, a one-sided analysis of either party may suffice depending on the circumstances.

Examples 3 and 4

Examples 3 and 4 cover fact patterns based on which tax administrations and taxpayers are highly likely to have different views.

These examples offer important points in terms of comparison. Still, it is somewhat questionable whether the premise upon which Example 3 is based is realistic. Whereas paragraph 77 states that Company B undertakes "the global distribution of the goods," in reality a business model where Company B performs the global distribution function is implausible. The distribution function would more likely be divided among and performed by multiple distribution subsidiaries responsible for the Americas, Europe, Asia, and other regions, respectively, while the function of overseeing the formulation of global marketing strategies is performed by the parent that supervises the R&D and manufacturing of products (which corresponds to Company A in Examples 3 and 4). Many multinational enterprise groups do not have more than one center of value creation within the group, as a rule. Thus, actual cases to which Example 3 applies are probably limited in number.

In Example 4, we agree with the conclusion but request additional guidance on the following statement in paragraph 83: "The marketing activities performed by Company B are more limited and do not significantly enhance the goodwill or reputation associated with the trademark and its distribution activities are not a particular source of competitive advantage in its industry." On what grounds this determination is based should be explained. Similarly, it is unclear what kind of functional analysis would lead to the differing conclusions in Examples 3 and 4—that is, the risks assumed by Company B are determined to be economically significant for the business operations in the Example 3, but not in Example 4. It is a source of concern that this matter may tend to be viewed differently by tax administrations and taxpayers.

Example 5

This example should also explain whether WebCo and ScaleCo share the assumption of economically significant risks. We would also ask that the method used to price the transfer of the program is explained.

Example 6

We agree that the transactional profit split method is unlikely to be the most appropriate method, which is a reasonable judgement. In practice, however, the views of tax administrations and taxpayers are likely to differ when evaluating whether Company B "make[s] any unique and valuable contributions" as stated in paragraph 92. This matter thus calls for a deeper analysis.

Example 8

This example is useful in that it also refers to the splitting of losses. We also understand how the conclusion might be reached that the profits should be split among the three companies based on their respective development costs. Nonetheless, in reality, a new product development project within a multinational enterprise group would be normally established by one group entity acting as the principal, with participation by other group entities as subcontractors. This example would therefore seem to leave a number of issues unaddressed. For example, whether it is appropriate to split the profits generated from the joint development project based exclusively on the development costs, despite the project having already shifted from the development stage to the manufacturing and sales stage. The treatment of the principal's entrepreneurial profits also needs to be addressed.

In addition, while Example 8 may be considered a fairly typical example of the shared assumption of economically significant risks, we hope that additional examples, including those based on fact patterns other than joint development, will be provided in the finalized guidance.

Example 9

The question remains regarding the reasonableness of applying the transactional profit split method to the profits generated from the contributions of parent Company A and subsidiary Company B where the subsidiary's contributions are "innovative marketing activities" harnessing the intangibles licensed by the parent, and the parent's contributions include the know-how it has developed and the trademark whose value it has enhanced over the years. Although this example describes Company B's activities as innovative, in reality there would seem to be many cases where a subsidiary simply utilizes the know-how and trademark licensed by the parent in the subsidiary's country of residence. Accordingly, more detailed explanation of Company B's innovative marketing activities are essential to determining whether its contributions are unique and valuable.

In situations like Scenario 2 where Companies A and B share in the assumption of economically significant risks, it would seem logical to use actual profits when splitting relevant profits. However, in cases like Scenario 1 where Companies A and B do not share in the assumption of economically significant risks, it might first be advisable to question whether the transactional profit split method should be selected as the most appropriate method, rather than proceed directly to the discussion about splitting anticipated profits.

Example 10

This example relates to the automotive industry. In this industry, however, it is difficult to conceive of any company agreeing to enter into a commercial agreement like the one concluded between Companies A and B—namely, an agreement whereby the parties mutually buy and sell pieces, molds, and components to each other in

apparently similar quantity. On top of that, this example does not sufficiently explain which party performs the R&D and product planning functions and what tasks these functions involve. Both pieces of information are important to intangibles analysis and need to be added. Paragraph 114 contains another point requiring further explanation, stating that "an asset-based splitting factor may be appropriate" if the analysis concludes that there is a strong correlation between the assets and the creation of value. An explanation of the analytical process leading to that conclusion would be helpful.

This example does not specify whether the assets referred to are tangible or intangible. If the assets include even limited tangible assets, it should be noted that the value of tangible assets, such as manufacturing facilities, does not necessarily correlate with the value of technologies integral to the tangible assets. In this case it might be prudent to consider other factors, such as the utilization rate of manufacturing facilities.

3. Responses to the OECD's Specific Questions

(1) Anticipated profits and actual profits

It is reasonable to a certain extent to regard the splitting of actual profits as the appropriate approach in cases where the parties share in the assumption of economically significant risks. However, given that it generally takes considerable time to identify relevant profits and make calculations based on profit splitting factors, companies may not be able to complete the splitting of actual profits before the tax return filing deadline if they operate in jurisdictions where the deadline is relatively earlier than in other jurisdictions.

If anticipated profits have been used, but actual profits turn out to be higher or lower than projected, care should be exercised to prevent tax administrations from enforcing the splitting of actual profits. Furthermore, irrespective of whether anticipated or actual profits are split, any calculations and adjustments related to the transactional profit split method must generally be determined "on the basis of information known or reasonably foreseeable" by the parties to the transaction at the time it was entered into, as clarified in paragraph 46.

(2) Profit splitting factors

(a) Capital or capital employed

Although we do not deny the applicability of capital or capital employed as profit splitting factors at times, in our view capital reflects the outcomes of various economic activities, and as such is not appropriate when evaluating unique and valuable contributions. For example, where the parties to a transaction do not capitalize R&D expenses, splitting profits based on each party's tangible assets is inappropriate as it does not take into consideration the R&D activities that are a source of corporate value. At the very least, capital or capital employed need to be used in combination

with another profit splitting factor.

The OECD/G20 Base Erosion and Profit Shifting Project: Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report, dated October 5, 2015 indicates that the amount of a company's stated capital or tangible asset stated in its country-by-country report cannot be employed as a profit splitting factor, nor can it be used for formulary apportionment purposes, without conducting a detailed transfer pricing analysis. This also applies to the comments regarding head counts of employees below.

(b) Head counts of employees

Levels of personnel expenses as well as of roles, motivation, and competitiveness of workers vary by country. Accordingly, overall head counts of employees are inappropriate for use as profit splitting factors. Nevertheless, headcounts of employees performing particular important functions in financial, investment management, and other industries could be used as one of several profit splitting factors after any required adjustments have been made.

(c) Adjustments for purchasing power parity

In general, we believe it is appropriate to adjust profit splitting factors, such as assets and costs, for purchasing power parity when companies in countries with significantly different economic environments are compared or when exchange rates are rapidly and widely fluctuating. However, attention should also be paid to an increase in the compliance burden resulting from such adjustments. We hope that straightforward implementation guidelines will be provided in the future.

4. Other Comments

(1) Documentation

The Discussion Draft contains the following statement in paragraph 10: "It will therefore be particularly important to document how the transactional profit split method has been applied." We look forward to specific examples and guidelines, in particular the items that should be documented and the extent of the descriptions required.

(2) Uncontrolled transactions that are comparable but not identical

To prevent tax administrations from arbitrarily selecting transfer pricing methods, the following statement in paragraph 14 requires further detailed guidance: "An appropriate method using uncontrolled transactions that are comparable, but not identical to the controlled transaction is likely to be more reliable than an inappropriate use of the transactional profit split method." Guidance is needed especially in the form of examples of "uncontrolled transactions that are comparable, but not identical," as well as concerning to what extent such uncontrolled transactions

are permitted to be used.

(3) Master files

Seemingly, the statement at paragraph 58 that the "Master File might be a useful source of information relevant to the determination of appropriate profit splitting factors" goes a little too far. Although a caveat is made at the end of the paragraph, which points out that the Master File is not required to contain granular or detailed information but intended only to provide a high-level overview of a multinational enterprise group, the statement in paragraph 8 should be worded more carefully.

(4) Residual profit split method

When splitting relevant profits in cases where both parties to the transaction make unique and valuable contributions, the residual profit split method should be used, as implied in paragraph 37. The residual profit split method is a conservative approach whereby profits are split based on a two-stage analysis, thus the residual profit split method is generally more reliable than the contribution profit split method.

(5) Cost-based profit splitting factors

In paragraph 67 of the section regarding cost-based profit splitting factors, the risk-weighting of costs is mentioned as an issue to be considered when each party contributes different intangibles. We look forward to examples illustrating how to weight costs by risk. Another point that requires detailed guidance is the following statement in the same paragraph: "[t]he manner in which independent parties would allocate retained location savings would need to be reflected in the profit split." This statement might be interpreted differently by tax administrations in different tax jurisdictions without further specific guidelines, in particular regarding how this relates to comparability analysis.

Sincerely,

Subcommittee on Taxation
KEIDANREN

KPMG

KPMG International

To	Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA	Date	September 15, 2017
From	KPMG International	Ref	KPMG Comments - Revised Profit Splits.docx
cc	Stephen Blough, KPMG in the U.S.		

Comments on Discussion Draft: Revised Guidance on Profit Splits

Professionals in the member firms of KPMG International ("KPMG") welcome the opportunity to comment on the Organisation for Economic Co-operation and Development ("OECD") Discussion Draft titled *BEPS Action 10: Revised Guidance on Profit Splits* (the "Discussion Draft").

The Discussion Draft is fourth in a series of documents[1] from the OECD addressing revised guidance on the transactional profit split method ("TPSM") discussed in Chapter II of the OECD Transfer Pricing Guidelines. The OECD received numerous comments from the public on the earlier documents, and it is clear that the Discussion Draft has tried to address some of those comments. For example, the discussion on parallel and sequential integration, which many commentators had questioned, is excluded from the Discussion Draft. The Discussion Draft takes a more balanced view of the TPSM, for instance, noting the *relative* reliability of the selected method over other methods. As another example, much of the discussion on anticipated versus actual profit splits that commentators had questioned as overly prescriptive has been revised or eliminated.

KPMG commends the OECD for its effort on the profit split guidance and recognizes how far the draft has advanced in the few years since the OECD first started working on the revisions. KPMG appreciates the openness of the OECD to comments on the earlier drafts on the TPSM and the improvements it has made to those earlier drafts. Nonetheless, we still have concerns on several key issues.

KPMG's comments on the Discussion Draft are presented below.

Summary of Comments

We first start with some general comments on the Discussion Draft, then go on to discuss the examples in the Discussion Draft in greater detail, and end with our comments on the three questions the OECD posed to commentators in the Discussion Draft.

KPMG has the following general comments on the Discussion Draft, which are discussed in greater detail in the sections below:

- The Discussion Draft would benefit from a clearer linking of the profit split guidance to the guidance previously provided in Chapter I of the OECD Transfer Pricing Guidelines ("Chapter I") on the role of contracts in determining the allocations of risk in a controlled transaction.
- We recommend that the OECD guidance reaffirm in Section C.2.2 (Nature of the Transaction) of the Discussion Draft the principle that the most appropriate method should be selected for evaluating the arm's length pricing of a transaction.

[1] The previous three are (i) *BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains*, December 16, 2014, (ii) section on *Scope of Work for Guidance on the Transactional Profit Split Method* in *Actions 8-10: 2015 Final Reports on Aligning Transfer Pricing Outcomes with Value Creation*, October 5, 2015, and (iii) *BEPS Actions 8-10: Revised Guidance on Profit Splits*, July 4, 2016.

- Section C.5 of the Discussion Draft provides general principles for the determination of profit-splitting factors. We recommend that the OECD include as a principle that the profit-splitting factors chosen should be in alignment with the guidance in Chapters I and VI[2].
- Annex I to the Discussion Draft, which contains ten examples to illustrate the guidance on the TPSM, is new to the OECD guidance on profit splits. KPMG believes that the examples should reflect the principles laid out in the Discussion Draft more clearly. In addition, we recommend that the OECD include an example to illustrate the principle that the TPSM should generally also apply, and apply in the same way, regardless of whether the transaction(s) result in a relevant profit or loss.

We discuss each of these issues in greater detail below.

Role of contracts

The Discussion Draft would benefit from a clearer linking of the profit split guidance to the guidance already provided in Chapter I on the allocation of risk. Chapter I of the OECD Transfer Pricing Guidelines provides a six-step framework for analyzing risk in a controlled transaction in order to accurately delineate the actual transaction. Under this framework, the contractual allocation of risk is respected unless the parties' conduct is inconsistent with the contract.

The sharing of risks plays a prominent role in the discussion on the appropriateness of profit splits in the Discussion Draft. The Discussion Draft, however, makes just one reference to contracts—more than halfway through the Discussion Draft, in paragraph 46.[3] Since contracts are a starting point for the determination of whether and how risks are shared, we believe that it is important for the OECD to clearly articulate that the profit split guidance is intended to follow the Chapter I guidance on the role of contracts.

For instance, paragraph 24 of the Discussion Draft reiterates the guidance in paragraph 1.105 of the OECD Transfer Pricing Guidelines that "[w]here a party contributes to the control of economically significant risk, but that risk is assumed by the other party to the transaction, this may, in some cases, demonstrate that it is appropriate for the first party to share in the potential upside and downside associated with that risk, commensurate with its contribution to control." It does also note that the "mere fact that an entity performs control functions in relation to a risk will not necessarily lead to the conclusion that the transactional profit split is the most appropriate method in the case." However, we believe that the guidance should make a stronger statement on respect for contractual terms when such respect for contracts is consistent with the Chapter I guidance in order to make clear that paragraph 24 does not necessarily support an application of a profit split whenever multiple parties control the risk. In other words, where multiple parties control risk, the profit split guidance should make clear that the contractual allocation of risk to one or more of those parties will be respected, as stated in paragraph 1.94[4] of the OECD Transfer Pricing Guidelines, and the evaluation of the TPSM as the most appropriate method should factor in the contractual allocation of risk. If the contract does not specify a sharing of risks between the parties even though both parties control the economically significant risks, a tax authority or taxpayer should not be allowed to assume the sharing of risks in contradiction to the contract and select the TPSM as the most appropriate method based on an inference of shared risks. The distinction between a split of actual profits and a split of anticipated profits is important in this respect as they may correspond to significantly different allocations of risk between the parties.

For instance, it is common for multiple entities to collectively control economically significant risks through their membership in global committees within the multinational group. It is possible that the intercompany arrangement in place allocates risks to all the entities controlling the risks, in which case

[2] All references to "Chapter VI" in this document refer to Chapter VI of the OECD Transfer Pricing Guidelines.

[3] Paragraph 46 of the Discussion Draft states "Additionally, it should be remembered that the starting point in the delineation of any transaction will generally be the written contracts which may reflect the intention of the parties at the time the contract was concluded."

[4] Paragraph 1.94 of the OECD Transfer Pricing Guidelines states "Furthermore, in some cases, there may be more than one party to the transaction exercising control over a specific risk. Where the associated enterprise assuming risk …controls that risk…, all that remains…is to consider whether the enterprise has the financial capacity to assume the risk. If so, the fact that other associated enterprises also exercise control over the same risk does not affect the assumption of that risk by the first-mentioned enterprise…"

there is a sharing of economically significant risks and the TPSM may be an appropriate method for evaluating the arm's length pricing between the relevant entities. Alternatively, the intercompany contract may assign the economically significant risks to one of the parties to the transaction. In this case, it would not be reasonable to assume shared risks or to split actual profits as if risks were shared, ignoring the risk allocation embodied in the intercompany contract.

Without a clearer reaffirmation of the Chapter I guidance on the role of contracts, the Discussion Draft may lead some to argue for a TPSM more often than is warranted.

Reaffirmation of the Principle of Selecting the Most Appropriate Method

As the Discussion Draft notes, "the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case",[5] and the selection of the most appropriate method should take into account "the *relative* appropriateness and reliability of the selected method as compared to other methods which could be used."[6] The Discussion Draft discusses the strengths and weaknesses of the TPSM as well as the nature of transactions where a TPSM may be potentially applicable.

The Discussion Draft describes three types of transactions in Section C.2.2 where the TPSM may be appropriate – (i) transactions where both parties make unique and valuable contributions, (ii) transactions involving highly integrated business operations, and (iii) transactions with shared assumption of economically significant risks (or where the parties separately assume closely related risks).

While we understand that the OECD's intent is to provide guidance on certain situations where the TPSM may be applicable, the guidance should reaffirm the principle of selecting the most appropriate method in its discussions of the three types of transactions listed above. In particular, the discussion of highly integrated business operations in Section C.2.2.2 should acknowledge that highly integrated business operations need not lead to the selection of the TPSM as the best method.

The second sentence in paragraph 19 of the Discussion Draft makes an absolute statement that 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 another party to the transaction performs functions, uses assets and assumes risks." The following sentence states that "[i]n contrast, many *instances of integration* within an MNE result in situations in which the contribution of at least one party to the transaction can in fact be reliably evaluated by reference to comparable uncontrolled transactions." (emphasis added).

The phrasing in the two sentences seems to imply that whereas in many instances of integration the TPSM may not be the most appropriate method, where there is a "high degree" of integration, the TPSM will be the most appropriate method. We disagree with this implication and believe that the second sentence in paragraph 19 should be revised. The term "high degree of integration" is subjective—what one tax authority or taxpayer considers a high degree of integration may be different from what another thinks is a high degree of integration. The guidance could then, in practice, be taken to mean that the TPSM will be the most appropriate method for a range of integration. More importantly, we do not agree that a high degree of integration will always lead to a TPSM, as it is only one amongst a variety of relevant factors. Finally, the selection of the TPSM as the most appropriate method cannot be made without comparing its reliability to the reliability of other potential methods under the specific facts and circumstances of the transaction involved.

Therefore, we recommend that the OECD either delete the second sentence of paragraph 19 or revise it and the following sentence as follows: "A high degree of integration means that the way in which one party to the transaction performs functions, uses assets and assumes risks is closely interlinked with the way in which another party to the transaction performs functions, uses assets and assumes risks. Many such instances of integration within an MNE result in situations in which the contribution of at least one party to the transaction can in fact be reliably evaluated by reference to comparable uncontrolled transactions."

[5] Paragraph 3 of the Discussion Draft.

[6] Paragraph 5 of the Discussion Draft.

As an example of highly integrated business operations, Paragraph 21 of the Discussion Draft describes a situation where each party has made a significant contribution (e.g., of an asset) whose value depends on the counterparty to the arrangement, and treats it as an example of a situation where the TPSM may be the most appropriate method. It is not clear why the OECD considers this an example of a highly integrated business operation. For instance, if in a transaction between two related entities within a pharmaceutical manufacturer one party licenses a molecule to the other for further development into a commercial drug product, each party contributes intangible assets (the molecule and the fully developed drug) whose value depends on the counterparty to the arrangement. However, their operations need not be highly integrated since one party simply hands off the development of the molecule to the other. Even if this situation is considered an example of a highly integrated business operation, it is not uncommon to find such arrangements between unrelated parties and it may be possible to find comparable uncontrolled prices for the license, so that the TPSM may not be the most appropriate method. Consequently, we suggest that the OECD also state in Paragraph 21 that the most appropriate method given the facts of the transaction should be selected (which, as illustrated by the pharmaceutical example in this paragraph, may not be the TPSM).

Further, we believe that the OECD combines two very different circumstances in its discussion of the third situation where the TPSM may be appropriate, i.e., transactions where the parties share the assumption of economically significant risks as compared with transactions where they separately assume closely related risks. The latter type of transaction, i.e., a transaction with the separate assumption of closely related risks, is a common occurrence between independent parties when they enter into market transactions. Independent parties typically do not resort to a profit split as a pricing mechanism for their transaction and there is no reason why related parties should be more likely to do so. Thus, we recommend that the separate assumption of closely related risks not be discussed as a situation where a TPSM may be most appropriate.

The relative reliability of the TPSM will depend in significant part on the reliability of specific determinations that must be made in its application, which are discussed in Sections C.3, C.4 and C.5 of the Discussion Draft. This consideration is relevant to all aspects of application including determination of profits to be split, where reliability of segmentation is an important consideration, and selection and weighting of profit-splitting factors, discussed further below. We suggest that the OECD emphasize the importance of considering the reliability of specific implementation determinations in assessing the relative reliability of the TPSM in determining the most appropriate method in a specific case. Specifically, we recommend that the Discussion Draft clarify that cases may commonly be encountered in practice where these issues materially impair the reliability of the TPSM such that another method is most appropriate, even in cases where the TPSM might otherwise be indicated.

Selection of Profit-Splitting Factors

Fundamental to the reliability of the TPSM is the identification and weighting of profit-splitting factors that reliably correspond to the allocation of profits that would be realized between unrelated parties. Sections C.3 and C.5 of the Discussion Draft provide general principles for the determination of profit-splitting factors but do not emphasize this critical point.

In cases where a residual analysis is used and the quantum of residual profit or loss is large, the reliability of the TPSM rests heavily on the reliability of the profit-splitting approach. The Discussion Draft properly notes that profit-splitting factors should be verifiable and accurately measured but says little on principles for determining whether the profit-splitting approach reliably reflects the allocation that would be realized between independent parties. As discussed below in our answers to the OECD's questions posed, KPMG does not believe additional guidance on specific profit-splitting factors is warranted. Rather, we recommend that the OECD emphasize (1) the need to support clear alignment of the profit-splitting factors with relative contributions to value of the parties (and, in the case of multiple factors, the need to weight factors based on relevance), and (2) that subjectivity in such judgments significantly reduces the reliability of the TPSM and that should be taken into account in determining the most appropriate method.

An important principle missing from this discussion is the alignment of the profit-splitting factors with the guidance in Chapters I and VI on risk and intangibles. The OECD does state in Section C.3 of the Discussion Draft that the relevant profits to be split and the profit splitting factors should be "consistent

with the functional analysis of the controlled transaction under review, and in particular reflect the assumption of economically significant risks by at least one of the parties." We recommend that the OECD further elaborate that the profit-splitting factors chosen should be in alignment with the guidance in Chapters I and VI on the assumption of economically significant risks and transfer pricing of intangibles.

In addition, the concept of arm's-length range is equally applicable to TPSM. The Discussion Draft is currently, however, silent on this point. Where the TPSM is applied *ex-post* as a means to test the financial results of intercompany transactions, as opposed to *ex-ante* as a planning tool to determine intercompany allocations, the OECD could consider an approach whereby the weights assigned to the profit-splitting factors are systematically varied to generate multiple allocation scenarios for each participating entity, and therefore a range of arm's length results.

Examples in the Discussion Draft

Annex I to the Discussion Draft, which contains ten examples to illustrate the guidance on the TPSM, is new to the OECD guidance on profit splits. KPMG believes that the examples should reflect the principles laid out in the Discussion Draft more clearly. In particular, the examples do not shed much light on why the TPSM was selected as the most appropriate method and why the other methods were not more appropriate. The examples fail to consider the effect of contractual relationships on the assumption of risk in selecting or rejecting the TPSM as the most appropriate method (except where Example 9 Scenario B refers to an agreement to split actual profit). Further, the examples are silent on the size of the residual profit and why the chosen approach in the example is a reliable way to split profits when the residual profits are large. KPMG recommends that the OECD provide more details on the application of the profit split in the examples addressing these issues.

We discuss below some open issues in the Discussion Draft's examples that we believe the OECD should address to make the examples more useful.

- We recommend that all the examples include a discussion of the contractual arrangements between the parties to the transaction; in particular, their contractual allocation of economically significant risks. As noted above, contracts are a starting point for the determination of whether and how risks are shared, and the profit split guidance should not replace the Chapter I guidance on respect for contracts. For instance, Example 8 presents a situation where multiple related entities jointly control an economically significant risk—development risk. However, the example is silent on the contractual allocation of the development risk. Example 8 states that "the accurately delineated transaction shows that the parties share the assumption of the same economically significant risk", but does not indicate what role the contractual arrangements among the parties plays in this determination.[7] Instead, it seemingly assumes that the parties share the development risk. Under the Chapter I guidance, the joint *control* of an economically significant risk is not equivalent to a *sharing* of the risk unless the contract also specifies that the parties will share the risk. By simply assuming a sharing of the risk in the presence of joint control over the risk, Example 8 overlooks the role of contracts in the allocation of risk as specified in Chapter I of the OECD Transfer Pricing Guidelines. We believe that the OECD should include a discussion of contractual terms in every example since (i) the contractual terms are an important element of the factual background of the case, and (ii) the discussion of contractual terms in the examples will also help to reaffirm the practice of applying the six-step framework on risks in Chapter I, which considers contractual terms under step 2.

- As noted in the Discussion Draft, the choice of the most appropriate method should depend on the *relative* appropriateness and reliability of the different methods.[8] We fully agree with this principle but find that the examples do not shed light on its application. Instead, the examples generally assume the TPSM to be the most appropriate method without consideration of the other methods. We believe that the OECD could greatly improve the applicability of the examples, as well as reduce potential misapplication of the TPSM by taxpayers and/or tax administrators alike, by discussing the

[7] In general, none of the examples provide guidance on the role of contractual arrangements in the accurate delineation of intercompany transactions.

[8] Paragraph 5 of the Discussion Draft.

relative reliability of the TPSM in comparison to the other specified methods. Each example would benefit from a discussion of how the other methods were considered and why they were rejected. For instance, Example 1 presents a situation where one party takes the development of a new pharmaceutical formulation to a certain stage and then licenses its intangible property to another entity for further development and commercialization. In addition to not discussing the contractual terms of the transaction (e.g., how risks are allocated between the parties—see previous point), the example assumes that both parties make unique and valuable contributions and, thus, the TPSM is the most appropriate method. There is no discussion of why the TPSM is more reliable than the other methods, such as the comparable uncontrolled price ("CUP") method. The pharmaceutical industry, in particular, sees numerous deals between third parties in just such situations, i.e., where one party does the initial development of a pharmaceutical molecule and licenses the right to further develop and commercialize the molecule to an unrelated party. It is possible to find information on such arrangements in public databases. It is therefore unclear why the CUP method, for instance, could not be more reliable than the TPSM in Example 1. We recommend that the OECD discuss the evaluation of other methods and why the TPSM was found to be the most reliable method in each of the examples.

- The examples give the impression that whenever multiple parties make unique and valuable contributions or share in economically significant risks or engage in highly integrated operations, the TPSM will be the most appropriate method. In other words, the examples seem to imply that meeting these conditions is sufficient for the selection of the TPSM as the most appropriate method. However, as the Discussion Draft notes, the TPSM *may* be the most appropriate method in these situations—which by no means implies that the TPSM will be the most appropriate method whenever these conditions are met. In fact, the Discussion Draft clarifies that the "presence or absence of one or more of the indicators [described in this section] will not necessarily lead to the conclusion that the transactional profit split method will (or will not) be the most appropriate method in a particular case."[9] The two examples where the TPSM is not selected as the most appropriate method (Examples 4 and 6) assume that one of the parties does not assume economically significant risks, does not make unique and valuable contributions, and is only integrated with the other party to a limited degree. These two examples do nothing to allay the impression that the three conditions are sufficient conditions for application of the TPSM. We recommend that the OECD include examples where both parties make unique and valuable contributions, or assume economically significant risks, or have highly integrated operations but the TPSM is not the most appropriate method to make it clear that these conditions are not sufficient for the application of the TPSM.

- Several examples assume unique and valuable contributions and, therefore, apply the TPSM as the most appropriate method. However, it is unclear from the examples why the contributions are considered unique and valuable. In fact, the examples relying on unique and valuable contributions as a basis for applying the profit split present commonplace situations where the contributions might not be unique and valuable. We have already discussed Example 1 above, where while the intangibles of Company A are likely valuable, it is also common to find similarly situated third parties entering into arrangements to license just such intangibles. Several examples[10] assume that the marketing and distribution activities of a party are unique and valuable or lead to the assumption of economically significant risks. For instance, Example 3 notes that the distribution activities of Company B are a key source of economic advantage over competitors. In particular, "Company B has developed a sophisticated algorithm to get feedback from customers on the performance of their products."[11] Since many distributors have mechanisms for obtaining feedback from customers, it is unclear why Company B's algorithm is a distinguishing value driver. By not clearly articulating why a contribution is unique and valuable, the Discussion Draft runs the risk of encouraging an application of the TPSM in situations where other methods may be more appropriate (see also earlier comments on selection of the most appropriate method). We suggest that the OECD develop the factual

[9] Paragraph 30 of the Discussion Draft.

[10] See, for instance, Example 2 and Example 3 of the Discussion Draft.

[11] Paragraph 80 of the Discussion Draft.

background of the examples further, clearly tying the selection of the most appropriate method to the facts of the case.

- We recommend that each of the examples in which the TPSM is selected as the most appropriate method include an affirmative statement that sufficient information is available to reliably determine the profits to be split and the relative value of each party's contribution, thereby emphasizing the importance of such issues in determining the relative reliability of the TPSM.
- Paragraph 2 of the Discussion Draft notes that the TPSM should generally also apply, and apply in the same way, regardless of whether the transaction(s) result in a relevant profit or loss. We generally agree and recommend that the OECD include an example to illustrate this principle. We do note, however, that while the TPSM should be used consistently, the way certain allocation keys are used and measured may need to vary in the case of profits versus losses. For instance, employee bonuses may be positively correlated to the contribution made to generating a profit but negatively correlated to the contribution made to generating a loss. In other words, a bank may give higher bonuses to the traders who have produced a larger profit or a smaller loss. In such a case, if we applied the profit split in the same manner to profits and losses, we would rightly attribute a larger share of the profit to the employees who had higher bonuses but would wrongly attribute a larger share of the loss to the traders who had larger bonuses. This does not mean, however, that either MNEs or tax administrations should be permitted to apply inconsistent methods in profit and loss situations. For example, neither MNEs nor tax authorities should be permitted to selectively apply a profit split to years in which there are combined profits for tax purposes and apply the transactional net margin method to years in which there are combined losses.
- The examples are primarily focused on the selection of the TPSM as the most appropriate method and less so on the application of the TPSM. As noted above, data issues may materially impair the reliability of the TPSM such that another method is most appropriate. The examples would add greater value if they discussed data reliability and illustrated the application of the TPSM based on the principles laid out in the Discussion Draft. For instance, how is the nature of profit to be split (operating profit, gross profit, or another measure) chosen, how is a contribution analysis applied in comparison to a residual analysis, and how are the profit-splitting factors chosen, weighted and applied. Example 8, for instance, talks about development expense as the profit-splitting factor but does not discuss how it is applied—e.g., are relative historical development expenses, capitalized expenses, annual ongoing development expenses, etc. used for splitting profits?
- The purpose of Example 5 is unclear. It does not appear to consist of anything more than an assertion that the TPSM is likely to be the most appropriate method if both parties' contributions are unique and valuable, and not the most appropriate method if the contributions are not unique and valuable. Examples 3 and 4 make this point in a more detailed fashion; further, Example 5 clearly embodies our concerns about conveying the incorrect idea that unique and valuable contributions by both parties is a sufficient condition for the TPSM to be the most appropriate method. We recommend Example 5 either be clarified to illustrate a discrete issue, or deleted.
- Example 7 would benefit from significant clarification. In KPMG's experience, the TPSM method may be used in the case of such portfolio management companies, but the specific facts advanced in the example leave unclear both the specific method used and the rationale. It appears that ASSET Co. contracts to provide portfolio management services to (unrelated) FUND Co. Related parties Company A and Company B provide valuable services to ASSET Co. with respect to ASSET Co.'s contract with FUND Co. Paragraph 100, at the end of the example, provides critical information relevant to the most appropriate method selection. It states that "Comparables for … the services performed by Company A and Company B together are available, but these provide no information on how to split those profits between Company A and Company B." Based on this statement it appears that comparables are available to reliably determine the total payments from ASSET Co. to Company A and Company B together. Some method would then be required to split that payment between Company A and Company B. If this reading is correct, we suggest that the example be revised to (i) provide this information earlier in the example before a conclusion regarding the most appropriate method is stated; (ii) indicate whether and how the available comparables are used to determine the total payment to Company A and Company B, or if instead the TPSM is used why it is

more reliable given the existence of those comparables; and (iii) explain why a profit split is the most appropriate method for allocating such payment between Company A and Company B, rather than, for example, some other allocation of the total fee using available comparables. Paragraph 96 states "Company A employs portfolio managers who specialise in Country A equity and Company B employs portfolio managers who specialise in Country B equity." Consequently, the example would benefit from further elaboration as to potential circumstances in which available market data, such as sub-advisory fees, would be a less reliable method of splitting the total fee than the TPSM.

- Example 9 provides a comparison of situations where actual or anticipated profit splits might be appropriate. The general points discussed above are applicable to this example. In addition, this example makes certain critical assumptions that we believe are either unwarranted or should be supported further. In particular, we question the assumption that a profit split is the most appropriate method based solely on the fact that both parties make unique and valuable contributions. Local marketing of trademarks and other intangibles is often carried out by an enterprise that is independent of the enterprise that developed the intangible, and a profit split usually is not used in those arm's length transactions. In addition, in Scenario 1, Company A develops intangibles and Company B markets the new product. In Scenario 2, Company A develops the intangibles and both Company A and Company B market the product. The example assumes that in Scenario 1 Company A does not bear economically significant risks related to the commercialization of the product whereas in Scenario 2 it shares these risks with Company B. The implicit assumption in Scenario 1 is that since Company A does not engage in marketing activities it cannot share in the risks of the commercial product. It must, therefore, share in anticipated profits and get a payment that is determined *ex ante* based on the discounted cash flows of the expected profits from selling the product. This example's view of the application of the TPSM has several flaws: (i) Scenario 1 does not explicitly discuss the contractual relationship, which might in fact specify a sharing of risks and actual profits, consistent with the conduct of the parties; (ii) both scenarios assume that actual volatility in the profits from the commercial product are attributable to commercialization risk whereas anticipated volatility (as captured in a discount rate, for example) is attributable to development risk—but there appears to be no basis for this assumption, and (iii) the related-party payment terms represent a certain allocation of risk, which the example overlooks in its determination of anticipated or actual profit splits.

Questions Posed in the Discussion Draft

The preamble to the Discussion Draft posed three specific questions to commentators. KPMG has provided its responses to these questions below.

1. The discussion draft addresses situations in which profit splits of anticipated profits or profit splits of actual profits are appropriate. Where it is established that the transactional profit split is the most appropriate method, please comment on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used.

   Response: Splits of anticipated or actual profits embody different allocations of risk. The allocation of risk in a transaction will be determined under the principles of Chapter I. The allocation of risks between the transacting parties will, thus, depend on the contractual arrangement between them and their conduct. This allocation of risk in the accurately delineated transaction should be respected in the choice of most appropriate method, which includes the decision as to whether a split of actual or anticipated profits is most appropriate. Thus, the choice of actual or anticipated profit split will largely be driven by the taxpayer's decision on how to allocate risk in the transaction, assuming its conduct is consistent with that risk allocation. We expect that the allocation of risk in the accurately delineated transaction will be respected in the selection of a split of actual or anticipated profits.

2. A number of profit splitting factors are addressed in the discussion draft. Comments are particularly invited on:

   a. Whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained, and if so, what factors need to be taken into account for its selection and application as a reliable profit splitting factor.

Response: We believe that references to capital or capital employed should be retained. Capital or capital employed may be a reliable measure of contribution to profits in certain situations. Capital could refer to operating assets and/or to funding, both of which could be reliable measures of relative contributions depending on facts and circumstances. For instance, investments in physical assets could be an indicator of relative contributions to a manufacturing operation. Financial capital could be an important factor in a financial services transaction. As with any other factor, capital or capital employed can be subject to measurement issues and will not be the most appropriate factor in every context. Thus, the same general principles that are used for selecting any other factor should be applied to the selection of capital or capital employed as a profit-splitting factor.

b. Should headcount of similarly skilled and competent employees be included as a potential profit splitting factor, and if so, in what circumstances would it be relevant?

Response: If it can be demonstrated through the functional and industry analyses that headcount is the best measure of the unique and valuable contributions of the various parties involved in the transaction, then headcount could possibly be a reliable profit-splitting factor. However, we don't believe that having "similarly skilled and competent" personnel is sufficient for using headcount as a profit-splitting factor. The assessment of whether personnel are similarly skilled and competent can be subjective. More importantly, even if personnel are "similarly skilled and competent" their roles and relative contributions can be very different. For instance, two people with the same educational backgrounds (which could be a measure of skills and competency) could have very different contributions to the multinational group if one, for instance, is the head of R&D and the other performs routine testing activities for products that have already been developed.

c. Given the existing guidance in Chapters I and IX of the Transfer Pricing Guidelines, should adjustments for purchasing power parity be made for profit splitting factor amounts, and if so, in what circumstances?

Response: We do not recommend that purchasing power parity ("PPP") be called out as an adjustment factor in the OECD guidance. We believe that the OECD guidance should provide general principles on the application of the TPSM and examples for illustrating those principles. The Discussion Draft does that. The fundamental principle in the application of the TPSM or any other method is that the most appropriate method given the facts of the transaction and the available data be selected. While the Discussion Draft provides examples of profit-splitting factors, these examples are not, and should not, be intended to represent an exhaustive listing of profit-splitting factors. Not all factors will be appropriate in all situations. Any profit-splitting factor selected for a particular case should be required to undergo a careful evaluation as to its appropriateness for the case. PPP indices are harder to measure than market exchange rates, infrequently updated, and not available for all countries – all of which make them less reliable than market exchange rates, which represent true and current market data. We do not believe that specifically discussing PPP adjustments will improve the Discussion Draft—the general guidance on the selection of profit-splitting factors should be sufficient to allow for an evaluation of the most appropriate profit-splitting factor to any particular set of circumstances.

d. What other profit splitting factors should be included in the guidance, and in what circumstances?

Response: As noted in the Discussion Draft itself, the appropriate profit-splitting factors will depend on "the facts and circumstances of the case."[12] What might be an appropriate profit-splitting factor in one case might not be in another. There could be profit-splitting factors that are unique to the facts and circumstances of a case. It is, therefore, not possible to present an exhaustive listing of profit-splitting factors that may be used in a TPSM. The OECD guidance should lay down general principles for selecting profit-splitting factors, as the Discussion Draft does, with additional emphasis on the impact of subjectivity on the

[12] Paragraph 31 of the Discussion Draft.

reliability of the TPSM. We do not recommend a lengthy list of profit-splitting factors to be included, which would run the risk of being viewed as an exhaustive listing, with tax authorities potentially questioning any deviation from the list.

3. Additional examples of scenarios in which a transactional profit split is found to be the most appropriate method due to the high level of integration of the business operations are sought, together with an explanation as to the reasoning thereto.

   Response: While we believe examples are useful in illustrating principles, an overuse of examples related to the high level of integration of business operations could encourage overuse of the TPSM whenever business operations are integrated, which is generally the case with multinational enterprises. The Discussion Draft already includes examples where business operations are highly integrated. For instance, Example 10 presents a case where business operations are integrated and the TPSM is applied. As noted above, the Discussion Draft would benefit from a clearer illustration of the principles of the TPSM. The OECD could better illustrate the principles of the Discussion Draft in a situation with a highly integrated business by improving the examples that are already in the Discussion Draft than by including additional examples. As noted above, we also recommend that the OECD include an example where the parties to a transaction are engaged in a highly integrated business operation but the TPSM is not the most appropriate method.

About KPMG

KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 152 countries and have 189,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

KPMG Contacts	**Firm**	**e-mail**
Stephen Blough	KPMG in the U.S.	sblough@kpmg.com
Brian Cody	KPMG in the U.S.	bcody@kpmg.com
Manal Corwin	KPMG in the U.S.	mcorwin@kpmg.com
Gianni De Robertis	KPMG in Italy	gianniderobertis@kpmg.it
Matthew Frank	KPMG in the U.S.	matthewfrank@kpmg.com
Peter Steeds	KPMG in the U.K.	Peter.Steeds@KPMG.co.uk
Prita Subramanian	KPMG in the U.S.	psubramanian@kpmg.com
Montserrat Trape Viladomat	KPMG in Spain	mtrape@kpmg.es
Thomas Zollo	KPMG in the U.S.	tzollo@kpmg.com

DUFF & PHELPS

Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris Cedex 16
France

15 September 2017

Delivered via e-mail: TransferPricing@oecd.org

Re: Discussion Draft for BEPS Action 10 – Revised Guidance on Profit Splits

Mark Bronson, Duff & Phelps, LLC [1]

I appreciate the opportunity to offer commentary on select aspects of the OECD's discussion draft of revised guidance on profit splits ("the draft guidance") issued on 22 June 2017. It is clear, from my reading of the draft revised guidance and from comparing that guidance to the prior discussion draft that a substantive amount of work has been performed by Working Party 6. This revised draft represents a meaningful improvement over the draft that was issued on 4 July 2016.

I wrote at some length in response to the July 2016 draft guidance as to the appropriate application of transactional profit split(s) ("TPS") to anticipated profits and to actual profits and the completely distinct circumstances that would lead to the appropriate application of each type of TPS. I will not repeat these points fully in this commentary, but will briefly reiterate that:

- The appropriate application of the TPS to anticipated profits may occur only when more than one party to the transaction being analyzed is making non-routine contributions.
- The appropriate application of the TPS to actual profits should occur when and only when it is determined that, under the accurately delineated transaction, multiple parties to the transaction bear risks[2] that cannot be meaningfully disentangled. This may be the case because it is determined that multiple parties jointly bear a particular risk or because they bear risks that arise from different direct sources, but which are so interrelated and/or correlated as to not be economically distinct.
- Constructs like "high levels of integration" are relevant only insofar as they yield a determination that multiple parties are jointly bearing risk(s).

[1] The opinions expressed in this paper are those of the author and do not necessarily reflect the views of Duff & Phelps as a whole or those of its clients.
[2] For ease of exposition, when "risks" are mentioned in this commentary, it should be understood to mean economically significant risks.

- Applying a TPS to anticipated profits does not necessarily mean that a TPS should also be appropriately applied to actual profits. These two types of TPS can exist quite distinctly, and the conditions that make one type of TPS appropriate may or may not have any relationship to the conditions that would make the other appropriate.
    - The presence of multiple non-routine contributions may or may not yield a conclusion that the parties necessarily jointly bear risks in a way that makes the application of a TPS to actual profits the most appropriate approach under the arm's length principal.
        - At arm's length, parties could (and do) determine fixed, non-contingent prices which leave the entire risk associated with the difference between expected and actual profits with only one of the parties, even when both parties are making non-routine contributions.

There are sections of the revised draft guidance where the underlying tenets summarized above are more clearly reflected than they were in the 2016 guidance. These revisions are, in my opinion, major improvements in the guidance. This includes:

- A revision to the discussion of business integration as a consideration for the application of the TPS (particularly in paragraphs 19 through 24) that seems to indicate that the extent to which risks are jointly borne within an integrated business will determine whether or not a TPS will be appropriately applied.
- Presentation of a clearly stated framework in paragraphs 43 through 45 indicating that:
    - The determination of the profits to be split, including whether those profits are actual profits or anticipated profits, should be aligned with the accurately delineated transaction (¶ 43);
    - The splitting of actual profits would only be appropriate where the accurate delineation of the transaction shows that the parties effectively share risks (¶ 44); and
    - That if both parties make valuable non-routine contribution but one of the parties does not share in the assumption of economically significant risks, a TPS applied to anticipated profits might be most appropriate (¶ 45).

While these improvements are substantive, I believe that there are a number of areas where additional clarification will be helpful to ensure that the guidance will result in clear and appropriate applications of TPS (on both an actual and/or anticipated profits basis). This commentary addresses a few critical points regarding the revised draft guidance, some of which are connected to the points summarized above.

The Draft Guidance Could be Clearer on the Distinctions Between TPS Applied to Anticipated Profits and TPS Applied to Actual Profits on a More Consistent Basis

The first question posed at the front of the draft guidance asks "Where it is established that the transactional profit split is the most appropriate method, please comment on the factors which should be taken into account in determining whether a profit split of anticipated profits

or a profit split of actual profits should be used." As discussed above, I believe that the draft guidance answers this question clearly and appropriately in paragraphs 43 through 45.

The paragraphs preceding this section, however, often continue to talk about TPS under a singular nomenclature, leaving the question of whether the TPS being discussed is to be applied to actual or anticipated profits. I believe that this treatment obfuscates the distinctions between the considerations that would govern each type of application (i.e., application to anticipated profits vs. application to actual profits). While the considerations that would govern these two types of applications may have some correlation, they are not identical.

Examples of this unclear language include:

- ¶ 6: "The main strength of the transactional profit split method is that it can offer a solution for cases where both parties to a transaction make unique and valuable contributions…" This statement should be clarified so that the reader understands that it is being made relative to the TPS applied to anticipated profits. This point does not describe a strength of the TPS as applied to actual profits.
- ¶ 7: "The [TPS] can also provide a solution for highly integrated operations in cases for which a one-sided method would not be appropriate." This statement should be clarified as applying only to the TPS applied to actual profits as there is no reason to think that business integration has any correlation with the presence of multiple parties making non-routine contributions. The fact that this paragraph immediately follows paragraph 6 which explicitly addresses circumstances yielding an appropriate application of TPS to anticipated profits and does so by saying that the TPS "can also provide a solution" in this situation could lead the reader to believe that the same type of application is anticipated in the two paragraphs. This would not be correct.
- ¶ 8: "Moreover, where there is a high degree of uncertainty for each of the parties in relation to a transaction, for example in transactions involving the shared assumption of economically significant risks by all parties, the flexibility of the transactional profit split method can allow for the determination of arm's length profits for each party that vary with the actual outcomes of risks associated with this transaction." This statement is clearly discussing the application of TPS to actual profits and that should be clearly stated. Furthermore, the presentation of a situation where all parties share the assumption of economically significant risk as an "example" of conditions yielding appropriate application of TPS to actual profits might lead readers to believe that such a condition is sufficient, but not necessary. This condition is the only condition in which TPS should be applied to actual profits. This type of application appropriately derives from and only from the joint sharing of risks by multiple parties to the transaction.
- ¶ 13: "The existence of unique and valuable contributions by each party to the controlled transaction is perhaps the clearest indicator that a transactional profit split may be appropriate….Depending on the facts of the case, other indicators could include a high level of integration in the business operations to which the transaction relate and the shared assumption of closely related economically significant risks….by the parties to the transactions. It is important to note that the indicators are not mutually exclusive and on the contrary may be found together in a single case" (emphasis added by author). This paragraph talks about TPS singularly, but the conditions referenced yield different TPS applications – the first would be to anticipated profits, the second to actual profits. Furthermore, while these conditions

need not be mutually exclusive, they also need not be highly correlated – a point that isn't as clear as it should be in the draft guidance.

- ¶ 37: [In reference to a one-sided method which establishes the value of one parties non-routine contributions through reference to residual profits after the routine contributions are benchmarked] "[The benchmarked routine profits] would generally not account for the return that would be generated by a second category of contribution which may be unique and valuable and/or are attributable to a high level of integration." This makes integration sound like it is on similar footing as the presence of a second party making non-routine contributions as it relates to the appropriate application of the TPS. It leads the reader to believe that high levels of integration (and the risk sharing that might come as a result of that) might lead to the same type of (expected) return as ownership of a non-routine contribution. This is misleading, as these two types of conditions yield two (different) types of TPS applications – one to actual profits, the other to anticipated profits.
- Some of the examples are also unclear on the distinction:
    - In examples 1, 2, and 5, two affiliated companies are determined to both be making valuable and unique contributions. The example concludes that the TPS is likely to be the most appropriate method, but makes no mention as to whether it should be applied to anticipated or actual profits. Sufficient information is not provided in the example as to whether the application to actual profits would be appropriate, because no information is discussed about the sharing of risks under the accurately delineated transaction.
    - In example 3, two parties make what appear to be valuable non-routine contributions. Unlike examples 1, 2 and 5, which mention absolutely nothing about whether or not the parties involved jointly bear risk, example 3 explicitly states that the parties to the transaction bear closely interrelated risks. Under these circumstances, the example concludes that the TPS is likely to be the most appropriate method. Again, it is not clear whether the example is advocating the application of TPS to anticipated profits or actual profits. In fact, the conclusion of example 3 is ultimately the same as the conclusion from examples 1 and 2 – the TPS should be applied. The reader is left to guess as to why the discussion of risk is included in example 3, but not in examples 1, 2 and 5 when the conclusions appear to be so similar. The guidance on the application of TPS would less ambiguous if these examples were expanded so that each included a discussion of whether or not the parties were jointly bearing risk, and were clearer on whether the TPS were being applied to anticipated or actual profits (and the reasoning for such application).

Lastly, in order to make the distinction between the two types of TPS clearer, it would be helpful to have an example where a TPS is appropriately applied to anticipated profits to set prices, but where those prices are not adjusted based on actual outcomes because the parties are not jointly sharing risks.

Regarding Profit Splitting Factors

The existing draft guidance does a good job of setting forth the framework for determining how profits should be split when the TPS is applied.[3] Paragraph 34 correctly states that the TPS "seeks to split the relevant profits from controlled transactions on an economically valid basis." In this statement, I take "economically valid basis" to mean "in a manner that is consistent with the arm's length principle." The draft guidance further correctly notes that "arm's length parties can be assumed to split profits on the basis of their relative contributions to the creation of those profits."[4]

Investment Drives Profit

With that, it is important to step back and think about what creates contribution to profit, and, more specifically, what creates contribution to accounting profits. Accounting profits fundamentally measure the difference between revenues and expenses, where expenses represent, in total, payments made to the various factors of production.[5] Labor, for instance, is paid wages (and benefits), but does not participate further in the accounting profits once those wages are paid.[6] Once all of the factors of production have been paid, and once the relevant taxes have been paid on income, whatever is left is for the benefit of capital providers only.[7] Profits accrue to those investors as a reward to the capital that has been put at risk.

As an illustrative example, suppose two investors form a joint venture and then use the funds to hire a worker. This worker is the only resource required to produce the joint venture's product. The worker will be paid whatever the market dictates. The payment may even be larger than revenues in the early years (or indeed over the long term if the venture proves to be unsuccessful). In any case, even over the long term it may be a very large portion of the

---

[3] For purposes of this section of the commentary, I am addressing only profit split factors for purposes of applying the TPS to anticipated profits. The determination of factors to be used to split actual profits would depend on the nature of the risk sharing between the parties. If the parties are sharing substantially all risks, it may be reasonable to think that the factors one would use to split actual profits might be similar to those that would be appropriate on a anticipated basis. If risk sharing is more limited, the nature of the profit split may be different, and could result in an more restricted measure of the profits that are to be split (as seems to be anticipated in paragraphs 47 through 49 of the draft guidance) or could require an adjustment to the ex-ante profit split mechanism that more appropriately addresses the nature of risk allocations under the accurately delineated transaction.

[4] Draft guidance, paragraph 54.

[5] This broad statement ignores timing differences between cash revenue and expense recognition and the recognition of the same for accounting purposes on an accrual basis, but the point that derives from the observation is still nonetheless generally true with respect to accounting profits under IFRS and other financial reporting principles.

[6] There are, of course, situations where labor takes some form of equity-based compensation as part of its pay package, but such a situation is most appropriately thought of as the aggregation of two transactions (the first where labor is paid, the second where labor uses some portion of that payment to invest in the company), rather than as a circumstance where labor makes a direct claim on profits.

[7] The accounting income that remains for capital providers would be for the benefit of debt and equity holders. Once interest is paid, the remaining profits would be for the benefit of equity capital holders only. For ease of exposition, capital will refer to equity capital for the remainder of this discussion.

revenue if that worker's skill set gives him or her a large amount of negotiating power with the investors. Accounting profits in this joint venture will be equal to the revenues the joint venture collects, less the payments it makes to this worker, and less any taxes due. The two capital investors will split these profits – the worker will not share in them.

Consequently, the only reasonable conclusion is that, at arm's length, capital investment is what creates profit. It is important to understand that, in making this statement, I am not saying that labor and other factors of production aren't valuable. Rather, I am saying that accounting profits represent what remains after those contributions have been compensated at market prices, and splitting accounting profits under the arm's length principal needs to stay cognizant of that fact.

Given this, the only profit split factors that will comply with the arm's length principal will be those that measure the relative value of the contributions to accounting profits made by the assets that have been created through investment. If this fundamental point is not clear, one can easily see how one might misapply profit splits because of a belief that the factors of production are in and of themselves valuable to creating the output of the company, even if though they are not the fundamental drivers of accounting profits.

Capital employed, headcount, and any other potential metrics for use as profit split factors needs to be evaluated against the platonic ideal – any appropriate profit split measure would meaningfully measure the relative value of contributions made to accounting profits by the assets contributed by the parties which are being exploited in the transaction being analyzed.

Headcount or Other Measures of Labor as a Profit Split Factor

The draft guidance asks whether headcount should be included as a potential profit splitting factor and, if so, in what circumstances. As discussed above, labor is not a direct claimant on (or contributor to) accounting profit. An established workforce certainly can be a valuable asset, but labor-based measures will only be meaningful to the extent that they proxy for the relative value of the assets being exploited in the transaction. Circumstances where this might exist include:

- Some specific segment of the workforce (and/or attributes that directly attach to that workforce, like customer relationships that are specific to individuals rather than the corporation more generally) represents the entire non-routine contribution to the business. In this instance, relative headcounts (or relative salary and benefits, or some similar labor-based measure) for an appropriately identified group of personnel could proxy for the relative value of the significant non-routine contributions of the transactions. These types of circumstances might be most likely to exist in businesses which are primarily service providers that rely primarily on the expertise and relationships of (some or all of) their personnel and do not, to a significant extent, rely on other types of intangibles that exist separate and apart from those personnel; or

- Circumstances where there are material contributing assets separate and apart from personnel, but where current labor-based measures are still good proxies for the relative value of the investments. This might be more likely to be the case where both parties had personnel making similarly valuable contributions to these other assets over similar periods of time so that a (hypothetically constructed) measure of relative total investment in such intangibles would not be expected to yield a result that's materially different from that derived from "snapshot" labor-based metrics like headcount or compensation. This point is not completely distinct from a point already incorporated into the draft guidance in paragraphs 66 through 68, which discusses the considerations that would inform the use of cost-based measures more generally. Those paragraphs recognize that if different types of assets are being contributed by the parties, or if the timing of expenditures made by the parties are different, cost-based measures may lead to inappropriate profit split factors. This same logic applies to people-based measures which are a special case of cost-based factors. It means that if different parties are contributing different types of assets (for instance, a highly unique and valuable workforce by one party, and a routine workforce and intellectual property by the other), a labor-based measure would necessarily be inappropriate because you'd be comparing a version of costs for different types of contributions.

Outside of these circumstances, the use of labor-based metrics in profit split applications would likely yield outcomes that are inconsistent with the arm's length principal.

Capital Employed as a Profit Split Factor

The draft guidance also asks whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained and, if so, under what circumstances. The current guidance mentions that "capital-based profit splitting 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."[8]

This type of measure has the potential for alignment with the platonic ideal as it would, under the right set of circumstances, capture relative investment which may, under the right circumstances, proxy for the value of relative contributions. To be clear, as stated earlier on in this commentary, the relative value of the assets derived from capital investment should ultimately be ***the*** consideration that would drive profit splits on an anticipated basis. There are, however, many potential issues with this measure because accounting measures of capital employed do not serve as a good proxy for such values, even on a relative basis.

One major problem is that accounting measures of capital employed depend on the accounting system's treatment of investments in intangibles. Under US GAAP, for example, most intangible investments that are made internally are expensed as incurred. Once such investments have been made, they reduce shareholder equity, and have no further impact on

[8] Draft guidance, paragraph 64.

the company's balance sheet. For this reason, accounting measures of capital employed would not capture internally made intangible investments that under US GAAP, and would not give a meaningful measure of relative contributions for companies where value is heavily driven by such investments.[9] Given the wide breadth of intangibles that share this type of treatment, it seems unlikely that accounting measures of capital employed would ever meaningfully capture the value of contributions under this type of accounting regime. Other commonly used accounting systems (such as IFRS), while not identical, feature largely similar treatment of intangible investments and would suffer from these and other shortcomings

Even when capitalized, accounting measures of capital employed are fundamentally cost-driven, and are subject to the same potential pitfalls that are discussed with respect to cost-based measures in paragraphs 66-68. Parties that make investments in different types of intangible investments might, all else equal, have similar measures of capital employed, even if one party's intangibles prove to be considerably more important to the success of the business than the others. Additionally, accounting measures of capital employed don't reflect important differences that may derive from the timing of investments other than those that are driven by the application of mechanistic depreciation and amortization algorithms.

Given that accounting measures of capital employed are simply a different form of cost-based metrics (and given that other productive guidance is offered on cost-based metrics generally), and given the likelihood of measurement issues associated with this measure, it is likely the case that accounting measures of capital employed would serve as a useful potential metric only in a very limited set of circumstances. These would namely be circumstances where cost-based measures would be expected to be useful under the existing draft guidance and where accounting measures of capital employed meaningfully capture the relevant costs associated with the investments that have been made. Therefore, the reference to capital employed could likely be struck without making the guidance materially less helpful.

****

Thank you for the opportunity to provide commentary on this discussion draft as the OECD continues its important work.

I am happy to discuss the comments made in this paper in more detail. Please contact me at Mark.Bronson@DuffandPhelps.com for more information.

---

[9] Acquired intangibles, on the other hand, are recognized on the balance sheet based on the values established through a purchase price allocation analysis and amortized over their identified useful life. This inconsistency in the treatment of internally developed vs. acquired intangibles would yield further challenges to the reliability of any profit split factor based on accounting measures of capital.

MDW CONSULTING INC.
TRANSFER PRICING EXPERTS

7 September 2017

Mr. Jefferson VanderWolk
Head of the Tax Treaty, Transfer Pricing & Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation and Development
2, rue André Pascal
75775 Paris Cedex 16
France

Re: Discussion Draft, Revised Guidance on Profit Splits, issued 22 June 2017

Dear Mr. VanderWolk,

Thank you for considering my comments in response to the 2016 Discussion Draft on profit splits and, where you agreed, revising the guidance in the 2017 Discussion Draft on profit splits.

The chart below shows the guidance on profit splits has increased significantly with each revision of the OECD Guidelines in 1995 and 2010 followed by the Discussion Drafts, Public Comments and Public Discussions held in 2015, 2016 and 2017, which should help the member countries reach a consensus view on profit splits prior to revising the OECD Guidelines in 2018.

Number of paragraphs in the OECD Guidelines on Profit Splits	1979 OECD Guidelines	1995 OECD Guidelines	2010 OECD Guidelines	2016 D. Draft	2017 D. Draft
In general	-	1	1	10	2
Most appropriate method	-	5	6	17	28
Guidance for application	-	15	31	30	38
Annex - examples	-	-	-	-	46
Total	-	21	38	57	114

Although the profit split is not widely used in Canada and other countries[1], its time is coming, with a growing body of knowledge provided by the OECD intended for greater and more frequent use.

Attached are my comments in response to the 2017 Discussion Draft on profit splits. I have good experience in using profit splits and welcome the opportunity to discuss this further during the public discussions on profit splits to be held at the OECD conference center in Paris later this year.

[1] The MAP Program Report published by the Canada Revenue Agency shows that, of all the transfer pricing methods used during the resolution of double taxation between Canada and opposing countries, the profit split was used only 4 of 100 times in 2014-15, 3 of 73 in 2013-14, and 2 of 92 in 2012-13.

100 King Street West, Suite 5700, Toronto, ON, M5X 1C7
P: 416.737.2276 | WWW.TRANSFERPRICINGSERVICES.CA

In brief, I am a Chartered Professional Accountant (CPA, CA) and Chartered Business Valuator (CBV) who specializes in transfer pricing since 1996, an expert witness in the Tax Court of Canada, and founder of MDW Consulting Inc., an independent firm that specializes in transfer pricing.

My comments follow the structure of the 2017 Discussion Draft as follows: Page

My comments also respond to the OECD's specific questions on: Page

I look forward to the public discussion on the transactional profit split method.

Sincerely,

Matthew Wall CPA, CA, CBV

Cc: Tomas Balco, Head of the Transfer Pricing Unit
Michael McDonald, Chair of Working Party No. 6

General

[Paras. 1-2]

Consider using the following four steps (not two) for applying the profit split method to be consistent with the OECD's focus on "aligning transfer pricing outcomes with value creation".

1. [New] Facts and circumstances for selecting the profit split as the most appropriate method.

   This step is not mentioned in paras. 1-2, but guidance is provided in paras. 3-30.

2. [New] Identify all of the related parties that should participate in the profit split method.

   This step begins by identifying all of the related parties involved in the supply chain for the research, development, manufacture, delivery, sale and support of a good or service.

   Next, identify the related parties that make significant contributions to "value creation", and include them in sharing the profits of the controlled transactions.

   Finally, identify the related parties that only make "routine" contributions, and exclude them from sharing the profits of the controlled transactions.

   It will be very important to document the facts and circumstances of the related parties in the supply chain and the reasons for including or excluding them from Steps 3 and 4 below.

3. Identify the profits to be split from the controlled transactions.

   This step is introduced in paras. 1-2 with further guidance in paras. 39-50.

4. Split the profits between the related parties on an economically valid basis.

   This step is introduced in paras. 1-2 with further guidance in paras. 51-68.

The most appropriate method [Paras. 3-30]

Rather than stating para. 30 as a conclusion, please move it to the top of this section, somewhere near paras. 3-5, since para. 30 clearly states the fundamental principles that apply for this method.

> 3. ~~30.~~ This section ~~has~~ describes~~d~~ certain characteristics of the transactional profit split method and provides~~d~~ a number of potential indicators as to when it may be found to be the most appropriate method as well as a number of factors which may point in the opposite direction. The guidance in this regard does not seek to be comprehensive, nor is it prescriptive. The presence or absence of one or more of the indicators described in this section will not necessarily lead to the conclusion that the transactional profit split will (or will not) be the most appropriate method in a particular case. Each case needs to be analysed on its own facts, and it will be important to consider the relative merits and shortcomings of available transfer pricing methods.

In this context, the significant length of the 2017 Discussion Draft (e.g., 114 paras.) helps explain these principles to overcome the complexity of this subject without imposing a rigid set of rules.

Paras. 3-30 of the 2017 Discussion Draft uses the profit split method as the most appropriate method when, for example, there are no reliable comparable uncontrolled transactions, and the facts and circumstances establish two or more related parties of the controlled transactions have one or more of the following: make unique and valuable contributions; own unique and valuable intangibles; have highly integrated operations; and/or, share "economically significant risks".

I am most concerned with the two phrases "unique and valuable contributions" and "economically significant risks" for reasons already explained in my comments on the 2016 Discussion Draft.

For example, the 2016 and 2017 Discussion Draft diminishes the original meaning and purpose by providing economic benefits for those making "unique and valuable contributions" to intangibles on the same or similar basis as the legal rights for those owning "unique and valuable intangibles."

Further, the application of "economically significant risks" based on the facts and circumstances can easily lead to very different interpretations, as shown in *Transalta Corporation v. The Queen [2010 TCC 375]*, which was ultimately decided by the tax court in favour of the taxpayer.

Respectfully, these phrases are used extensively, are not clearly defined, and can be subjective. Please see my comments on pages 8 and 9 regarding these phrases when used in Examples 1-10.

Guidance for application – in general [Paras. 31-38]

Thank you for clearly stating and reinforcing the fundamental principles at the top of this section.

Para. 31 confirms the draft guidance is not intended to be prescriptive, not a rigid set of rules.

> 31. These Guidelines do not seek to provide an exhaustive catalogue of ways in which the transactional profit split method may be applied …

Para. 31 clearly states that the draft guidance depends on the facts and circumstances.

> 31. … Application of the method will depend on the facts and circumstances of the case and the information available …

Para. 31 confirms the overriding objective is the same or similar as the arm's length principle.

> 31. … 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.

In this context, the significant length of the 2017 Discussion Draft (e.g., 114 paras.) helps explain these principles to overcome the complexity of this subject without imposing a rigid set of rules.

Guidance for application – determining the profits to be split [39-50]

Question 1 asks for comments on "the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used."

This is a complex issue that is heavily dependent on the facts and circumstances in each case.

The 2017 Discussion Draft has been careful to avoid overly prescriptive remedies for when to use the anticipated profits, and when to use actual profits, while at the same time providing draft guidance and examples that illustrate the facts and circumstances that lead to one or the other.

For example, paras. 27 and 44 uses actual profits if related parties share "economically significant risks", while para. 45 uses anticipated profits if they do not share "economically significant risks".

Example 9 illustrates which profits to split depending on the "economically significant risks."

However, sharing "economically significant risks" is not a stand-alone factor, it usually stems from and/or is the result of other facts and circumstances – e.g., when related parties make unique and valuable contributions, own unique and valuable intangibles, and/or are highly integrated.

For example, the 2017 Discussion Draft provides the following illustrations:

a) If the related parties "make unique and valuable contributions", they are less likely to share economically significant risks, and should use anticipated profits based on para. 45.

b) If the related parties "own unique and valuable intangibles", they are more likely to share economically significant risks, and might use actual profits based on paras. 17, 27, 49.

c) If the related parties are "highly integrated", they are more likely to share economically significant risks, and might use actual profits based on paras. 19, 44.

However, the above illustrations of the 2017 Discussion Draft are not conclusive since the other type of profit might be used in (a), (b) and (c) under a different set of facts and circumstances.

Further, there are more complex examples involving more than two related parties whereby, for example, one related party resembles (a) above, another resembles (b) and quite possibly a third resembles (c) above. What then, which profit should be used, the anticipated profit or actual profit?

Practitioners should always be cautious when using these illustrations, remembering to observe the fundamental principles – e.g., these guidelines are not prescriptive, application of the profit split depends on the facts and circumstances in each case, and the overriding objective should closely approximate the split of profits that would have been realised between independent enterprises.

Guidance for application – splitting the profits [Paras. 51-68]

Question 2 asks for comments on the profit splitting factors mentioned below.

Capital or capital employed

The current guidance for capital or capital employed[2] in paras. 36, 56 and 64 should be retained since it can be relevant and reliable depending on the industry, business or transaction.

Care should be taken since capital or capital employed can be a "blunt instrument" for splitting profits. Although it can be reliably measured, unless there is a strong correlation between it and the creation of value represented by the relevant profits, using capital or capital employed for splitting profits could unfairly skew the outcome towards one or more related parties and away from others.

Headcount of similarly skilled and competent employees

The current guidance for employees in paras. 57, 62 and 66 should be retained.

Care should be taken when selecting employees based on headcount, position, compensation, or some combination as a profit splitting factor. Some level of sensitivity analysis is recommended to mitigate the risk of unfair bias that skews the outcome towards one or more related parties.

Further, inquiries should be made to identify employees and independent contractors, since the sum of these represents all of the personnel that might be contributing to "value creation." This is more common in certain industries and might identify comparable uncontrolled transactions to consider.

Purchasing power parity

For good reasons, the 2017 Discussion Draft does not address purchasing power parity.[3]

"Empirical evidence has shown that for many goods and baskets of goods, purchasing power parity is not observed in the short-term, and there is uncertainty over whether it applies in the long-term. In "Burgernomics," (2003) a prominent paper … authors Michael Pakko and Patricia Pollard cite several confounding factors as to why purchasing power parity theory does not line up with reality."[4]

---

[2] Investopedia defines capital employed as the total amount of capital used for the acquisition of profits. It is the value of all the assets employed in a business and can be calculated by adding fixed assets to working capital or subtracting current liabilities from total assets. By employing capital, you make an investment.

[3] Investopedia defines purchasing power parity as an economic theory that compares different countries' currencies through a market "basket of goods" approach. Two currencies are in equilibrium or at par when a market basket of goods (taking into account the exchange rate) is priced the same in both countries.

[4] ñWhat is Purchasing Power Parity?ò, *Investopedia,* www.investopedia.com, 31 Aug 2017.

Other profit splitting factors

Para. 57 of the 2017 Discussion Draft identifies other profit splitting factors.

Although Question 2(d) asks for additional examples, they may not be needed, since the guidance does not seek to provide an exhaustive catalogue of ways for using the profit split method.

Annex I – Examples [Paras. 69-114]

Examples 1-4 for unique and valuable contributions

It is questionable whether (or not) the profit split method should be applied in Examples 1-4.

Example 1 implies – without stating – Co S made "unique and valuable contributions" by performing clinical trials of a pharmaceutical product that was researched, developed and patented by Co A. It fails to mention – and assumes – there are no comparable uncontrolled transactions, and Co S shares economically significant risks, which might not be true for this industry and transaction.

The difficulty with Example 2 is that it fails to mention the history of the organization including, for example: (i) whether (or not) B Co acquired or developed the land, people and processes in use by A Co; (ii) the level of management, oversight and involvement B Co has in the operations of A Co; and, (iii) whether (or not) A Co shares in the economically significant risks born by B Co.

The extra details in Example 3 are helpful. However, paras. 77-80 could be interpreted to characterize Co A as a "full-fledged manufacturer" and/or Co B as a "full-fledged distributor", independent and separate from one another, which can be examined using another method. It is not until para. 81 states Co B bears economically significant risks, and para. 82 implies Co B is highly integrated with Co A, that the profit split method is "likely to be the most appropriate method."

Example 4 has the same facts as in Example 3, except "the marketing activities performed by Co B are more limited" and the "risks assumed by Co B are not economically significant", therefore concluding "the most appropriate method … can be determined using a one-sided method."

There are subtle differences between Examples 3 vs 4 that can lead to different interpretations of the facts, circumstances, delineation of the actual transaction between the associated enterprises, and ultimately the selection (or rejection) of the profit split as the most appropriate method.

Despite best efforts, Examples 1-4 fails to distinguish the general set of facts that do (or do not) result in "unique and valuable contributions" that do (or do not) "share economically significant risks" and do (or do not) support using the profit split method as the "most appropriate method."

Example 5 for unique and valuable intangibles

Example 5 fails to illustrate the guidance in paras. 17 and 18 for unique and valuable intangibles.

Apart from stating the web crawler was designed by WebCo and scaled-up by ScaleCo, Example 5 does not mention how this involves intangibles, partially developed intangibles, or hard-to-value intangibles. Instead, para. 88 concludes "WebCo's and ScaleCo's contributions are unique and valuable", which is subject to interpretation and provides less certainty and support for using the profit split method if, for example, "each party … legally owns unique and valuable intangibles".

Examples 6 and 7 for highly integrated business operations

Example 6 fails to illustrate the guidance in para. 19 since Co A and Co B are not highly integrated business operations and, as a result, the profit split is not the most appropriate method.

Example 7 provides an example for highly integrated business operations, but since it involves the global trading of financial instruments, it might not readily apply for other industries.

Other examples

Example 8 provides a brief illustration of the contribution analysis, which is rarely (if ever) used.

Example 9 explains Co A is the parent company and Co B performs "innovative marketing activities" deemed to be a "unique and valuable contribution". Scenario 1 splits the anticipated profits, while Scenario 2 splits the actual profits, based on "economically significant risks."

Example 10 raises the question, if Co A manufactures auto parts that are used by Co B to manufacture and sell an automobile, should Co A share in the profits earned by Co B?

Practitioners should always be cautious when using these illustrations, remembering to observe the fundamental principles – e.g., these guidelines are not prescriptive, application of the profit split depends on the facts and circumstances in each case, and the overriding objective should closely approximate the split of profits that would have been realised between independent enterprises.

Although Question 3 asks for additional examples, they may not be needed, since the guidance does not seek to provide an exhaustive catalogue of ways for using the profit split method.

September 13, 2017

Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration
Attn. Mr. Jefferson VanderWolk
Head, Tax Treaties, Transfer Pricing, and Financial Transactions Division
2, Rue André Pascal
75775 Paris, France

Re: Comments on Discussion Draft on BEPS Action 10: Revised Guidance on Profit Splits (2017)

Dear Mr. VanderWolk:

The National Foreign Trade Council (the "NFTC") is pleased to provide written comments on the Discussion Draft on BEPS Action 10: Revised Guidance on Profit Splits, published June 22, 2017 (the "Discussion Draft").

The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations, and we appreciate the opportunity to comment on this important project. A list of the companies comprising the NFTC's Board of Directors is attached as an Appendix.

This letter is divided into two parts. The first part provides general comments and observations regarding the Discussion Draft. The second part provides responses to the questions for commentators in the Discussion Draft.

General Comments

Changes from the 2016 Discussion Draft. The NFTC believes that some of the changes from the July 2016 Discussion Draft improve and clarify the guidance. These changes include the deletion of references to a value chain analysis, which is appropriate given that the value chain analysis is only a tool in the accurate delineation of transactions, a topic fully addressed in Chapter 1. The NFTC also supports the deletion of the introductory language in the July 2016 Discussion Draft related to splits of actual profits vs. anticipated profits, and the more

appropriate discussion of that issue in section C.4 (Guidance for application – Determining the profits to be split). As noted below, however, we do not agree with changes that appear to expand the scope of cases in which it would be appropriate to consider the transactional profit split method.

Strengths and weaknesses of the transactional profit split method. In general, we believe that the strengths of the transactional profit split method ("TPSM"), relative to other transfer pricing methods, are well stated in paragraph 6 of the Discussion Draft: the TPSM can offer a solution for cases in which both parties to a transaction make unique and valuable contributions to the transaction, such that there is no reliable data from comparable transactions that can be used to directly evaluate the price of the transaction. Even in such a case, tax administrations must consider whether other methods can provide a more reliable result – a lack of close comparables should not result in an automatic application of the TPSM. Moreover, the methodology used to split the profits may be based on data from comparables. We do not believe that paragraphs 7, 8, or 9 are strictly necessary as they do not identify strengths beyond that identified in paragraph 6 and therefore should not be offered as incremental or additive strengths of the TPSM. For example, to the extent a one-sided method is inappropriate for evaluating highly integrated operations, the method is inappropriate because both parties make unique and valuable contributions such that there is no reliable data from comparable transactions that can be used to evaluate the price of the transaction.

In general, we believe that the weaknesses of the TPSM are understated, especially with regard to its application during a retrospective examination. A reliable application of the TPSM requires particular financial data. A profit split of anticipated profits requires forecasts of anticipated profit from the transaction being evaluated, while a profit split of actual profits requires a determination of the actual profits from the transactions being evaluated. In many contexts, such financial data will not be prepared or maintained in the normal course of business. A "transaction" for transfer pricing purposes typically is not an accounting unit. If associated enterprises choose to apply a TPSM, they can prepare and maintain appropriate financial data to facilitate its appropriate application; in such a case, a tax administration can evaluate that financial data and determine whether the TPSM was appropriately selected and applied. Where this is not the case, and where relevant financial data is not otherwise maintained, it will be difficult or impossible for a tax administration (or an associated enterprise) to reliably apply the TPSM on a retrospective basis. For example, in the case of a regional manufacturer that supplies products to several local country distributors, it may not be possible to accurately determine the profits of the manufacturer attributable to products sold to any one distributor (any such determination would likely rely on highly subjective simplifying assumptions, such as assumptions regarding the appropriate allocation of operating expenses). While the Discussion Draft acknowledges these difficulties in the guidance on how to apply the TPSM (see in particular paragraphs 60 and 61), it is important to acknowledge that these difficulties affect the reliability and practicality of the TPSM and therefore play a role in evaluating whether to apply the TPSM. We recommend more clearly articulating the difficulty in reliably applying a TPSM on a retrospective basis in paragraph 10 or a new paragraph following it.

Nature of the transaction. The NFTC strongly agrees with the statement in paragraph 13 of the Discussion Draft that the "existence of unique and valuable contributions by each party to the controlled transaction is perhaps the clearest indicator that a transactional profit split may be

appropriate." Another factor identified in paragraph 13 is a high level of integration in the business operations to which the transactions relate. In describing the level of integration required, we recommend the insertion of an explicit statement in paragraph 13 or paragraphs 19-22 that the common ownership and common overall management of two enterprises is not the same as a close integration of the business activities of these enterprises. Moreover, high levels of integration are common to many business arrangements and therefore should not be an independent factor favoring the TPSM. Rather, a high level of integration is one of many factors to be considered in the accurate delineation of the transaction and the selection of the most appropriate method. For example, it is possible for an enterprise to engage third party manufacturers to use their highly integrated supply chains to produce complex devices. To the extent these third party manufacturers are not compensated with a profit split, their existence creates comparables that can be used to evaluate similar transactions between affiliated enterprises. Finally, we recommend stating in paragraph 13 that a TPSM is likely to be more appropriate than other methods only if there is sufficient and reliable financial data to determine the anticipated profits or actual profits from the transactions being evaluated.

Paragraph 14 provides that where one party to the transaction performs only simple functions, does not assume relevant economically significant risks, and does not otherwise make any unique and valuable contributions, a TPSM "typically would not be appropriate." Further, the lack of information on closely comparable transactions "should not per se lead to a conclusion to that the TPSM is the most appropriate method." The NFTC believes that this language is far too equivocal. An application of the TPSM to a party that does not make unique or valuable contributions or assume relevant economically significant risks will not produce results that reflect the transaction undertaken. The use of another method, such as the transactional net margin method, will almost certainly reach more reliable results even if the comparables data is inexact and requires adjustment. We recommend more definitive language to stress this point.

Paragraph 24 is the last paragraph of section C.2.2.3, which illustrates cases in which the parties have highly integrated operations. Paragraph 24 addresses a case where one party contributes to the control of economically significant risk that is assumed by the other party to the transaction. Implicitly, that other party also contributes to the control of the economically significant risk and has the financial capacity to bear the risk. Under paragraph 1.94 of the transfer pricing guidelines, that other party is entitled to the potential upside and downside from the realization of the risks assumed. The first party, which contributes to the control of risk, should be appropriately compensated for its risk management functions. See paragraph 1.105. Paragraph 24 states that the performance of risk management functions by the first party "may, in some cases, demonstrate that it is appropriate for the first party to share in the upside or downside associated with that risk." While we understand that there may not be complete consensus regarding the interpretation of paragraphs 1.94 and 1.105, we interpret them to provide that the "usual" case in which a party becomes entitled to the potential upside and downside from risk is for that party to assume or be allocated such risk under the general rules of Chapter 1. Absent additional or exceptional facts and circumstances (e.g., a contingent payment arrangement provided by contract), a party that merely contributes to the control of economically significant risk would be entitled to compensation for its services, which would not result in the realization of upside or downside from the risk at issue. Risk exists in all business transactions, and so shared control over risk should not be an independent factor favoring a split of profits realized from such risk; rather, shared control over risk is one of many factors to be considered in the

accurate delineation of the transaction and the selection of the most appropriate method. The result in paragraph 24 therefore seems inconsistent with paragraphs 1.94 and 1.105. Moreover, unlike the other paragraphs in section C.2.2.3, paragraph 24 does not illustrate a case in which the parties have highly integrated operations; rather, it illustrates a case in which one party performs risk management services for the benefit of another party. Accordingly, we strongly recommend deleting paragraph 24.

Guidance for application - in general. Section C.3.1 of the Discussion Draft sets out two approaches to splitting profits: a contribution analysis and a residual analysis. Under the contribution analysis, relevant profits are divided on the basis of the relative value of the contributions by the parties to the transaction. While the Discussion Draft notes that the division can be supported by external data where available, it allows use of "information internal to the MNE group" in the absence of such data. A contribution analysis that relies solely on information "internal to the MNE group" to determine a split of profits raises the specter of formulary apportionment, or the division of profits on the basis of factors that may or may not bear on the results achieved by independent enterprises under comparable circumstances. Under the arm's length principle, transfer pricing analysis must be based on information that shows either how independent enterprises actually price transactions or, in the absence of such information, on how they would price transactions in comparable circumstances. Typically such an analysis should rely, at least in part, on some external data. Where no external data regarding the division of profits is available, then the residual analysis would tend to produce a more reliable result because at least some of the profits will be allocated on the basis of external benchmarks under step one of that analysis. If only internal data is available, its relevance to establishing transfer pricing should be tied to how independent enterprises would price transactions in comparable circumstances. Accordingly, even if only internal data is available, the method and factors used to split the profits should be determined by reference to external information. We recommend clarifying paragraphs 35 and 36 by (1) referencing information internal to the MNE group only to the extent such information provides evidence of how independent enterprises would have divided relevant profits, and (2) stating explicitly that if there is no reliable evidence of how independent parties would have divided the relevant profits, the residual analysis likely will be more appropriate.

Examples. The NFTC appreciates the effort to illustrate the guidance through examples. In general, however, the NFTC believes that it is difficult to develop examples that illustrate the process for determining whether a TPSM is an appropriate method that can be reliably applied. We recommend providing more examples that illustrate cases in which the TPSM is not appropriate, perhaps as a result of key changes to the facts of examples in which the TPSM is an appropriate method (Examples 3 and 4 are helpful in this regard). If additional examples are considered, we recommend an example demonstrating that the retrospective application of the TPSM in the context of a tax examination is not appropriate because the financial data to reliably apply such a method (e.g., relevant profit related to the transaction being evaluated) was not prepared or maintained in the ordinary course of business and it would not be practicable to construct such data.

Responses to Specific Questions for Commentators

1. The discussion draft addresses situations in which profit splits of anticipated profits or profit splits of actual profits are appropriate. Where it is established that the transactional profit split is the most appropriate method, please comment on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used.

The NFTC agrees with the statement in paragraph 43 that the determination of whether the profits to be split are actual profits or anticipated profits should be aligned with the transaction as accurately delineated. The TPSM can be the most appropriate method in cases in which both parties to a transaction make unique and valuable contributions, such that there is no reliable data from comparable transactions that can be used to evaluate the price of the transaction. In such circumstances, and in general, a profit split of actual profits is appropriate only where there is a high level of integration of activities, including activities related to the control and management of the economically significant risks associated with the transaction, such that parties would be willing to share those risks. This is reflected in paragraph 44. In addition, a profit split of actual profits is practical only where it is possible to reliably determine the actual profits from the transactions being evaluated. This may not be possible in the case of a retrospective application of the TPSM in an examination. The NFTC recommends that this practical observation should be reflected in paragraph 44 as it represents a practical bar to applying the TPSM in many cases.

A profit split of anticipated profits should be considered in other cases where the parties of a transaction make unique and valuable contributions, consistent with paragraph 45. We note that in practice the results of a profit split of anticipated profits may not differ significantly from the results derived under other methods, for example, an application of the CUP method or the TNMM to a license of intangible property where the royalty to the licensor is evaluated using a forecast of cash flows of the licensee. The application of one of these other methods is likely to be simpler and therefore more appropriate.

2. A number of profit splitting factors are addressed in the discussion draft. Comments are particularly invited on:

> *a. Whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained, and if so, what factors need to be taken into account for its selection and application as a reliable profit splitting factor.*

The NFTC supports the use of capital as a profit splitting factor where there is a strong correlation between capital employed and the creation of value in the transaction at issue. Capital employed is a reflection of amounts that parties have put at risk.

It may not be possible, however, to observe relative capital employed, in particular when one or both parties have incurred expenses to develop intangibles. Asset-based factors that rely on balance sheet valuations also may not be reliable as balance sheets do not account for the value of intangibles in a consistent manner. A common method of allocating profits resulting from the exploitation of unique and valuable intangibles contributed by two parties to a transaction is to determine the relative value of the intangibles based on the capitalized intangible development costs incurred by each party. This approached is addressed generally beginning with paragraph 66, and can be applied in a manner that accounts for the factors identified in the Discussion Draft (e.g., differences in the risk profile and timing of expenses). It may be appropriate to acknowledge the relationship between these two categories of factors. A cost-based profit split factor may be appropriate because it serves as a proxy for an asset-based or capital-based factor to the extent the costs taken into account represent investments that can be capitalized into assets.

b. Should headcount of similarly skilled and competent employees be included as a potential profit splitting factor, and if so, in what circumstances would it be relevant?

In general, the NFTC believes that an allocation factor should result in a division of profits that would have been reflected in an agreement between independent enterprises in similar circumstances. The TPSM is appropriate only in cases where both parties make valuable and unique contributions and share control over significant economic risks. It is unlikely that relative headcount, alone or in combination with other factors, would result in a division of profits in such circumstances that is consistent with arm's length results. To the extent the parties to a transaction make contributions through the performance of services, it is likely that a method other than the TPSM would be appropriate because it is likely that data can be derived from the results of third parties that perform similar services. To the extent the contributions of both parties are unique and valuable and the TPSM is determined to be the most appropriate method, then other factors (e.g., relative payroll) would provide a more reliable result than headcount.

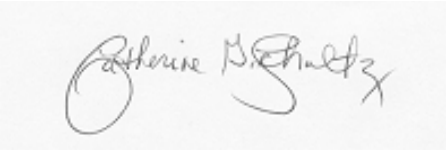
> *c. Given the existing guidance in Chapters I and IX of the Transfer Pricing Guidelines, should adjustments for purchasing power parity be made for profit splitting factor amounts, and if so, in what circumstances?*

The NFTC does not believe that adjustments for purchasing power parity ("PPP") should be considered for profit splitting factor amounts. International accounting standards require the use of exchange rates, and not PPP, to translate and equate the result of operations in different currency environments. The use of PPP as an alternative to exchange rates would require the redetermination of accounts, which would be burdensome and unnecessary.

> *d. What other profit splitting factors should be included in the guidance, and in what circumstances?*

The NFTC has not identified factors other than the general asset-based and cost-based factors described in the Discussion Draft.

Sincerely,



Catherine G. Schultz
Vice President for Tax Policy
National Foreign Trade Council
cschultz@nftc.org
202-887-0278 ext. 2023

Appendix

Appendix to NFTC Comments on BEPS Discussion Draft on Action 10: Revised Guidance on Profit Splits (2017)

NFTC Board Member Companies:
ABB Incorporated
Amazon
Amgen
Applied Materials
Baxter International Inc.
British American Tobacco
Cargill
Caterpillar Incorporated
Chevron Corporation
Cisco Systems
Coca-Cola Company
ConocoPhillips, Inc.
Corning
Deloitte & Touche
Dentons US LLP
DHL North America
eBay, Inc.
E.I., du Pont de Nemours & Co.
Ernst & Young
ExxonMobil Corporation
FCA US LLC
Federal Express
Fluor Corporation
Ford Motor Company
General Electric Company
Google, Inc.
Halliburton Company
Hanesbrands Inc.
Hewlett-Packard Company
HP Inc
IBM Corporation
Johnson Controls
KPMG LLP
Mars Incorporated
Mayer Brown LLP
McCormick & Company, Inc.
Microsoft Corporation
Mondelez International Inc.
Oracle Corporation

Pernod Ricard USA
PMI Global Services Inc.
PricewaterhouseCoopers LLP
Procter & Gamble
Qualcomm Incorporated
Siemens Corporation
TE Connectivity
Toyota Motor Sales, USA Incorporated
United Parcel Service, Inc.
United Technologies
Visa, Inc.
Walmart Stores, Inc.

NERA
ECONOMIC CONSULTING

NERA Economic Consulting
1 Rue Euler
75008 Paris
France
www.nera.com

Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA

VIA E-MAIL (TransferPricing@oecd.org)

September 15, 2017

DISCUSSION DRAFT ON THE REVISED GUIDANCE ON PROFIT SPLITS

Comments by Emmanuel Llinares, Harlow Higinbotham, Vladimir Starkov and Nihan Mert-Beydilli NERA Economic Consulting [1]

Dear Sir or Madam,

In the context of the BEPS Action Plan, Working Party No. 6 of the OECD has released on June 22, 2017 a discussion draft for public review (the "Discussion Draft") which includes revised guidance on profit splits. This Discussion Draft includes proposed amendments to Chapter II of the OECD Transfer Pricing Guidelines ("TPG").

The OECD has asked for comments and discussions on several issues that will be taken into account for the revisions to the relevant guidance in Chapter II of the TPG.

We thank you for the opportunity to provide comments on this Discussion Draft.

1. Introduction

We welcome the revised Discussion Draft of the OECD on profit splits. We appreciate that the draft includes recommendations that define the principles of a profit split analysis, without being prescriptive as to actual approaches to apply the method. This is important. We believe that prescriptive recommendations on how to apply the profit split method would likely lead to

[1] These comments represent independent views of the authors and do not necessarily reflect the views of NERA Economic Consulting

increased misuse of the method. Operating models of multinational enterprises are constantly evolving and it will be nearly impossible to predict what will be relevant a few years from now. In our opinion, a non-prescriptive guideline on the profit split method is the only way to ensure a sustainable interpretation of the arm's length principle in a complex area such as profit splits. In other words, the guidance needs to be clear on the principles and careful in their wording and application, and step away from implementation details, which are driven by the specific circumstances of each individual case.

In the rest of these Comments, we address the questions raised by the OECD in the order in which they were set forth in the Discussion Draft.

2. Comments on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used

2.1. General comments on the applicability of the method

One of the key features of the profit split method is that, unlike one-sided methods, it is typically applied without an external benchmark other than the combined profitability of the parties. Applying the method therefore requires a well-defined rationale for splitting the combined profits at arm's length as well as the ability to distinguish what the parties can be held responsible for in terms of relative contributions or other bases for determining the profit split.

Doing so will generally benefit from an analytical framework that relies at least in part on a value chain analysis. We note that the Discussion Draft seems to make reference to this approach in paragraph 13. We wish to emphasize that, in our opinion, the same concepts of value creation touched upon in paragraph 1.51 of the TPG and embedded in the analysis of intangibles in Chapter 6 (6.10, 6.49, 6.78, 6.133) are fully relevant here. A more explicit reference to paragraph 1.51 would be helpful in the context of this document. While the analysis of value creation is not a substitute for the determination of profit split factors, it provides important contextual information that helps best decide whether the method is appropriate in, and to provide insights on how it may be best be applied to, the circumstances of a case.

The Discussion Draft also points out in paragraph 28 that "a lack of comparables alone is insufficient to warrant the use of a transactional profit split." Further, in cases where relying on comparables is appropriate, but data on comparable benchmarks are scarce, the OECD encourages taxpayers (in paragraph 14 of the Discussion Draft) to rely on uncontrolled comparables even if they are imperfect rather than having recourse to the profit split method. We share this view and would add that in this context, adjustments to the comparables would likely be indicated. We believe that increased access to economic and financial data facilitates the application of adjustments in transfer pricing.

2.2. Specific comments on the factors that lead to select a split of anticipated or actual profits

At paragraphs 44 and 45, the Discussion Draft indicates that the distribution of risks between the parties should matter for the selection of anticipated or actual profit when applying the profit split method. Notably, paragraph 44 of the discussion draft reads: "*the splitting of actual profits […] would therefore only be appropriate where the accurate delineation of the transaction shows that the parties either share the assumption of the same economically significant risks associated with the business opportunity or separately assume closely related, economically significant risks associated with the business opportunity and consequently should share in the resulting profits or losses.*"

In relation to this, we are of the opinion that the analysis of whether or not parties actually share economically significant risks should be conducted in light of the revised Chapter I of the TPG, in the context of accurately delineated transactions. In this respect, the steps highlighted in paragraph 1.60 of the TPG should be relevant. The categorization of risks provided in Paragraph 1.72 of the TPG is particularly helpful as a starting point of the analysis. We believe that the Discussion Draft would benefit from making explicit reference to the framework already described in Chapter I of the TPG. In this context, difficulties may arise in relation to risks affecting all businesses undertaking an activity. In the context of a discussion of the control over risks, the TPG at paragraph 1.67 indicate that "*[s]ome risks cannot be influenced, and are a general condition of commercial activity affecting all businesses undertaking that activity. For example, risks associated with general economic conditions or commodity price cycles are typically beyond the scope of an MNE group to influence.*" The Discussion Draft is silent on these risks. An analysis in line with the guidance contained in Chapter I, including particularly an analysis of the roles of the related parties, their contribution to value creation, and the delineation of the transaction would inform a determination as to which entity or entities effectively assume such risks in the context of the application of the profit split method.

As a side note, it is worth keeping in mind that the Guidelines, whether they look at anticipated or at actual profits, tend to deal with transfer pricing from a *testing* point of view; they give little or no guidance as to the process of *setting* prices.

The Discussion Draft considers that risk assumption by both parties and sharing of risks are the key required conditions for application of the profit split method. When the relevant (non-routine) risks are shared with respect to ongoing operations, a split of *actual* profits is indicated, since the parties assume the risks that affect the actual outcome. In contrast, when the relevant risks are shared with respect to future operations and the relevant transaction involves a transfer of ownership rights to future cash flows (such as an IP license transaction, certain financial products, or a buy-in in a restructuring), the split of *anticipated* profit will be preferable.

When *anticipated* profits are split, the price of a transaction is set by reference to the share of profits that the parties expect to generate from that transaction; but such parties may not share contemporaneously the risks related to that transaction, unlike in the situation when the actual profits are split.In line with the statements in paragraph 45 and example 9, we believe that in a

number of circumstances arising with the licensing of intangibles, the licensor may have developed an intangible and made the key risk-related decisions associated with the development of such intangible while the licensee has made key risk-related decisions associated with the exploitation of the intangibles that may have limited relationship with the risks associated with the development of such intangibles *per se*. So in this instance, both parties are incurring significant risks (and this is worth reiterating). However, the exploitation of the intangible may reveal that the intangible does not in fact realize the value that was initially anticipated. In cases of significant deviation, we should consider that parties may be able to renegotiate their arrangement, in line with what one may expect third parties to do. Example 9 in this respect introduces the fact that royalty payments may take different forms (e.g., lump sum, sales based royalty, etc.). It may worth stressing that the form of the payment should be consistent with the ability to assume risk. In this respect, the parties' ability to assume risk may also need to be factored in. In such situations, we believe that, if the profit split method is the most suitable method to apply, then it should be applied on the basis of anticipated profits. This is important as, in our experience, the profit split method is commonly used to price intangibles in line with the Guidance in Chapter VI of the TPG. We have provided in an Appendix to these Comments a simplified example on how this may be applied.

3. Discussion on split factors

3.1. Introductory remarks

As a preliminary comment, we note that the Discussion Draft offers limited guidance on how profit splitting factors can be used in the context of a contribution analysis. In this context, we wish to make reference to the work on the comparable profit split method that was initiated over two decades ago.[2] The comparable profit split method can be viewed as one way to apply the profit split method through a contribution analysis.

As described above, profit splits are appropriate in situations where there is a fundamental sharing of economically significant risks between the parties, either on a prospective, anticipated basis or in terms of actual profit results. At arm's length, parties entering into such arrangements can be assumed to share profits in proportion to their relative contributions to the joint generation of profits based on information known or reasonably foreseeable at the time the transactions were entered into[3] and in view of the associated risks undertaken by the parties.[4]

In many situations, each party's relative investment in long-lived assets, including intangible assets like technology and some marketing intangibles as well as tangible physical and/or financial assets, represents both the contribution to the generation of the relevant profits being shared and the investment at risk. Residual analyses refine this paradigm by distinguishing

[2] Richard Rozek and George Korenko, "Transfer Prices for the Intangible Property Embodied in Products with Extraordinary Profit Potentials", Tax Notes International, October 18, 1999.

[3] *Cf.* 2017 *Discussion Draft*, paragraph 46.

[4] *Cf.* 2017 *Discussion Draft*, paragraph 26.

between relatively "routine" contributions of assets that can be valued at arm's length based on external market benchmarks and "non-routine" assets that constitute the more fundamental contributions to the residual profits that are at risk and that are shared between the parties that contribute such non-routine assets.

As described further below, however, not all situations appropriate for application of the profit split method are amenable to using costs or capital employed as profit splitting factors, as other profit split factors may be more reliable. We believe that it is important for the OECD's guidance on profit splits to allow such alternative factors to be used where warranted in view of the underlying value chain profit contributions and the available evidence that such alternative factors can be applied reliably.

3.2. Capital- and Cost-Based Factors

We agree with the conclusion that a prescriptive list of criteria or allocation keys in the TPG is undesirable,[5] and that the appropriate approach should be tailored to the underlying value chain analysis and risks. Following general principles adopted in the TPG for determining the most appropriate transfer pricing method,[6] capital- or cost-based factors should be defined taking the following considerations into account:

i. *Capitalized costs* are generally preferable to ordinary period costs when the underlying assets have different durations, including different gestation lags[7]

ii. *Discount factors* may be appropriate in situations involving longer-lived investments with significant durations between expenditures and value realization[8]

iii. *Risk weighting* may also be appropriate where cost contributions have differing risks of success or failure[9] or where there are intercountry differences in the cost of capital

iv. *Relative costs* should be measured consistently in terms of *currency* and relevant *purchasing power parity* (additional details on this are provided below), including location savings if appropriate[10]

v. *Consistent accounting* of profits and capitalized costs may be appropriate if there are material differences between available financial or managerial accounting statements and the economically relevant measures of profit and capital[11]

---

[5] *See* 2017 *Discussion Draft*, paragraph 51.

[6] Chapter II, Part 1 of the TPG, paragraphs 2.2-2.5.

[7] *Cf.* 2017 *Discussion Draft*, paragraph 56.

[8] *Cf.* 2017 *Discussion Draft*, paragraph 67.

[9] *Cf.* 2017 *Discussion Draft*, paragraph 66.

[10] *See* part (c) discussion below and 2017 *Discussion Draft*, paragraph 67.

vi. *Relevant markets* for which the profits to be split are established should be defined based on the underlying market and competitive situation and value chain analysis, together with corresponding allocations of internal accounting data.[12]

While profit splits are analogous to joint ventures and are informed in part by the same principles that inform joint venture profit allocations, they are not joint ventures in fact but instead apply joint venture principles in determining the allocation of profits based on the facts and circumstances. The most appropriate profit split factor in one set of circumstances may not be appropriate under different circumstances, depending upon the underlying profit drivers and the relative contributions and risk capacities of the parties.

For example, high levels of combined profit may be split appropriately based on the relative contributions of intangible investments, whereas losses attributable to unforeseen external events would appropriately be allocated to all invested capital. Such differences can be mitigated in part by consistent application of profit split factors over the life-time of the arrangement, including loss years and the overall business cycle,[13] but they cannot be presumed to apply uniformly in all situations. Accordingly, we object to the presumption stated in paragraph 2 of the Discussion Draft of symmetrical treatment of profits and losses[14] and would instead emphasize the need to allow for and to reflect the underlying profit drivers in each situation.

3.3. Headcount and Employee Compensation Factors

In situations where significant value contributions are provided by human capital, employee compensation can be an appropriate profit split factor. Financial services and other services industries may be particularly amenable to using compensation as a profit split factor, as well as other industries or business segments where human capital is a major contributor to value based on the underlying value chain analysis. Certain attributes of compensation data make it especially suitable for its use for this purpose: since compensation of employees can generally be characterized as arm's length, except for situations involving owner-managers, it can be considered as an arm's length indicator of relative non-routine, entrepreneurial value. Headcount, on the other hand, is typically less indicative of entrepreneurial value in and of itself, and may therefore be less reliable for this purpose.

Given that compensation policies differ by industry and by firm, use of compensation as a profit split factor should be evaluated for each specific case. For example, variable compensation for management may be a better indicator of relative contribution to value creation than total compensation, since variable compensation may be more closely tied to the entrepreneurial

---

[11] *Cf.* 2017 *Discussion Draft*, paragraph 61.

[12] *See* 2017 *Discussion Draft*, paragraphs 39-42.

[13] *Cf.* 2017 *Discussion Draft*, paragraph 33.

.

value provided by individual employees, although the degree to which variable compensation approximates the value contribution can vary depending on the industry or firm. In addition, annual compensation may not properly reflect relative contributions with respect to longer-term risk taking or in situations where there are other contributors to value such as legacy intangibles that do not rely on human capital.

Compensation-based factors should be defined taking the following considerations into account:

i. *Labor cost differences between countries* should be evaluated and adjusted based on consistent measures reflecting *cost of living*, *inflation*, and *purchasing power parity* (an additional discussion of this is provided below);

ii. *Consistent accounting* of compensation data should take into account differences in regulations related to employment, benefits, and taxes;

iii. *Relevant employees* for which compensation data are used should be defined based on the underlying value chain analysis and value drivers, and, depending on the circumstances may be limited to senior management of a business unit or certain categories of employees who provide non-routine, entrepreneurial contributions.

The decision on whether or not the *compensation for the C-suite employees* would need to be a part of the profit split will need to be considered carefully based on the specifics of the firm and the industry. Often, C-suite executives are responsible not only for the specific value drivers in question, but also for all other functions in the organization and maintaining the company as a going concern, *i.e.*, strategic risks.

3.4. Are adjustments for purchasing power parity needed for profit split factors?

Ultimately, a profit split seeks to replicate third-party bargaining over combined outcomes, so profit split factors should reflect the respective value contribution and bargaining power of the parties. In many cases, costs (or capital) can be an appropriate measure of these factors. Adjustments should then be made if (and only if) the adjusted costs are a more reliable measure for the relative contribution of the parties. Alternatives available to the bargaining parties are important as well. For instance, if one of the parties is only able to provide contributions that are similar to those that can be sourced elsewhere in the marketplace, such party would not be entitled to an adjustment that increases its contribution, and, indeed, may not be entitled to any residual profit at all. Thus, we believe that adjustments should not be made purely because of some observed price level differences, but rather any such adjustment should demonstrably lead to a more reliable assessment of the parties' contributions.

When a multinational group can relatively freely invest in various entrepreneurial activities, and the profit splitting factors can be reliably measured by financial investments alone, a purchasing power parity adjustment may not be appropriate. Economic theory suggests that the benefit of

the investment activities in different regions should be proportional, at least on the margin, to the amount of invested funds:

> *"Given competitive capital markets and the fact that capital is a scarce resource, capital is invested in the enterprise (or appropriately defined business segment thereof) up to the point at which its marginal prospective return just equals the competitively determined cost of capital for the enterprise, business segment, or value-added stage. (...) Accordingly, the principle of compensating each value-added stage with an operating profit proportional to the relative capital investment of each stage (...) is consistent with the overall long-run return available to the enterprise and with the joint venture principle of providing to each party a return equivalent to what independent parties transacting such a joint venture as stakeholders would have bargained at arm's length"*[15]

Accordingly, the question of adjustment for purchasing power parity in the application of the profit split method may arise only in situations when the profit splitting factors are measured by capitalizing the intangibles development costs or by applying the intangibles development costs directly.

To illustrate this point, assume that the profit split method will be applied to transactions between two affiliates of a multinational group, one of which (Affiliate A) resides in a "high-cost" country, and the other (Affiliate B) resides in a relatively "low cost" country. In order for the profit split to be an appropriate method, both Affiliates A and B provide non-routine contributions to the value chain creating a certain product (or service) XYZ. Further analysis will depend on whether "location rents" are present in the supply chain for the good (or service) XYZ. A detailed discussion of the "location rents" appears, for example, in the series of articles titled "Location Specific Advantages".[16] As discussed in these publications, location rents may be present under only two conditions (and only as long as those conditions exist):

(1) the group is able to exercise a certain degree of market power over its products (e.g., via the protected IP) *and* has exclusive access to the location rents (by either being a first mover into the "low-cost" country or by protecting its market position in the "low-cost" country in some other way), or

(2) while the group's products are sold in a competitive market, the group maintains an exclusive access to location rents (i.e., prices for the group's products are set by the markets outside the "low-cost" country).

The "low cost" Affiliate B would be entitled to the non-routine compensation only in the case when it was instrumental in securing access to these location rents (in the opposite case, when the access to location rents was secured by the Affiliate A by virtue of its business development

---

[15] H. N. Higinbotham, "Profit Split Methods," section 10.03[3]. LexisNexis, *Practical Guide to U.S. Transfer Pricing*.

[16] S. Gonnet, et al. "Location Specific Advantages: An Economist's View." *Transfer Pricing International Journal*, Special Issue, November 2011.

activities or through its monopoly power, the location rents would belong to the Affiliate A alone). Assuming that the Affiliate B is entitled to the location rents (i.e., Affiliate B was responsible for securing exclusive access to location rents via its own market position or monopoly power), the next question is whether the market price of the good (or service) XYZ is determined by the competitive forces in the home market of the Affiliate B or in the markets outside of the Affiliate B's country. In the former case, the non-routine contribution of Affiliate B does not merit an additional adjustment since the location rent that accrues to Affiliate B already compensates it for providing access to its home market (an example of this kind may be a luxury brand owned by Affiliate A and sold by Affiliate B in its home market). In the latter case, there may be a need for a purchasing power parity adjustment to the non-routine contribution of Affiliate B's employees in the value chain of the XYZ good or service (for example, empirical observations suggest that it is often the case that the decision-making employees of global asset management firms earn similar gross compensation regardless of their geographical location).

3.5. Other split factors

Other split factors can be also be used. In this context, we provide below two examples.

In some cases, the use of other profit split factors is appropriate. Specifically for those companies or business divisions that are integrated into a very unique value chain, it may be useful to rely on the expert assessment of the people most knowledge and informed about the company and the factors that give rise to its success. This can mean that survey data can in some instances be used as an appropriate profit split factor, if it can be demonstrated that survey leads to a reliable economic assessment. In these circumstances, it is important to design and conduct the survey appropriately to avoid any undue influence.

Game theory may also provide a relevant framework for assessing the relative bargaining power of the individual entities in a multinational enterprise and provide an estimation of the likely outcome of a negotiation. Shapley Value in particular starts with the assumption that players entering into long-term cooperative relationship will only join a coalition (of a sub-set of players) if they expect to gain from it. This approach may offer a useful framework to analyse the relationship between members of a multinational enterprise, working in a long-term open-book relationship, jointly contributing to value creation. In the context of the profit split method, this approach enables to determine the contribution of a member of a multinational enterprise based on its incremental contribution to the rest of the group, or the contribution of one piece of intangible based on its incremental contribution to the other pieces of intangibles.[17]

[17] A. Voegele, S. Gonnet, B. Gottschling. Oct 2008, "Transfer Prices Determined by Game Theory: Underlyings", BNAI Tax Planning International Transfer Pricing. Nov 2008, "Transfer Prices Determined by Game Theory: Application to IP", BNAI Tax Planning International Transfer Pricing Dec 2008, "Transfer Prices Determined by Game Theory: Application to the Banking Industry", BNAI Tax Planning International Transfer Pricing.

4. Examples

We note that the examples provided in the Discussion Draft include limited details. This may be dangerous as one would see situations where such examples, as drafted could easily be abused. In addition, we are of the opinion that it is not ideal to start with a potentially complex pharmaceutical industry example that can have multiple interpretations depending upon the decision-making process within that sector. We would suggest starting with example 8.

In the appendix of this document, we provide a simplified example for the application of profit split based on anticipated profits.

5. Conclusion

We praise the work of the OECD on this Discussion Draft. In particular, we are of the opinion that (i) there should be no systematic use of the profit split method and that (ii) the method should be used in the context of pricing transactions or series of transactions and is not an alternative to a global apportionment formula. We believe that the Discussion Draft was prepared with this state of mind. We are looking forward to the next version of the Discussion Draft and would be pleased to support the OECD in any further dialogue if appropriate.

Appendix – Example of profit split of anticipated profits

Sharing of anticipated Profits from an IP License

In this example, the transacting parties are in the service industry. The core business of the multinational enterprise is the provision of certain services that are provided to third party clients in a number of countries. One party, the Licensor is both the intangible owner and central service provider who hosts some key central functions the role of which is related to these intangibles. The other party, the Licensee, is an operating company with significant know-how to run its business. It exploits the intangibles and benefits from the services received by the Licensor. The intangibles include marketing intangibles relating to the services, as well as a range of centrally developed processes and know-how which corresponds to the definition of intangibles under the guidance provided in Chapter VI of the TPG. The Licensor is not providing any services to third party clients. Its sole role is to develop, enhance, maintain and protect the intangibles and license them to the Licensee.

The Licensee is the face to the market with regards to the delivery of the services. It is responsible for the provision of the services to (third party) clients. As part of its day-to-day activities, it is in a position to contribute to the development and enhancement of intangibles notably through process improvements and enhancing the reputation of the brand. Its core activities are operational in nature. The Licensee exploits the intangibles.

Given that both parties contribute to the development of intangibles, albeit to a different extent and in the absence of reliable comparable to apply the CUP method, the profit split method is selected. In the case at hand, since a portion of the activities of the Licensee can be benchmarked using comparable companies, the residual profit split method is relied upon. In step 1, the routine remuneration of the Licensee is determined through the application of the transactional net margin method. The financial results of the Licensor and the Licensee are then taken into account to determine the residual profits.

The residual profits are then split on the basis of the investments (estimated through a capitalized cost approach) made by the Licensor and the Licensee to continue to maintain, protect, develop, and enhance the intangibles. These investments include notably activities performed by the Licensor and the Licensee in this respect. The royalty is calculated so that it enables the Licensor to obtain revenue that compensates it for its investments including a share of the residual profits. The royalty is fixed on the basis of forecast financials (i.e., anticipated profits) for the coming three years.

Since the Licensor and the Licensee are facing risks that are quite different (the Licensee is subject to market risks and a number of operational risks that it can control while the Licensor faces strategic risks that it can control in the development of differentiating intangibles that it has overall responsibility for), the profit split is not meant to be adjusted unless there are exceptional circumstances. However, the split factor is reviewed and recalculated periodically to reflect longer term changes that may affect the business. In this context, it would therefore seem that a split of anticipated profit is appropriate. However, as

mentioned above, special circumstances may lead to consideration of a change in the split factor.

Breslin Consulting, LLC
1200 18th Street, NW, Suite 700
Washington, DC 20036
Tel: 202 468 9347
pbreslin@breslinconsulting.com
www.breslinconsulting.com

September 15, 2017

Tax Treaties, Transfer Pricing and Financial Transactions Division
Center for Tax Policy and Administration (CTPA)
Organisation for Economic Co-operation and Development (OECD)

(*delivered via email*)

BEPS Action 10—Revised Guidance on Profit Splits **(Public Discussion Draft: 22 June – 15 September 2017)**, (hereinafter, the "draft")

Comments by Pat Breslin[1]

Dear members of the OECD/CTPA and working parties:

Breslin Consulting would again like to thank the OECD/CTPA and the corresponding division and working parties for the opportunity to comment on this very important project. I preface by noting extensive experience in areas directly relevant to the draft—including as a business executive negotiating complex arm's length arrangements with many features of transactions on which the draft focuses, including contributions of unique and valuable intangibles by both parties to such transactions. Furthermore, my experience as an economist and expert on transfer pricing includes extensive experience with respect to profit split methods.

In general, I organize my comments to address the "Specific Questions for Commentators" provided in the introduction to the draft. Question 1 is addressed first below, considering the requested focus on profits splits of anticipated profits and actual profits. Questions 2 and 3 receive focus simultaneously while being addressed in the aggregate through a case example. The case discussion thus uses a holistic approach to comments, but with certain reference to areas of direct relevance to questions 2 and 3, and to the draft more generally.

To summarize the contents of the comments more specifically, responses to Question 1 address factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used. Responses to questions 2 and 3 are provided using a case example and related discussion. Such discussion addresses testing reported outcomes with a profit split method, using multiple methods including a profit split method, two-sided analysis of

[1] The author would like to thank Julia Barakat, Jianwen Lu and Shiyuan Zhang of Breslin Consulting, LLC for their helpful assistance, research and analysis in support of these comments.

integrated business operations, and measuring profit allocations by assets and considering capital requirements.

Question 1: Comments on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used

In the author's view, the draft successfully distinguishes the concepts it describes as a "profit split of actual profits" from "a profit split of anticipated profits." It also provides consistent rationale for this distinction. Primary rationale for the latter include the resulting effects when transacting parties share the assumption of specific, economically significant risks (or separately assume closely related risks)—including a greater likelihood that such parties may be willing to share profits corresponding to the assumption of such mutual risks.

Proposed revisions to terminology describing the two profit split approaches

As a preliminary comment, the author proposes revisions to the terminology that the draft employs to describe these two concepts, including the terms 1) "a profit split of actual profits" and 2) "a profit split of anticipated profits," respectively.

Alternative terms the author would respectfully offer include the following. The terms "profit split of actual profits" and derivative terms used in the draft would be replaced by the terms "percentage based profit split."

Additionally, the terms "profit split of anticipated profits" and derivative terms used in the draft would be replaced by the terms "absolute profit split."

The rationale for the terms "percentage based profit split" in place of "actual profit split" is that, in practice, one may see that the effect of using a "profit split of actual profits" is a consistent application of an appropriate percentage-based allocation factor—conceptually determined *ex ante*—to the base of relevant profits to be split, *ex post.*

In this respect, the same percentage-based allocation consistently applies to both *expected* results, *ex ante*, and to *actual* results, *ex post.* Hence, one might argue, this percentage based approach (*i.e.* the "actual profit split" approach in the current draft) is not only employed to split "actual" profits, but also would have been conceived to split *expected* or *anticipated* profits under the required *ex ante* analysis from which it derives. (See the draft paragraph 46 and related comments elsewhere.)

To the author, it is this consistent application of a percentage-based profit allocation (or "split") that seems to be the key practical distinction regarding this approach—notwithstanding the *ex post* alignment the approach also achieves with the (actual) transfer pricing outcome, the playing out of the economically significant risks (which are also assumed by the parties, *ex ante*), and the corresponding profit allocations.

Of course, it is quite true as well that it is the "actual" combined profits, *ex post*, that are ultimately "split" with this approach. But referring to it as only a split of "actual profits" could be perceived as understating the critical *ex ante* aspect that applies to this approach and to the profit split method in general.

From the author's perspective, the *mechanism* of the percentage-based allocation factor (derived *ex ante*,

and consistently applied *ex post)* inspires the proposed terminology change. For some (including those less versed in transfer pricing) it also may better reflect what seems to be one of the approach's more salient distinctions relative to the "profit split of anticipated profits" described in the draft.

Conversely, as currently described in the draft, a "profit split of anticipated profits" may employ different pricing and profit-splitting mechanisms that result in "anticipated profits" that are calculable, *ex ante* **and** *ex post,* in terms of *absolute* profits.[2] *Ex post,* it is the actual outcomes relating in part to the parties' *different* risks assumed, *ex ante*, that determine their *actual* levels in absolute profits—individually for each party, and on a combined basis.

Of course, with this (non-percentage based) "absolute" profit approach, one may express the division of the combined profits between the parties in percentage terms as well. Relevant total (absolute) profits would serve as the base (the denominator), with each party's separate profit serving as a numerator.

However, in the case of the absolute profit split, an imputed or *effective percentage* split of the profits will differ when calculated on an *ex ante versus* an *ex post* basis. The unique conditions pertaining to the percentage based profit split (*i.e.* currently the "actual profit split" in the draft)—*i.e.* the conditions producing a consistent percentage split on either an *ex ante* or *ex post* basis—are not present with this absolute profit approach. That is, the degree to which the parties' experience a proportional alignment in terms of risks assumed and profit outcomes under the percentage-based approach is lacking under the absolute profit approach. In short, unlike the percentage based profit split, with the absolute profit split, percentage allocations differ between expected and actual results.

The author hopes that, were these revisions to be adopted, such terminology might have the benefit of avoiding misinterpretations that could otherwise arise—especially for those less well-versed in subject matter concerning transfer pricing and profit split methods.

For example, given that the allocation factors for a "split of actual profits" are derived *ex ante* and apply consistently *both* to expected profits and to actual profits, the approach would not be misconstrued as only pertaining to actual profits. Or, for example, that an "anticipated profit split" is also applicable to actual results, *ex post,* might be clearer when it is described as an absolute profit split approach—for which a consistent percentage profit allocation over time is not necessarily intended.

The remaining comments below will set aside the terminology revisions proposed above for future consideration. That is, all comments below adhere to the draft's terminology regarding 1) "a profit split of anticipated profits" and 2) "a profit split of actual profits" unless otherwise noted.

Key indicators for potential use of transactional profit split method and approaches

In general, the draft appears clear that factors that determine whether a profit split of *anticipated,* or of *actual* profits should be used emanate from the process of accurately delineating the transaction as

[2] For example, see Example 9, Scenario 1 in the draft which describes conditions appropriate for applying an "anticipated profit split" approach in which transaction payment terms may alternatively take a variety of forms, including a single lump sum payment or a sales-based royalty. Also, notably in Scenario 1, the risk profiles of the parties individually and in relation to each other do not appear to justify an "actual profit split" that would derive from a corresponding percentage-based allocation mechanism—as described in Scenario 2.

described in Chapter I, thus taking into account the facts, circumstances, functions, assets and risks of the transacting parties in relation to the transaction and each other.

From this process, key factors will inform whether or not a transactional profit split method is appropriate in general, relative to other available methods. As paragraph 3 notes, the availability of reliable information to apply other methods must also be considered, including whether or not comparable uncontrolled transactions are available, their degree of comparability with the controlled transaction, and the ability to make reliable adjustments for material differences between the controlled and the uncontrolled transactions, for example.

In Section C.2.2, the draft elaborates on the nature of transactions for which use of a transactional profit split, in general, may be appropriate, focusing on three key indicators. All three of these indicators may thus be factors regarding whether a profit split of anticipated profits or actual profits should be used, among others. They include,

- Unique and valuable contributions by each of the parties to the transactions (C.2.2.1)
- Highly integrated business operations (C.2.2.2), and
- Shared assumption of economically significant risks, or separate assumption of closely related risks (C.2.2.3)

As the draft makes clear in paragraph 4, however, the presence or absence of any such indicator should not be used as a deterministic rule or criterion that would require or prevent the application of a transactional profit split method as the most appropriate method. Each indicator may (or may not) be present in applying the method, depending on the facts and circumstances of the case.

But, according to the draft, in cases where a profit split method is found to be the most appropriate method based on the accurate delineation of the transaction, it is likely that one or more of these three indicators will be present and require focused attention.

Mutual risk assumption by the parties

According to the draft, use of a **profit split of actual profits** should give primary consideration to whether the transacting parties **share the assumption of certain specific (or closely related) economically significant risks**.[3] That is, the parties must either 1) share the assumption of the same economically significant risk(s), or 2) separately assume closely related and economically significant risks—*e.g.*, risks for which the outcomes are difficult to isolate from each other. (Hereinafter, these comments will collectively refer to these two conditions as "mutual risk assumption" by the parties, or the "mutual risk condition.")

In effect, the draft appears to require the mutual risk condition between the transacting parties in order for a profit split of *actual* profits to apply (*see* paragraph 44). However, when the mutual risk condition is present, it is "likely" but not certain that a profit split of actual profits "will be warranted." This thus leaves the possibility that a profit split of anticipated profits could apply in some cases when the mutual

[3] The concept of an "economically significant risk" is introduced and described thoroughly in OECD Transfer Pricing Guidelines (TPG) Chapter I, including, for example, TPG, Section D 1.2.1.1: para 1.71-1.76

risk condition is present, assuming that the transactional profit split method (in general) is appropriate.

According to paragraph 27,

> If each party shares the assumption of economically significant risks or separately assumes inter-related, economically significant risks and a transactional profit split is considered to be the most appropriate method, *it is likely that a split of actual profits*, rather than anticipated profits, *will be warranted* since those actual profits will reflect the playing out of the risks of each party. That is, the transfer pricing outcome—a sharing of actual profits—should align with the accurate delineation of the transaction. (emphasis added)

While the point in paragraph 27 seems well-taken, out of an abundance of caution the author would suggest some modification to add clarity and/or avoid any potential for confusion; in particular, with regard to the wording,

> If each party shares the assumption of economically significant risks…it is likely that **a split of actual profits**, rather than anticipated profits, will be warranted since **those actual profits** will reflect the playing out of the risks of each party.

Clarifying relevant profits and actual profits

Here, it may be helpful for the draft to make a clearer distinction between the relevant profits themselves (*i.e.* stated in paragraph 27 as "those actual profits")[4] and the appropriate approach to splitting the profits (*i.e.* stated as "a split of actual profits").

For example, it may be preferable to replace the phrase "since those actual profits will reflect the playing out of the risks of each party" with "since, *ex post*, the relevant profits subject to the actual profit split approach will reflect each party's assumption of, and the playing out of, such economically significant risks." Here, the term "relevant profits" is used in place of "those actual profits" as it is already well established in paragraph 1 and is elaborated upon elsewhere (*e.g.* paragraphs 35, 37, 39 and 40).[5]

The author's concern is that, without such revision, a reader may potentially confuse "those *actual* profits" as specifically relating, *per se*, to the application of a "split of *actual* profits."[6] Elsewhere, the

---

[4] The same suggestions made in regard to "those actual profits" here would also apply to the subsequent sentence that states, "That is, the transfer pricing outcome—a sharing of **actual profits**—should align with the accurate delineation of the transaction." (emphasis added)

[5] For example, paragraph 40 refers to the situation as, "Where the **relevant profits *to be split*** are comprised of profits of two or more associated enterprises…" (emphasis added) Paragraph 39 more fully states, "The **relevant profits** to be split under the transactional profit split method are the profits of the associated enterprises relating to the controlled transactions in which the associated enterprises are engaged. It is essential to identify the level of aggregation, see paragraphs 3.9-3.12. The **relevant profits** to be split should only be those arising in relation to the controlled transaction or transactions under review. In determining those profits, it is therefore essential to first identify and accurately delineate the transactions to be covered by the transactional profit split method, and from this identify the relevant income and expense amounts for each party in relation to those transactions."

[6] Note that even if a different meaning was intended, such revisions may still be helpful to remove potential ambiguity. For example, even if the draft wording "those actual profits" is taken simply in reference to "the profits, *ex post*"—*i.e.* without any connection to the approach using "a split of actual profits, rather than anticipated profits"—the dual connotations of "actual" here would benefit from clarification.

draft is clearer that the profit splitting approach does not necessarily have a specific connection with the relevant profits that are to be split—as the phrase "those actual profits" might imply here.

For example, in paragraph 27, it would not necessarily be the case that the actual profit split approach would be warranted even under the mutual risk condition described. Rather, paragraph 27 states that, under such circumstances, it "is likely" but not certain that a split of actual profits would be warranted. In such a case, it would seem that the relevant profits (as defined by the draft) would exist *a priori* and irrespective of the determination of the profit splitting approach—or at least independently from it to some degree. Indeed, as paragraph 4 makes clear, under these same conditions a transactional profit split method may not apply at all.

Section C.4.1 elaborates further on considerations in applying transactional profit splits of actual and anticipated profits. Paragraphs 43 to 46 set forth related considerations in this regard. Paragraph 43 notes,

> The determination of the profits to be split, including whether those profits are actual profits or anticipated profits, should be aligned with the accurately delineated transaction.

This is a welcome reinforcement of the role that accurately delineating the transaction plays in the determination of "the profits to split," *i.e.* the relevant profits in paragraphs 1 and 39 of the draft, for example. The paragraph also appears intended to highlight that the corresponding facts and circumstances that underlie the relevant profits, including the functions, assets, and risks of the parties in relation to each other, should play a role in determining whether a profit split or actual or anticipated profits should be used.

Nevertheless, it seems worth reiterating that the use of the terms "actual profits" and "anticipated profits" in paragraph 43 might also be revised to help to avoid potential confusion as well. In each case, it appears that the intended meaning relates to the "relevant profits" as defined in paragraphs 1 and elsewhere, as opposed to "actual" or "anticipated" profits. (To be clearer, please note that this comment is *not* in reference to the proposed revisions to terminology, in general, which were discussed earlier above.)

Thus, as above, the author would hesitate to describe the "relevant profits" themselves as "actual profits" in relation to when an actual profit split approach is appropriate, and as "anticipated profits" when a split of anticipated profits is used. The author's interpretation of the draft (*e.g.* at paragraphs 27 and 44) is that, at least in some cases, either an actual profit split or an anticipated profit split approach can potentially apply to the same transaction and under the same facts and circumstances that yield the same (combined) relevant profit—*i.e.* before that relevant profit is split.

Paragraph 44 adds useful clarification. It states,

> Where the transactional profit split method is found to be the most appropriate, **the splitting of actual profits**, i.e. profits which have been affected by the playing out of economically significant risks, **would** therefore **only be appropriate** where the accurate delineation of the transaction shows that the parties either share the assumption of the same economically significant risks associated with the business opportunity or separately assume closely related, economically significant risks associated with the business opportunity and consequently should share in the resulting profits or losses.

Once again, the pivotal factor here is the mutual risk assumption between the parties. That is, use of a

profit split of actual profits requires that (i.e. "would only be appropriate" if) the mutual risk condition described in paragraph 44 is present.

Thus, in order to justify a splitting of *actual* profits, paragraph 44 draws a clear connection between 1) the extent to which the transacting parties' **share assumption of certain specific or closely related risks** (that is, share the assumption of the same economically significant risks, or separately assume closely related and economically significant risks), and 2) whether they "consequently should **share in the resulting profits or losses**."

The last *consequence* stated just above seems to be of particular importance. The paragraph's chief purpose appears to clarify that, in order for the use of a splitting of actual profits to be appropriate, the accurate delineation of the transaction would show that "the parties **either**

a) share the assumption of the same economically significant risks associated with the business opportunity or

b) separately assume closely related, economically significant risks associated with the business opportunity **and**

c) consequently should share in the resulting profits or losses." (letter list format added)

Item *c* above would appear to be of significance. It could be interpreted to say that when the preceding conditions including items *a* and *b* apply, then the parties "consequently should share in the resulting profits or losses." As items *a* and *b* are previously recognized in tandem in the draft (*e.g.* in paragraph 27) perhaps one would assume they would be taken together.

Nevertheless, it remains for additional clarification whether in item *c* "consequently should share in the resulting profits or losses" is meant to express a *necessary* (or *inevitable*) *consequence* of items *a* and *b*, or rather is meant to say more loosely that "sharing in the resulting profits or losses *may* result," or "be more likely" or "more appropriate" as a result.

Paragraph 44 continues by noting such shared risk assumption "may occur in scenarios where the business operations are highly integrated and/or each party makes unique and valuable contributions." However, as noted in paragraph 30 and elsewhere in the draft, the presence or absence of highly integrated operations and/or unique and valuable contributions is not determinative as to whether any form of profit split applies.

Questions 2 and 3: Case Example on testing reported outcomes with a profit split, using multiple methods, two-sided analysis of integrated business operations, and measuring profit allocations by assets and capital requirements

The remaining comments take a case approach to responding to questions 2 and 3 from the draft section "Specific Questions for Commentators." Question 2 focuses on "profit splitting factors" including the use of asset-based factors such as capital. Question 3 seeks examples of profit split application where business operations are integrated.

The first sentence of paragraph 1 of the draft sets forth context that ultimately relates to the comments below responding to Question 2 and Question 3. It states,

> The transactional profit split method seeks to **establish** arm's length outcomes or **test** reported outcomes for controlled transactions by determining the division of profits that independent enterprises would have expected to realise from engaging in a comparable transaction or transactions. (emphases added)

The author has significant experience in transfer pricing controversy matters in particular, including audits involving taxpayer's and the U.S. and foreign governments, and related appeals procedures and litigation.

Naturally in such contexts—regardless of methods used—transfer pricing analyses are often employed to *test* the arm's length nature of *reported outcomes* for controlled transactions. The author's more frequent focus on testing reported outcomes, *ex post,* would also apply to experience with respect to applying a transactional profit split method more specifically.[7]

In a controversy context, one may test not only reported outcomes, but also adjusted transfer pricing outcomes resulting from taxing authorities' audit analyses that produce (asserted or proposed) adjustments to a taxpayer's taxable income. Without divulging details or confidential information, the author will draw from a variety of such experiences as an expert in transfer pricing—informed as well by separate experience as a technology business executive negotiating actual arm's length arrangements with many of the features of specific relevance to the draft.

The draft does an excellent job of emphasizing the need to maintain an *ex ante* perspective in applying the method, whether or not it is used to establish (or "set") transfer prices consistent with arm's length outcomes, or to "test" such transactions, *ex post.*

This integrated view of the past, present and future is the stuff of which arm's length negotiations and transactions are made. Indeed, at arm's length, independent parties must negotiate based on their expectations and the best available information (known today) about subsequent events (in the future)—facing risks associated with this uncertainty. As paragraph 46 notes,

> In any application of a transactional profit split, care should be exercised to ensure that the method is applied 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 2.12 and 3.74.

The author notes the cited paragraph 2.12 (of the final 2017 TPG) is not specific to the transactional profit split method nor any other method. Rather, the paragraph concerns whether or not one may use *multiple* methods in determining one arm's length outcome. Though multiple methods are not generally required, this paragraph notes cases when doing so may be useful, including "for difficult cases, where no one approach is conclusive [and] a flexible approach would allow the evidence of various methods to used in conjunction." The author has experience with such cases that concurs with the guidance.

The complex nature of cases wherein a profit split method might be appropriate would often benefit from an approach using "evidence of various methods in conjunction." This concurs with the author's view

[7] Hereinafter, these comments will use the terms "profit split method" or the "method" in direct reference to the "transactional profit split method" as used and described in the draft.

and, indeed, is exemplified in the draft in part by the "residual profit split" method—which is but one such example. In the author's view, if one is to properly measure the contributions of the parties in an application of a profit split, inherent to that would be to determine the arm's length value for each such contribution in a manner consistent with the TPG Chapter 1 and the guidelines in general. As another example, as noted in Chapter 8:

> Under the arm's length principle, the value of each participant's contribution should be consistent with the value that independent enterprises in comparable circumstances would have assigned to that contribution.

The author thus concurs with paragraph 46 and TPG paragraphs 2.12 and 3.9 which it cites. Paragraph 3.9, in a different but related vein, discusses whether and when it may be useful or, potentially, necessary to aggregate multiple transactions in one analysis and/or application of one method. Again, such guidance provides direct and welcome reference in the draft—as in certain cases profit split methods may also be appropriate in such contexts.

Furthermore, as indicated above, the controversy context will often require opposing parties to put forth, rebut and/or adjust competing methods towards a resolution. And, similarly, negotiating at arm's length, independent parties will also consider and, sometimes (but not always), share evidence from multiple sources and independent analyses—it's everyday economics to do so (*e.g.* comparison shopping, capital budgeting, comparing comparable home prices and values).

To complete this current discussion of paragraph 46, it continues,

> That is, irrespective of whether a transactional profit split of anticipated or actual profits is used, unless there are major unforeseen developments which would have resulted in a renegotiation of the agreement had it occurred between independent parties, the basis upon which those profits are to be split between the associated enterprises, including the profit splitting factors, the way in which relevant profits are calculated, and any adjustments or contingencies, must generally be determined on the basis of information known or reasonably foreseeable by the parties at the time the transactions were entered into.

This reference to profit splits of "anticipated or actual profits" is taken by the author to mean the two approaches outlined in the draft. Further comments on these approaches in more direct response to Question 1 in the draft are provided elsewhere. Next, the comments will provide an example case description that will facilitate further comments.

Controversy Example and Comments on Question 2

The following example digests and genericizes an actual case. The author hopes the simplified description will nonetheless provide a helpful basis for later comments that are directly relevant to the draft.

The case concerns a transfer pricing matter that involving two multinational affiliates that together provided a combination of equipment and services to their third party customers located in Country B. The customers accessed these combined resources on an integrated basis in their own production processes.

Affiliate A in Country A acquired and owned the equipment—assets in which it made significant long

term capital investments of 100. A contributed rights to use this property. Affiliate B in Country B provided the services to the customers while operating the equipment. B interfaced with the customers, while managing its working capital needs to perform under the contract.

The dispute emerged from an audit, in which the government in Country B (the government) adjusted affiliate B's transfer prices. That is, it asserted a transfer pricing outcome that differed from B's reported outcome. The government relied on a transfer pricing analysis that applied a one sided method to B.

The government method used a markup on total costs based on a set of asserted comparable firms—effectively using a form of TNMM under the guidelines. Thus, the government adjusted B's *operating profit / total costs* (the markup) to a level matching a range of markups earned by independent firms.

B argued that, in focusing on profit as a percentage of total costs, the government did not demonstrate that the set of independent firms were sufficiently comparable to B to support the adjusted price outcome. Affiliate B showed that the analysis of the comparable firms' assets, functions and risks relative to affiliate B was not thorough.

Most notably, the government comparables generally owned substantial assets including equipment and other fixed capital assets. However, B—the tested affiliate—did not own such assets. As a percentage of total costs, the operating assets of the comparable firms were over 100% while, for B, this percentage was 40%.

The situation reflected differences that could materially affect the comparison, as described in paragraph 1.40 and elsewhere in the guidelines.

> Where there are differences between the situations being compared that could materially affect the comparison, comparability adjustments must be made, where possible, to improve the reliability of the comparison.

Such a situation has multiple potential resolutions. In this case, B offered multiple analytical approaches, each consistent with the guidelines, that were effectively used in conjunction. Among these, a form of a profit split method was used to "test" whether the outcomes under different methods and assumptions were arm's length.

First, however, through its counsel and experts, B rebutted the government comparables as presented. B noted that either 1) one must identify comparable firms whose assets, functions and risks were more closely comparable to B, or 2) alternatively, one must make adjustments for any important differences that materially affect the comparison. Here, the differences in levels of operating assets to total costs clearly stood out.

Further, B demonstrated that it was necessary to consider a two-sided approach. B noted that, at arm's length, *both* parties would necessarily have to agree to a transaction price or the deal would be rejected by at least one party. That is, each party would have realistic options to consider—external to the subject transaction. Naturally, these other alternatives would affect the prices at which the parties would be willing to transact with each other.

In this case, a proper comparability analysis would consider the levels of capital investments made by

each of the parties' (A and B) as reflected in their assets. A's asset levels—and corresponding risks—during the period were 100. B's asset levels were at 20. Furthermore, the government's comparables had asset levels over 100% of their total costs, while B's were only 40% of its costs.

Capital markets are highly competitive and clearly reflect arm's length conditions. This means that firms that own expensive assets must generate operating profits high enough to cover their capital costs. Otherwise, they would be unable to get investments to support their asset levels. Investors would simply seek other investment options instead—as happens every day.

Expanding our simplified example data above, assume a comparison of Company X and Company Y. Here, Company X is analogous to Affiliate B in the case—the tested party in a one-sided transfer pricing analysis. Company Y is the representative comparable firm put forth by the government (*e.g.* the comparable independent firm with the median profit result).

First, assume that both X and Y have the same cost of capital of 10%--that is, in each case investors require a return of 10% on their capital investment.

Also, assume X has assets of 20 and Company Y has assets of 100. Further assume that, based on its higher levels of assets, Y has higher capital costs per dollar of accounting costs than X; recall that these accounting costs (referred to elsewhere as "Total Costs") were the denominator in the markup on total costs in the government's method.

Importantly, note that these accounting costs do *not* include Y's capital costs that it must pay to its investors. Still, however, Y will need to earn enough additional operating profit to cover such capital costs.

This also means that in the asserted "arm's length" markup for Y, the numerator for Y (operating profit) is *overstated* and the denominator (total accounting costs) is *understated* in any comparison with X—to the extent that Y's asset levels and associated capital costs are incrementally greater than those for X.

A proper comparison of X and Y must take this difference into account. For example, assume that both X and Y have the same cost of capital of 10%. That is, for each, their investors require a return of 10% on their capital investment.

Also assume that X has Revenue of 52, Total Costs of 50, and thus Operating Profit of 2, and X has Operating Assets of 20.

Thus, without any adjustment, X earns a profit markup on costs of 4% (*i.e.* 2/50) and has Operating Assets to Total Costs of 40% (*i.e.* 20/50). Furthermore, of paramount concern to investors, X has a return on operating assets of 10% (*i.e.* 2/20). That is, its Operating Profit as a percentage of Operating Assets is sufficient to meet its cost of capital.

Now assume comparable Company Y has Revenue of 110, Total Costs of 100, and thus Operating Profit of 10, and Y has Operating Assets of 100. Thus, Y has earned a markup on costs of 10% (10/100) and has Operating Assets to Total Costs of 100% (100/100). Further, Y's return on operating assets is 10% (*i.e.* 10/100).

If Y's profit markup on Total Costs result were considered to be X's required "arm's length" return, this would suggest that X should earn 5 in profit (*i.e.* rather than 2) in order to meet with an arm's length markup on Total Costs of 10% (*i.e.* 5/50)—*i.e.* the same profit markup percentage on costs as earned by Y. (In the actual case described previously, the upward adjustment the government made to B's taxable income was far more substantial.)

However, such a result would be incorrect. Recall that like comparable Company Y, taxpayer Company X already achieves a profit return on Operating Assets of 10%. (The ROA automatically takes differences in capital intensity into account.)

Furthermore, any comparison of Company X and Comparable Y's results on a cost basis must consider their relative asset levels—and corresponding capital costs. In such a case, asset level differences should be measured as a percentage of Total Costs, if one is to use the government's chosen denominator for the markup. Here, while X Operating Assets equal 40% of its costs (*i.e.* 20/50), Y's Operating Assets are 100% (*i.e.* 100/100).

Therefore, Y has asset levels that are 60% higher than X (as a percentage of accounting costs)— (*i.e.* 60% = 100% - 40%)—and its cost of capital reflects that it must provide investors their required return (*10%*) for each dollar of assets. To compare Y with X, one must adjust Y's results for this difference.

To adjust for this material difference in capital intensity, one must multiply Y's Operating Assets (100) by the incremental difference in asset levels that Y maintains relative to X (60%). Thus, in a valid comparison, additional capital costs to Y are imputed as 6 (*i.e.* 100 * 60% * *10%*).

Accordingly, Y's adjusted Operating Profit would be 4 (*i.e.* 10 – 6) and its adjusted markup on total costs would be 4% (*i.e.* 4/100)—here, the same as X. This shows that X's 4% markup result is consistent with an arm's length result demonstrated by comparable Company Y, after adjusting for significant differences in the companies' assets and corresponding risks that have a material impact on the comparison.

Many might see the above-mentioned comparability adjustments for differences in levels of assets as similar in many ways to adjustments routinely performed and included in many transfer pricing analyses and reports.

But the main point for the purposes of Question 2 is: asset-based factors such as capital, or Operating Assets as above, often overcome the need for a multitude of adjustments. Before and without any capital intensity adjustments, X already had a defensible arm's length Operating Profit, measured as a percentage of Operating Assets, relative to Comparable Y.

That is, the Company X return on operating assets result of 10% demonstrated an arm's length return, consistent with the guidelines and acceptable to independent investors in competitive capital markets.

Profit Split Test

In the case described above, using variations in comparable sets put forth by the government and the taxpayer, Company B consistently was within an arm's length range when using an ROA.

Further, it was shown that assets were the appropriate factor for measuring the profit allocation through a profit split analysis. With B's original reported income, the same reported profit outcome that yielded the 10% ROA results for A and B (each individually) yielded the appropriate profit split corresponding to their relative Operating Asset allocation (*i.e.* A/B) of approximately 80% to 20%--in percentage terms.

Of course, B also demonstrated arm's length returns after asset intensive comparable firms were properly adjusted for the incremental capital costs associated with their higher levels of assets relative to B.

But this fact was readily demonstrable without the need to perform the comparability adjustments described above, if one were to use an asset-based net profit measure like the ROA. Such asset-based measures already take differences in assets, capital intensity, and related risks into account.

B's profit split analysis also demonstrated that the consequences of the government's proposed upward assessments to B's taxable income were profoundly obvious as *non*-arm's length. While A's large capital investments accounted for over 80% of total assets of A and B combined (*i.e.* 100/120 for A/(A+B) in Operating Assets)—the government's taxable income adjustment resulted in a split of combined Operating Profit at about 50% to 50% for A/B.

However, this 50/50 profit split based on the government analysis was easily shown to be untenably non-arm's length as well. While, before the government assessment, both A and B earned an ROA of about 10%, after the government's income adjustment, B would be earning an astronomical ROA of over 100%.

Perhaps worse, at least from the vantage point of arm's length investors in competitive capital markets, this profit split left A with a return below its required cost of capital—as low as 5% in some scenarios. This too would be untenable at arm's length. The taxpayer's originally reported profit allocation between A and B—corresponding to their 80% to 20% asset allocation—thus carried the day in this dispute.

In summary, the government position was more clearly shown to be untenable with the use of a profit split method. Meanwhile, the focus on asset allocation and required returns to capital was a very useful and practical basis for measuring allocations of profits in this case—as in many other cases with similar issues.

Sincerely,

Pat Breslin
Washington, DC
September 15, 2017

(Delivered via email)

Pirola
Pennuto
Zei
& Associati
studio di consulenza
tributaria e legale

Sede legale: 20124 Milano - Via Vittor Pisani, 20
Tel. (+39) 02 669951 - Fax (+39) 02 6691800
E-mail: info@studiopirola.com
www.pirolapennutozei.it

Codice fiscale e Partita iva: 06946520159

Uffici in:
Milano, Roma, Torino, Verona, Padova, Bologna, Brescia, Napoli, Parma, Londra, Pechino, Shanghai

20124 Milano - Via Vittor Pisani, 20
Tel. (+39) 02 669951 - Fax (+39) 02 6691800

Milan, 15 September 2017

OECD Discussion drafts on the attribution of profits to permanent establishments and transactional profit splits

By email: *TransferPricing@oecd.org*

Studio Pirola's observations

Studio Pirola Pennuto Zei & Associati welcomes the opportunity offered by the OECD to provide its comments to Documents: i) "*Additional Guidance on the Attribution of Profits to Permanent Establishments* - which deals with work in relation to Action 7 ("*Preventing the Artificial Avoidance of Permanent Establishment Status"*) of the BEPS Action Plan, and ii) "*Revised Guidance on Profit Splits"* - which deals with work in relation to Actions 8-10 ("*Assure that transfer pricing outcomes are in line with value creation"*) of the BEPS Action Plan, of particular scientific and academic but also practical interest.

Specifically, we would like to propose the following comments.

****

i) Discussion draft containing Additional Guidance on the Attribution of Profits to Permanent Establishments

As a general introduction, we note that the Public Discussion Draft "*Additional Guidance on the Attribution of Profits to Permanent Establishment* appears to base most of its observations and conclusions on the AOA - the Authorised OECD Approach - contained in Article 7 in the 2010 version of the MTC as outlined in the 2010 Report on the Attribution of Profits to Permanent Establishments ("2010 Profit Attribution Report"). This approach states that the profits to be attributed to such independent entities must be determined through an analysis of the functions and risks assumed by the PE pursuant to the "*significant people function doctrine*" - SPF doctrine. We agree with this approach which we consider applicable to the determination of the profits to be attributed to i) an existing and registered PE of a foreign head office or ii) a hidden PE.

In addition, please note that:
a) the AOA approach should not be intended to charge the taxpayer with more burdensome documentation requirements in connection with deemed dealings and the taxpayer should not bear costs and burdens not in line with the

circumstances. Having regard to the complexity of the matter and the lack of consistent expert opinions on the subject, the OECD's guiding principle (whether the AOA approach is adopted or otherwise) should be an approach based on documentary and administrative simplification both in the preliminary stage of the assessment of a PE and for the determination of the (possible) income attributable to it.
In the circumstances, the accounting reconstruction of the income to be attributed to a hidden PE/DAPE (based on the functions and risks assumed) becomes a key issue. Regardless of the principles adopted, such reconstruction would be a complex and not-so-obvious task which Tax Administrations should increasingly focus on, especially (as is the case in Italy) where the income relevant for tax purposes is (solely) that deriving from the results of the accounting records, for both IAS/IFRS compliant companies and companies which adopt domestic accounting principles.

b) With particular regard to the reconstruction of DAPE's profits and losses based on the AOA approach, in our opinion the Tax Administrations should coordinate the application of the rules under article 9 of the OECD Model Tax Convention (Transfer Pricing) – to be prioritized – with those under article 7 of the OECD Model Tax Convention. In our view, for the purposes of determining DAPE's income, it would be appropriate (as well as more efficient), to apply first the transfer pricing rules under article 9 of the Model Tax Convention (if applicable) to the transactions carried out between *TradeCo*/*SiteCo* and SELLCO, before determining the profits to be attributed to DAPE under article 7, thus prioritizing Article 9 over article 7. The application of the arm's length principle to the transactions between DAPE and SELLCO, and the arm's length remuneration of any functions carried out in Country S to the benefit of *TradeCo*/*SiteCo* imply per se a "fair" attribution of income to SELLCO in Country S, which should neutralize the tax claims of the latter State.
In addition, we agree with the OECD position to deduct the sales commission paid by *TradeCo*/*SiteCo* to SELLCO when determining DAPE's income in Country S: should no deduction be allowed, double taxation would arise.

c) There may be cases where SELLCO realizes a profit whereas DAPE is in a loss position: the fact that they are two different entities would make it impossible – at least in principle – to offset profits against losses, resulting in double taxation. As already noted[1] it would probably make more sense to consider SELLCO and DAPE as a single taxable person carrying on business in Country S, with the result that:

- the sales commission paid to SELLCO may be deducted from the income of the single tax entity carrying on business in Country S;
- any losses realized by DAPE may be offset against SELLCO's profits;
- SELLCO's and DAPE's respective profits and losses can be consolidated for tax purposes in Country S.

[1] Cf. Studio Pirola's Observations, September 2016.

In our opinion SELLCO and DAPE should be treated as a single and indivisible taxable person, with the possibility to consolidate any opposite financial results realized by them in Country S.

ii) Revised guidance on profit splits

a) First of all, we note that the revised discussion draft on profit split correctly states the difficulty in the adoption of a 'pure profit splitting method' and the preference for the approach of a residual profit split methodology, which is the most used in the practical transfer pricing evaluation. Indeed, even if a unique contribution in a transaction is identified, the remuneration is almost always made up of profits referred to (i) a routine activity (valuable with a one-side method or a traditional one, if applicable) and (ii) an extra profit referred to the intangible asset(s) or the extra profits generated through integrated transactions (i.e. the unique contribution), which should be apportioned through significant drivers, to be identified according to the specific case. This circumstance allows the use of the residual profit split method in most of the cases.

b) Among the different drivers to be used in order to split the profit of a unique contribution transaction, we believe that the reference to the transactions of an independent comparable set is quite difficult criteria to apply, since it should be necessary to identify the "comparable extra profit" generated by independent enterprises. The identification of the unique qualifying contribution in uncontrolled transactions is almost impossible due to the lack of reliable information about the functions and the actual business activity performed by independent companies.
Moreover, it needs to be pointed out that the purpose of the 'splitting keys' is not the evaluation of the extra contribution generated, but the allocation of the extra profit among the entities involved in the transactions. Therefore, the reference to independent comparable transactions - as well as being quite difficult to apply - is not necessary and it can lead to misleading results, since, being the contribution unique, the external comparability is excluded.

Based on this, we deem that, once identified the unique contribution to be evaluated in the controlled transactions, the asset-based and the cost-based drivers mentioned in the discussion draft should be considered the most reliable in order to split the profit, since they are based on the accounting data of the entities directly involved in the transactions, thus taking into account the effective involvement (in terms of asset, capital employed or expenses incurred) of each associated company.

c) As reported in the discussion draft, the choice of the drivers depends on the specific case, even if it is possible (and necessary) to provide guidelines in order to establish if the reference to assets, capital employed or costs incurred is the most suitable one for the profit splitting purposes. In this respect, we would like to point out the following:

Asset-based factors

The net operating capital employed (in terms of the value of all the assets and liabilities used, excluding the net equity and the net financial position), should be selected as a reliable profit splitting key in the following cases:

I. The companies involved in the transactions are engaged in a value added business, so that they qualify as full manufacturing companies or, in any case, are engaged in a complex production activity. Those businesses need strong investment for the development of internal key competences, through which the entity gains competitive advantage on the market. Should this be the case, the net operating capital employed should be regarded as the most reliable factor to split the profit among the associated entities.

II. Consistently with the OECD transfer pricing guidelines on the adjustments for the distribution activity, the net operating working capital is suitable for the split of the extra profit resulting in the intercompany transactions involving simple manufacturing activities (i.e. contract manufacturing) or distribution (not including marketing intangible, for which the driver should be based on the costs actually incurred for the intangible development and maintenance).

Cost-based factors

The costs incurred should be used as profit splitting factors where marketing intangibles, generating extra profits, are involved in the transactions. Should this be the case, the marketing costs shall be considered as the most reliable factor.

It is also necessary to underline that a profit splitting factor based on headcount or employee costs should lead to unreliable results, since:

I. The number of employees involved in the transactions is very rarely connected to the extra profit;

II. The employee costs greatly depend on the geographic area where the company is located and in most cases they are not directly connected with the profit generation. Nevertheless, a different conclusion could be reached when highly trained and experienced resources are involved in the transaction, thus creating a 'valuable asset', to be carefully considered as a key to identify the competitive advantage based on which the extra profit should be allocated.

d) Finally, we share the remarks contained in the document referred to the need to carefully identify and value the assets and the costs to be used as splitting factors. The figures used should be based on common accounting standards among the entities involved and possibly with an external certification about the fairness and accuracy of the costs accounted.

Sincerely,

Studio Pirola Pennuto Zei & Associati

Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA
2, rue Andre Pascal
75775 Paris Cedex 16
France

By email to: TransferPricing@oecd.org

15 September 2017

Dear Sir/Madam,

BEPS Action 10 - Public Discussion Draft on the Revised Guidance on Profit Splits

PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the OECD's *Public Discussion Draft on the Revised Guidance on Profit Splits* (Discussion Draft).

We appreciate the efforts from the OECD in developing revised guidance on profit splits methodologies (PSM) and acknowledge that the issue may be very difficult and complex. The Discussion Draft attempts to link the use of the PSM to the new guidance developed under Chapter I (in particular the Risk Section) and Chapter VI (Intangibles) of the 2017 OECD Transfer Pricing Guidelines (TPG). However, we believe the principles and approaches outlined in the discussion draft could be improved in several ways in order to provide a common understanding and practice for both taxpayers and tax administrations as to when and how the PSM should be applied.

The Discussion Draft builds on the 2016 Discussion Draft and the comments from stakeholders received on that 2016 Discussion Draft. The current Discussion Draft maintains a distinction between PSM based upon projected profits and actual profits. A discussion on several issues that were addressed in the 2016 Discussion Draft, such as the guidance on allocation of synergies or the use of sequential or parallel PSM, is no longer present in the current Discussion Draft. We believe those deletions strengthen the Discussion Draft, as those issues were difficult to understand and not helpful in providing guidance on when the PSM is the most appropriate transfer pricing method. We agree with the decision to remove the specific section in the previous draft on value chain analysis as well. There should be no suggestions that VCA is an application of the PSM or that it is required. Including it in the discussion on PSM in the TPG may have suggested or encouraged a use of the term 'profit split' that does not correspond to the 'transactional profit split method' with which this part of the TPG deals.

PricewaterhouseCoopers International Limited
1 Embankment Place
London WC2N 6RH
T: +44 (0)20 7583 5000 / F: +44 (0)20 7822 4652

We have a few suggestions to improve the Discussion Draft even further but would also like to note what we regard as a significant danger:

- There remain some ambiguities in areas that are fundamental to the selection and application of the PSM which create the risk that profit split becomes the 'default' method when transfer pricing gets difficult.

- The ambiguities relating to 'highly integrated' operations are of a particular concern because here the danger is of introducing a type of global formulary apportionment by another name and thereby contradicting the principles on which the TPG are built.

- The examples currently compound this problem because they use subjective, undefined terms to support use of the PSM in situations when comparables can generally be found in practice. Additionally, the vast majority of the examples conclude that the PSM is the most appropriate method, even though in practice it is only infrequently the most appropriate method, leading to the risk that the PSM may be seen as almost the default pricing method.

Our detailed comments are appended to this letter but in summary our suggestions for improving the draft are as follows.

- The Discussion Draft should be streamlined to focus on the basic principle supporting use of the PSM as the most appropriate transfer pricing method – when both parties make unique and valuable contributions (i.e., contributions for which comparables are not available or reliable projections to use an income method).

- It should reflect the implications that the existence of unique and valuable contributions bring. Specifically, that it will be impossible to be prescriptive about factors and weightings and that they must be chosen on a case-by-case basis so as to be consistent with the division of profits that would have resulted if unrelated parties had made their contributions and divided the benefits therefrom in proportion to their relative investments.

- The proposed revised guidance in the Discussion Draft in places reads as an apportionment methodology and not a method for establishing a transfer price. It should be emphasized that the transactional profit split method is a method for arriving at a price for a transaction in accordance with the arm's length principle and is not an actual distribution of profits.

- The factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used are not well-defined. Having followed the debate we believe this is not due to lack of analysis but because the distinction and the appropriate circumstances in each case are so varied that it is difficult, if not impossible to be clear. Consequently we believe this should be substantially reviewed or deleted in its entirety.

- Finally, the proposed revised guidance focusses to some extent on the split of gross profits but does not elaborate or explains under what circumstances such split could be more appropriate;

More detailed responses to the questions to commentators and comments on the discussion draft can be found in appendix 1 and appendix 2 respectively.

For any clarification of this response, please contact the undersigned or any of the contacts below. We look forward to discussing any questions you have on the points we raise above, in our more detailed comments or on other specific matters raised by respondents to the Discussion Draft. We would welcome the opportunity to contribute to the discussion and to speak at the public consultation meeting to be held in November 2017.

Yours faithfully,

Stef van Weeghel, Global Tax Policy Leader
stef.van.weeghel@pwc.com
T: +31 (0) 887 926 763

PwC Contacts	Email
Isabel Verlinden	isabel.verlinden@pwc.com
Horacio Peña	horacio.pena@pwc.com
Adam Katz	adam.katz@pwc.com
David Ernick	david.ernick@pwc.com
Stefaan De Baets	stefaan.de.baets@pwc.com
Phil Greenfield	philip.greenfield@pwc.com
Andrew Casley	andrew.j.casley@pwc.com

Appendix 1 – Specific questions for commentators

1. **The discussion draft addresses situations in which profit splits of anticipated profits or profit splits of actual profits are appropriate. Where it is established that the transactional profit split is the most appropriate method, please comment on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used.**

We found the discussion of the terms 'profit split of anticipated profits' and 'profit split of actual profits' to be confusing and difficult to understand. We recommend substantial redrafting or otherwise deletion of this section of the Discussion Draft.

Typically when using a PSM, the actual profits are split, but the split ratio (or ratios) may be determined on the basis of anticipated (or projected) profits (ex ante approach) or actual profits (ex post approach). The application of strict decision factors in determining whether the transfer pricing should be established on the basis of a profit split of anticipated profits or a profit split of actual profits is contrary to the guidance on ex ante or ex post assumption of risk as discussed in paragraph 1.78 and in section C.3.3.1 of the 2017 TPG or to the guidance in paragraph 3.71 which allows both approaches or a combination of approaches. The issue is that the upside and downside effects of the risk are attributable to the party (or parties) that assume(s) the risk and the methodology should reflect that in line with the accurately delineated transaction.

The Discussion Draft identifies the sharing of economically significant risk (or the separate assumption of closely related risk) as the criteria for determining whether actual or anticipated profits are to be split. We do not understand why this issue in particular should be picked out nor do we understand what that means. We do not find the referenced example (example 9) to be helpful in this regard. It would seem that the members of an MNE group generally share all economically significant risks to a certain extent; therefore it is unclear what the purported connection to any particular risk is. As a result, the distinction between actual and anticipated profits seems artificial and therefore counterproductive.

2. **A number of profit splitting factors are addressed in the discussion draft. Comments are particularly invited on:**

    a. **Whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained, and if so, what factors need to be taken into account for its selection and application as a reliable profit splitting factor.**

The proposed guidance should not exclude any potential profit splitting factor in principle as long as the profit split factor chosen is appropriate and reflects the value added or unique and valuable contributions to the transactions. In particular in the financial sector or in capital intensive industries capital and capital employed may be an appropriate profit splitting factor. Alignment is needed with the accurate delineation of the transaction and hence it becomes a facts and circumstance test.

b. **Should headcount of similarly skilled and competent employees be included as a potential profit splitting factor, and if so, in what circumstances would it be relevant?**

Care needs to be exercised as the use of headcount as a profit splitting factor may be more favourable towards labour intensive parts of the group, although headcount may not be linked to or be correlated with value creation. There is the risk of double usage of the factor (for example under workforce in place as a comparability factor and as a profit split factor). Further it may become an arbitrary exercise to establish whether the employees in the different locations are effectively similarly skilled and competent or not. When using headcount as a profit split factor payroll or other elements such as seniority could be used to weight headcount. Further we acknowledge that headcount may be considered as a comparability issue. In using factors like headcount or payroll, care should be exercised that profits are not shifted towards high cost countries or towards labour intensive parts of the group, but reflect the remuneration for the unique and valuable contributions.

c. **Given the existing guidance in Chapters I and IX of the Transfer Pricing Guidelines, should adjustments for purchasing power parity be made for profit splitting factor amounts, and if so, in what circumstances?**

Purchasing power parity ("PPP") is not useful for determining profit splitting factors, for several reasons. We consider PPP to be an alternative to exchange rates, but the relevant accounting standards (e.g., GAAP or IFRS) use exchange rates not PPP. Further, determining and calculating PPP adjustments is complicated and would be unreliable in practice. Finally, PPP calculations are likely to reflect economic differences between countries that may be irrelevant to the factors being used for the profit split. Consequently, exchange rates are a better basis for making adjustments.

d. **What other profit splitting factors should be included in the guidance, and in what circumstances?**

The proposed guidance should not be prescriptive and any list or examples should be clearly non-exhaustive. Transfer pricing is always based on particular facts and circumstances and in the case of profit split, where unique and valuable contributions are being made, this is doubly true. The basic principle is that any splitting factor may be acceptable as long as it is aligned with the accurate delineation of the transaction and leads to an arm's length result.

When the PSM is selected as the most appropriate method there should be flexibility in the choice of splitting factors and any limitation thereof should be discouraged provided the splitting factor is appropriate and linked to the attributes which lead to its selection as the method used.

3. **Additional examples of scenarios in which a transactional profit split is found to be the most appropriate method due to the high level of integration of the business operations are sought, together with an explanation as to the reasoning thereto.**

We do not have an additional suggestion on examples where a PSM is the most appropriate method due to the high level of integration.

Appendix 2 – Detailed comments

Section C.1 General

Paragraph 1 states that "As is the case with all transfer pricing methods, the aim is to ensure that profits of the associated enterprises are aligned with the value of their contributions." We find this statement confusing, as the profits of unrelated parties are not necessarily aligned or equal to the value of their contributions. It seems to be confused with the case where the PSM can be applied to divide the profits based on the relative value of the contributions by each of the associated enterprises participating in the controlled transactions. The goal of all transfer pricing methods is to determine arm's length pricing. It is not clear whether "value" is meant to be something different than arm's length pricing. We recommend at least defining what is meant by "value" and if that differs from arm's length pricing or otherwise deleting this sentence.

Section C.2 on when a transactional profit split method is likely to be the most appropriate method

It is unclear what is meant under paragraph 5 with the term '*relative* appropriateness and reliability of the selected method as compared to other methods which could be used'. There is no further guidance on how the term 'relative appropriateness and reliability …' must be addressed or interpreted. The selection of the PSM as the most appropriate method must in any way be supported by (or deduced from) the functional analysis and the absence of comparables (or the difficulty in obtaining them) cannot be a sufficient reason to select the PSM.

Section C.2.1 discusses the strengths and weaknesses of the PSM. Paragraph 11 notes that the fact that the PSM is rarely used among independent enterprises "should not be a factor" in whether it is the most appropriate method. However, paragraph 15 then notes that "it may also be relevant to consider industry practices" regarding whether independent parties actually use "profit splitting approaches." It goes on to note that such industry practices may be a "pointer" and should be "taken into account" in determining whether the PSM is the most appropriate method.

We believe the contradictory nature of these two paragraphs will lead to confusion in practice, and therefore recommend deletion of both. Additionally, deletion of these paragraphs is appropriate because, regardless of the OECD view as to whether industry practices regarding use of the PSM by independent parties is relevant or not to selection of the PSM as the most appropriate method for pricing related-party transactions, that is a larger issue that belongs in Chapter III, Part I, Section A of the TPG on selection of the most appropriate transfer pricing method. In other words, whether use in practice of any transfer pricing method (not just the PSM) by independent parties is relevant to determination of the most appropriate transfer pricing method for pricing related party transactions is a question that must be answered with respect to all transfer pricing methods, not just the PSM.

Section C.2.2 discusses the appropriateness of the PSM according to the nature of the transactions, including transactions involving intangibles. Paragraph 18 of that section indicates that the PSM may be the most appropriate method for a transfer of fully developed intangibles where no reliable comparables can be identified and references are made to the relevant paragraphs in Chapter VI. The guidance in Chapter VI, however, refers in turn to the guidance on PSM and thus it results in a circular reasoning. Nevertheless further guidance on the use of the PSM for such transactions is welcomed.

Paragraph 18 also makes an explicit reference to the guidance on hard-to-value intangibles (HTVI) under Chapter VI. Such reference to HTVI are not useful in the discussion on PSM and should be deleted.

Section C.2.2.2 addresses highly integrated business operations. We find this section to be nebulous and confusing. Paragraph 19 notes that most MNE groups are integrated "to some extent," but that "a particularly high degree of integration in certain business operations" may justify use of the PSM as the most appropriate transfer pricing method. Other paragraphs in this section use various synonyms for "a particularly high degree of integration" (e.g., "interlinked," "highly inter-related," "inter-dependent," "a high degree of inter-dependency") to make the same point.

We do not believe the use of many synonyms is helpful, particularly in the section which seeks to define or explain what the term is supposed to mean and in many cases will amount to the fact that both parties are making 'unique and valuable' contributions which seems to be the implication of both paragraphs 21 and 22.

Unless the Discussion Draft can define the precise factors which outline the dividing line between the integration which exists in "most" MNE groups and the "particularly high degree of integration" justifying application of the PSM, then this section should be deleted. Otherwise we are concerned that "integration" can be asserted arbitrarily to justify use of the PSM whenever a tax authority wishes to claim a greater share of profits.

Additionally, paragraph 20 contains a reference to Part III of the Authorised OECD Approach (AOA) developed under the 2010 Report on the Attribution of Profits to Permanent Establishments. Although the reference is theoretically correct, it is confusing to refer to the AOA in the TPG. In principle the AOA applies the TPG by analogy. In the AOA some concepts like Key Entrepreneurial Risk Taking Functions and Significant People Functions are used that are not known in the TPG. By mixing the TPG and the AOA there is a significant risk that some principles or concepts that are used in the AOA may find their – incorrect - application in the TPG.

Section C.2.2.3 discusses the appropriateness of the PSM where both parties share the assumption of economically significant risks, or where each party separately assumes risks that are closely related.

The Discussion Draft identifies the sharing of "economically significant risks" and the "separate assumption of closely related risk" as the criteria for determining whether actual or anticipated profits are to be split. It is unclear what those terms means and we do not find the referenced example (example 9) to be helpful. It would seem that the members of an MNE group generally share all economically significant risks to a certain extent; therefore it is unclear what the purported connection to any particular risk is. The Discussion Draft appears to be confusing what unrelated parties do when they enter into a partnership with the reasons for using a PSM as the most appropriate pricing method in related-party transactions. And the distinction between actual and anticipated profits seems

artificial, as ultimately it is actual profits that are split. Consequently, we recommend either substantially reviewing or deleting both sections C.2.2.3and C.4.1.

Section C.2.3 discusses the use of PSM in the absence of reliable information. The proposed guidance at the end of paragraph 28 indicates that a lack of comparables alone is not sufficient to use the PSM. This guidance could be strengthened and other examples may be added. For example not only the lack or absence of comparables but also difficulties in finding appropriate comparables do not automatically lead to the application of the PSM. The proposed guidance may clear the way to using the PSM as a default method where no or only a few comparables are available or where there are difficulties in finding appropriate comparables, without having due regard to the other criteria for selecting the most appropriate method. The reference to the valuable and unique contributions by both parties as a condition for the selection of the PSM could be usefully repeated here. A reference could be inserted relating to the use of one-sided methods in the absence of valuable and unique contributions by both parties.

The conclusions of **Section C.2.4** are of a general nature and could be better addressed under section C.1. (General).

Section C.3 - Guidance for application – In general

Section C.3.1 discusses the approaches to splitting profits. Unlike earlier versions of the TPG, the Discussion Draft limits the approaches to splitting profits to the contribution analysis and the residual analysis. We agree that in practice, after more than 20 years of experience since the 1995 TPG were published, no other approaches have been detected. The wording of the brief discussion in paragraph 34 on the residual profit split should be aligned with the more in depth discussion in paragraph 37. The term 'one-sided methods and benchmarked using comparables' in paragraph 37 could be replaced with 'traditional transaction methods or a transactional net margin method, by reference to the remuneration of comparable transactions between independent enterprises'. The text in the Discussion Draft can be interpreted as leaving out the CUP-method, which cannot be the intention of the draft guidance.

Section C.4. Guidance for application – Determining the profits to be split

Section C.4.1. contains a discussion on whether the transactional profits should be split on the basis of the actual profits or the anticipated profits. As already indicated in our comment letter on the 2016 Discussion Draft, we believe that the distinction in practice between the two approaches is rather confusing. As indicated in that comment letter, a split of anticipated profits is a prospective or *ex ante* basis for setting a price while a split of actual profits is more likely to involve retrospective or *ex post* adjustments to the price of the transaction. The attempt to link the ex ante and ex post approaches to whether the parties do share or not in the assumption of the same economically significant risk or

separately assume closely related economically significant risks is artificial (note our comments above, that we recommend either substantially reviewing or deleting both section C.4.1 and section C.2.2.3. We reiterate that a PSM is a 'transactional transfer pricing method' to arrive at a price for a specific transaction (or transactions that are appropriately aggregated) and should not be confused with an actual distribution of profits amongst the members of the same multinational group. Such an approach would be akin to formulary apportionment.

Under **Section C.4.2** an attempt is made in paragraph 48 to link the measure of profits to be split with the accurate delineation of the transaction. The example in that paragraph is flawed, however, since the example seems to assume that market risk is only recorded for accounting purposes at the level of volumes of sales and prices charged. There may be costs or income associated with market risk that are recorded at the operational level. This recording of such costs or income may also depend on the domestic accounting systems. In using a PSM it may be appropriate for the parties involved to use similar or the same accounting mechanisms for transfer pricing purposes (for example IFRS) in order to avoid accounting differences. The examples in paragraphs 48 and 49 should discuss the split on gross or operational level but lack detail on whether a split on gross profit or on net (operational) profit is appropriate. These paragraphs also convey a message that the PSM is an allocation of profits methods rather than a price-setting exercise. The surviving use of the term 'value chain' in the last sentence of paragraph 48 of the Discussion Draft sits poorly, as that term is not used anywhere else in the TPG.

Section C.5 Splitting the profit

Section C.5.1 contains a discussion on the profit splitting factors and indicates they should reflect the key contributions to value (paragraph 54). The guidance further indicates that a functional analysis and an analysis of the context of the transactions *may* be helpful. The guidance should be strengthened and should indicate that a functional analysis is crucial in determining the relative contributions of the parties and their weighting.

Paragraph 58 is incorrect and should be reviewed or deleted. It inappropriately concludes that information contained in the Master File (important drivers of business profit, principal contributions to "value creation," and key group intangibles) can be a useful source of information relevant to the determination of appropriate profit splitting factors. That cannot be true, as the master file is simply too broad and general to provide any information useful to the selection of the PSM. The selection and application of the most appropriate method is in principle to be found in the local file.

Transfer pricing is "facts and circumstances," and it also must be done at the transactional level. The master file provides no information at all at the transactional level, or even at the level of the legal entity, or even at the country level. It provides information at the MNE Group level. As noted in the Final BEPS Action 13 Report, "Taxpayers should present the information in the master file for the MNE as a whole." Consequently, the master file provides no relevant information for the selection of the transfer pricing method at the transactional level.

Examples

We recognise the difficulty of drafting appropriate examples to illustrate the issues concerning the selection and the application of the PSM as the most appropriate transfer pricing method and appreciate the efforts in that regard. We believe, however, the examples contain fundamental flaws, and should be revised to accurately and correctly reflect the issues and to turn them into useful examples. We also note that most of the examples seem to be missing essential facts to come to the conclusion that the PSM is or is not the most appropriate method. Below we provide brief comments on each example with the aim of constructing such fit for purpose examples as mentioned.

We also note that the conclusion in 8 of the 10 examples is that the PSM is the most appropriate transfer pricing method. We find that troubling as in practice the PSM is only rarely the most appropriate method; the examples are prescriptive and seem to put a thumb on the scale in favour of use of the PSM in most cases.

Finally, although the examples use generic descriptions and are meant to be illustrative only, we believe the examples address in an inappropriate way commercially rational business structures where one-sided transfer pricing methods could be appropriately applied and lead to the wrong conclusions without an in-depth analysis of all the facts and circumstances surrounding the case. The way the examples are formulated there is a danger that they will be interpreted as being prescriptive for similar cases without performing the appropriate analysis.

Example 1: This example is confusing. Paragraph 69 states that Company A obtains a patent for "a new pharmaceutical formulation," yet paragraph 70 seems to refer to the same item as a "potential pharmaceutical product." Additionally, the example seems to conclude that Company S's subsequent development of the product and obtaining authorization from the relevant regulatory body is sufficient to warrant application of the PSM. That may be the case in certain circumstances, but would not necessarily be so in all cases. The functions performed by Company S can all be benchmarked, and so the parties could have alternatively structured their contract such that Company S was compensated with a one-sided transfer pricing method.

Example 2: As for example 1 we find this example to be prescriptive. B Co performs simple marketing and distribution functions for which comparables can generally be found and therefore the PSM will usually not be the most appropriate method. Like other examples, the example attempts to turn routine contributions into unique and valuable contributions (supporting application of the PSM) by inserting arbitrary and undefined adjectives – in this case by stating that B Co performs "extensive" advertising, which leads to the tea commanding a "premium" price.

For the conclusion in this example to be correct it would be necessary to impute additional facts supporting a finding that both parties made unique and valuable contributions. But equally, additional facts that apply in many real cases would lead to the opposite conclusion. For example, under the revised Guidelines as they stand B Co would need to be doing rather more than simply spending advertising dollars which may be adequately compensated through a traditional transfer pricing method.

Example 3: This example repeats the focus on arbitrary and undefined adjectives (in this case, "cutting-edge" global marketing activities and a "sophisticated" algorithm) to attempt to support application of the PSM. We are concerned that tax authorities may inappropriately lean on such subjective terminology to arbitrarily assert that comparables can never be found for what are generally routine, benchmarkable marketing activities.

We also find the ipse dixit statement about the importance of certain functions ("The distribution activities performed by Company B are a key source of economic advantage over competitors.") to be unhelpful. It assumes key elements which should be derived from the transfer pricing analysis, and makes a general assumption that can seldom be verified (i.e., whether it is the R&D, the manufacturing, or the marketing is the key source of economic advantage over competitors). The statement that the economically significant risks are "closely inter-related and interdependent upon each other" is similarly unhelpful.

Example 4: This example appears to be the cognate to example 3, and makes ipse dixit statements going the opposite way (i.e., the marketing activities are "more limited" and are "not a particular source of competitive advantage," "the potential success of the new line of products is largely dependent on its technical specifications," and the risks assumed "are not economically significant."). No objective factors are provided as to how such conclusions can be reached, leading to the risk of arbitrary application of the purported criteria for determining appropriateness of the PSM.

Example 5: We find this example confusing. For example, it is not clear what "scaling-up the web crawler and deciding the crawling strategy" means. If these activities involve writing computer code, it is not clear why they would warrant use of the PSM for those types of services comparables can be generally readily available.

Example 6: We find this example not useful as it assumes the conclusion it needs to make; namely, that Company B does not make any unique and valuable contributions, the risks are not economically significant, and the operations of Company A and Company B are only "integrated" and "dependent" "to some degree."

Example 7: The example states that comparables are available for the portfolio management services performed by Company A and Company B, but leads to the result that the PSM is nonetheless the most appropriate method. That may be the case if Company A and B had written their intercompany contract that way, but it could also be the case that the intercompany contract could have been written so that either or both of Company A and Company B was compensated based on the returns indicated by the comparables for the portfolio management services. The conclusion of the example is prescriptive.

The examples assumes that the portfolio managers in each case are active managers. By assuming equal weighting from both companies on the investment committee the example avoids one of the more difficult issues, namely the relative value of the allocation of funds compared to stock selection. This may be mentioned more explicitly in the example.

Example 8: We find this example to be prescriptive as well; the parties could have agreed to a PSM or alternatively they could have agreed that any or all three of the related parties be compensated based on comparables for the development and manufacturing services performed.

Example 9: For the reasons stated earlier, we recommend that the guidance on the distinction between splitting actual or anticipated profits be substantially redrafted or deleted. And again, the use of subjective, undefined adjectives ("intensive" marketing activities, "innovative" marketing activities) to attempt to justify use of the PSM is inappropriate. Again, the imputation of additional facts would be necessary and additional facts that frequently apply between independent parties would lead to the opposite conclusion (for example where the marketing of company B builds on or extends that of Company A).

Example 10: We find this example not useful, as it makes arbitrary assumptions to justify its conclusion. It simply states that the manufacturing activities of Company A and Company B are "integrated" without stating how. And as we noted before, the fact that activities are asserted to be "integrated" provides no useful guidance as to when the PSM is the most appropriate method. It also simply asserts that Company A and Company B are engaged in a "complex" web of intragroup transactions, but does not further explains how that complex web is analysed to come to the conclusion that their manufacturing risks are "highly interdependent." We believe the example puts too much emphasis on arbitrary adjectives which are likely to lead to a great deal of uncertainty in application of the PSM.

Comments on the Public Discussion Draft

BEPS Action 10: Revised Guidance on Profit Splits

August 21st, 2017

Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA
By email: TransferPricing@oecd.org

We are pleased to provide comments on public discussion draft *BEPS Action 10: Revised Guidance on Profit Splits* (the draft) through the consultation taking place from June 22, 2017 to September 15, 2017.

This document may be posted on the OECD website. Full credit goes to Robert Robillard, RBRT Inc. [1]

1. Profit Split Methods Remain Methods of Last Resort

On one hand, paragraphs 7 and 19 of the draft suggest that the "transactional profit split methods" offer a "solution for highly integrated operations". This assumption is also found in earlier drafts on the profit split methods released in 2014[2] and 2016.[3] Likewise, this idea is found in previous editions of the guidelines released in 2010 and 1995/1997.[4] Paragraphs 20 and 21 of the draft, as well as Example 6 provide occurrences that may allegedly justify the use of profit split methods according to the OECD.

---

[1] Robert Robillard, Ph.D., CPA, CGA, Adm.A., MBA, M.Sc. Economics, M.A.P., is Senior Partner at RBRT Fiscalité / Tax (RBRT Inc.) in Canada and blogger on transferpricinghub.com. He teaches at Université du Québec à Montréal; 514-742-8086; robertrobillard@rbrt.ca. Robert is a former Competent Authority Official and Audit Case Manager at the Canada Revenue Agency.

[2] OECD (2014), *Public Discussion Draft. BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains*, public consultations from December 16, 2014 to February 6, 2015, see par. 5-8 and par. 22-25.

[3] OECD (2016), *Public Discussion Draft. BEPS Actions 8-10. Revised Guidance on Profit Splits*, public consultations from July 4, 2016 to September 5, 2016, see par. 21 and par. 24-27.

[4] See par. 2.115 of the 2010 edition of the guidelines, which is a partial duplicate of par. 3.5 of the 1995/1997 edition of the guidelines.

This guidance remains to this day at best debatable and at worst incorrect in light of the typical franchise business model. Franchisor and franchisees do not "split profits". More broadly, profit split methods are rarely, if ever, encountered in arm's length commercial dealings. The guidance included in paragraphs 7 and 19-21 of the draft as well as Example 6 should be revised accordingly.

On the other hand, another option is available to the OECD editors or writers. As it was indicated in the 1995 edition of the guidelines, profit split methods are oftentimes considered as methods of "last resort" in transfer pricing. This specific overarching guidance is missing from the draft with respect to profit split methods. Paragraph 1 of the draft should therefore be improved as follows (suggested additions are in bold characters):

> "1. The transactional profit split method seeks to establish arm's length outcomes or test reported outcomes for controlled transactions by determining the division of profits that independent enterprises would have expected to realise from engaging in a comparable transaction or transactions. **Enterprises rarely, if ever, use a transactional profit split method to establish their prices.**[5] **It should always be considered as a method of last resort.** The method first identifies the profits to be split from the controlled transactions—the relevant profits—and then splits them between the associated enterprises on an economically valid basis that approximates the division of profits that would have been agreed at arm's length. As is the case with all transfer pricing methods, the aim is to ensure that profits of the associated enterprises are aligned with the value of their contributions."

2. "Unique and Valuable Contributions"

Paragraphs 6, 13 and 16-18 of the draft put forward that profit split methods are more than welcome in cases where each party brings "unique and valuable contributions" to the controlled transaction. There is little doubt based on previous BEPS guidance that "unique and valuable contributions" is meant here to be defined in terms of "contributions to intangible property".

However, this "guidance" basically goes against what typical arm's length parties would do in their business dealings. Case in point, every Subway franchisees, McDonald franchisees, Starbuck franchisees, etc., provide "unique and valuable contributions" on top of the marketing campaign, business processes, etc., provided by the franchisor. Each franchisee brings its expertise into the fold. It is usually a prerequisite to actually becoming a franchisee. This know-how is a central component for the success of the franchisee. It is indeed "intangible property" in the broadest sense of the concept.

[5] This wording comes from par. 3.2 of the 1995/1997 edition of the guidelines.

However, none of these business arrangements between franchisors and franchisees ever lead to a "split of the profits". This guidance should therefore be removed from the draft.

Another option available to the OECD editors or writers would be to clearly state the intent behind that construed guidance on profit split methods where it is deemed that every party has "unique and valuable contributions". In short, profit split methods where each party brings "unique and valuable contributions" to the controlled transaction serve as a mechanism to allocate taxable profits between tax authorities without having to resort to global formulary apportionment. As such, paragraph 6 of the draft should therefore be improved as follows to bring it into line with the arm's length principle (suggested additions are in bold characters and suggested subtractions have been struck off):

> "6. **Although it is a method of last resort,** the main strength of the transactional profit split method is that it can offer a solution to **tax authorities** for cases where ~~both parties~~ **every party** to a transaction **is deemed to make** unique and valuable contributions (*e.g.* contribute unique and valuable intangibles) to the transaction. ~~In such a case independent parties might effectively share the profits of the transaction in proportion to their respective contributions, making a two-sided method more appropriate.~~ Furthermore, since those contributions are **deemed** "unique" and "valuable" **by tax authorities** there will **likely** be no reliable comparables information ~~which~~ **that** could be used to price the entirety of the transaction in a more reliable way, through the application of another method. In such cases, the allocation of profits under the transactional profit split method **by tax authorities** may be based on the contributions made by the associated enterprises, by reference to the relative values of their respective functions, assets and risks, **as well as available external market data**. See section C.2.2 below on the nature of the transaction."

3. "External Market Data"

The relevance of "external market data" in profit split methods is erroneously underlined throughout the draft. Paragraph 14 of the draft suggests that a "lack of information on closely comparable, uncontrolled transactions […] should not *per se* lead to a conclusion that the transactional profit split is the most appropriate method." Paragraph 28 of the draft indicates that "if information on reliable comparable uncontrolled transactions is available to price the transaction in its entirety, it is less likely that the transactional profit split method will be the most appropriate method." This is inaccurate.

The suitability of the profit split method should not be grounded in the availability or lack thereof of "external market data". Any transfer pricing method starts with the "comparability

analysis", which is at the "heart of the application of the arm's length principle."[6] In other words, proper application of the arm's length principle requires external market data. Without external market data, a profit split method shows no distinctive feature in comparison to global formulary apportionment.

Paragraph 14, 28 and 101-102 should be revised accordingly by the OECD editors or writers to match with the guidance included in paragraph 35 of the draft with the following minor improvements (suggested additions are in bold characters and suggested subtractions have been struck off):

> "35. Under a contribution analysis, the relevant profits, which are the total profits from the controlled transactions under examination, are divided between the associated enterprises in order to arrive at a reasonable approximation of the division that independent enterprises would have achieved from engaging in comparable transactions. This division **must** ~~can~~ be supported by comparables data, ~~where available~~ **whether in the comparability analysis or through the implementation of the profit split method.** ~~In the absence thereof,~~ It should **not** be **solely** based on the relative value of the contributions by each of the associated enterprises participating in the controlled transactions, determined using information internal to the MNE group (see section C.5.2). ~~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 party's contributions.~~"

4. The "Contribution Analysis"

Although profit split methods are transfer pricing methods of last resort, they may indeed be some rare occurrences where they should and must be used to determine the respective arm's length profit margin of each party involved in the controlled transaction. The guidelines have a long-standing tradition regarding the role of the "contribution analysis" to determine each party right to a share of the profits, which dates back to the 1995/1997 edition of the guidelines.[7]

The absence of any reference to the value chain analysis in the draft is nonetheless regrettable, especially in light of the excellent 2013 OECD study on the matter.[8] The value chain analysis is one of the most important features that allow for the arm's length application of the profit split method in comparison to global formulary apportionment.

---

[6] See par. 1.6 of the 2017 edition of the guidelines.

[7] See par. 3.6-3.8.

[8] OECD (2013), *Interconnected Economies. Benefiting from Global Value Chain*.

Paragraphs 24-27 of the 2016 draft on profit split methods[9] should be included in the guidance after paragraph 33 in the draft (i.e., they would be numbered paragraphs 34-37). These four paragraphs should be included with the following improvements (suggested additions are in bold characters and suggested subtractions have been struck off):

> "~~24.~~ **34.** 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~~ **is required to use 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.~~ **35.** 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.~~ **36.** 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. **The starting point of the value chain analysis will generally be the written contracts between the related parties.** In considering where and how value is created, the analysis should also consider whether such value-creation is sustainable, for instance, whether market advantages

[9] OECD (2016), *op. cit.*

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.~~ **37.** 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 [of the draft which refers to highly integrated operations]."

5. Contractual terms and contractual arrangements

Paragraph 12 and 17 of the draft basically indicate that the "accurate delineation of the transaction" must take into account "the commercial and financial relations between the associated enterprises, including an analysis of what each party to the transaction does, and the context in which the controlled transactions take place."

Contractual terms are only alluded to in paragraph 46 of the draft as a "reminder". It is finally acknowledged in paragraph 46 that the "starting point in the delineation of any transaction will generally be the written contracts" for the purpose of the profit split method.

This is incorrect from an arm's length transfer pricing standpoint. Contractual terms and contractual arrangements are both essential components in the actual delineation of the "commercial and financial relations between the associated enterprises". Paragraph 12 of the draft should therefore be improved as follows (suggested additions are in bold characters):

> "12. The accurate delineation of the actual transaction will be important in determining whether a transactional profit split is potentially applicable. **The starting point in the delineation of any transaction will generally be the written contracts, which may reflect the intention of the parties at the time the contract was concluded. See paragraph 1.42. In addition,** this process should have regard to the commercial and financial relations between the associated enterprises, including an analysis of what each party to the transaction does, and the context in which the controlled transactions take place. That is, the accurate delineation of a transaction requires a two-sided analysis (or a multi-sided analysis of the contributions of more than two associated enterprises, where necessary) irrespective of which transfer pricing method is ultimately found to be the most appropriate. (See paragraphs 1.33-1.35)"

We are available to discuss these suggested changes at your convenience.

Robert Robillard, Ph.D., CPA, CGA, Adm.A., MBA, M.Sc. Economics., M.A.P.
Senior Partner, RBRT Fiscalité / Tax (RBRT Inc.)
Université du Québec à Montréal
514-742-8086
robertrobillard@rbrt.ca

August 21st, 2017

15 September 2017

Tax Treaties, Transfer Pricing and Financial Division
Organization for Economic Cooperation and Development
2 rue André-Pascal
75775, Paris, Cedex 16
France

Dear Sir/Madam

BEPS Action 10: Public Discussion Draft on the Revised Guidance on Profit Splits

We thank you for the opportunity to comment on the *Discussion Draft – BEPS Action 10, Revised Guidance on Profit Splits* released on 22 June 2017.

RELX Group is a global provider of information and analytics for professional and business customers across industries. We operate in four major market segments: Scientific, Technical & Medical; Risk & Business Analytics; Legal and Exhibitions. RELX Group serves customers in more than 180 countries and has offices in around 40 countries. It employs approximately 30,000 people worldwide.

RELX Group accepts that from a practical perspective the transactional profit split method (TPSM) can often be more difficult and time consuming to implement than the other one-sided transfer pricing methods and we believe that the main goal of OECD discussion draft should be to provide additional clarity to the application of the TPSM without altering the way the most appropriate transfer pricing method is selected. We set out below our representations on the Discussion Draft:

1. The discussion draft refers to "operating profit" as a concept through the entire document, but this term is not defined in the 2017 TP Guidance glossary, nor is it a measure defined under IFRS. We would suggest including a definition in the glossary.

2. Similarly, the draft refers to "unique and valuable contribution" in several parts of the document, but the term "unique and valuable" is not clearly defined. We suggest including guidance and examples to help identify when a contribution could be considered "unique and valuable".

3. Paragraph 32 of the discussion draft identifies two main factors for the relevant profit to be split and for the profit split factors i.e. the basis on which the profit is split. Firstly, the way in which the profit is to be split has to be consistent with the functional analysis of the controlled transaction under review and reflect the assumption of economically significant risks by at least one of the parties. We agree that it makes sense to split profits based on the functions and risks assumed by each party to the transaction. Secondly, the profit to be split and the profit split factors should be "*capable of being measured in a reliable manner*". Although we recognise that there may be practical difficulties in detailing the ways the profit to be split and the profit split factors should be measured, including a clear definition and examples in the guidance of what "reliable measurements" are, would assist MNEs and Tax Authorities in determining in what circumstances profit splits are appropriate. This is particularly relevant when other internal data rather than those mentioned in para 60 to 63 of the guidance are used (e.g. relative value of employees).

4. We agree that the contribution analysis should be one of the possible approaches to TPSM. However, due to the complexity of the application of the contribution analysis, we would recommend that further detailed guidance is provided on this analysis.

5. Paragraphs 60 and 61 of the discussion draft refer to the drawing-up of balance sheets where assets-based or cost-based profit splitting factors are applied. We consider that there are practical difficulties in achieving this as drawing-up full balance sheets would be time consuming and might require expensive changes to accounting systems. Producing these balance sheets would be difficult on a contemporaneous basis and would be still more challenging if a balance sheet needs to be prepared some years after the transaction occurred.

Specific Questions included within the discussion draft:

1. Whether a split of profit should be based on actual or anticipated profits is dependent on the specific facts and circumstances of the transaction as indicated in paragraph 43 which states that "The determination of the profit to be splits, including whether those profits are actual profit or anticipated profit, should be aligned with the accurately delineated transaction". Therefore, the use of TPSM based on anticipated or actual profit depends on:

    - The level of integration between the companies and what is stated in the written agreement

    - The availability of data

- The volatility of the market where the associated parties operate and the controlled transaction takes place, and whether the actual profits are expected to be significantly different to the anticipated profits.

Although paragraph 45 suggests the use of anticipated profits for situation where the associated companies make unique and valuable contributions and this seems generally applicable in similar situations, it does not mean that actual profits are only applicable in scenarios where the companies are highly integrated.

While we fully agree with the statement at paragraph 46 which clarifies that the delineation of the transaction and the selected profit split factors should be based on written agreements and the use of hindsight should be avoided as this will provide more certainty for multinational companies, this whole area seems still quite opaque in the OECD guidance. We suggest including further examples on this regard to help identifying when the use of anticipated vs actual profits is most appropriated.

2. *A number of profit splitting factors are suggested in the discussion draft. Comments are invited on*:

    a. *Whether reference to capital or capital employed should be retained as a potential profit splitting factor*. Although capital itself may be an important factor in general, its role should be analysed in respect of the transaction under analysis and to what extent the profits are derived from the deployment of capital as opposed to other off-balance sheet factors (e.g. labour). Additionally, it would worth clarifying whether the capital or capital employed as reflected on the balance sheet can be used as a factor or whether any adjustments are required.

    b. *Whether headcount of similarly skilled and competent employees should be included as a profit splitting factor*. Headcount may be a suitable factor depending on the facts and circumstances of the transaction. Analysis would need to be undertaken to ascertain which employees to include and their relative value as it should be noted a higher headcount number in a specific function does not necessarily reflect higher value. Hence the reference to "similarly skilled" is particularly important. Employees engaged in more routine activities should be excluded (and should command a routine return).

c. *Whether adjustments should be made for purchasing power parity*. This would be difficult to estimate. For example, although labour cost could potentially be used as profit splitting factor, the cost of living in different countries influences the payroll cost itself and it would be difficult to quantify an appropriate adjustment. Whilst we agree that the guidance should not be overly prescriptive, we welcome as much detail and as many examples as possible to define the factors that can be used as a basis for splitting profits.

3. Example: The example below is one where a Residual Profit Split analysis should be considered the most appropriate transfer pricing method, and sets out how it should be applied.

Company A, company B and company C are members of an MNE group that globally sells online data services and the companies are located in different jurisdictions.

Companies A, B and C each own certain brands and product offerings but they have entered into an agreement that these be pooled together and sold to customers as a package via an online platform. Companies A, B and C have worked together and continue to work together to develop the online platform along with other technology that supports the product offerings. The three companies also share certain back office functions including communication, finance, legal and HR. Each company has its own salesforce.

Companies A, B and C are the main intangible owning companies. Functional analysis has concluded that the significant people functions (SPF) are located within companies A, B and C and the economically significant risks in relation to the high-value functions are also shared between companies A, B and C.

While each of the three companies contributes unique intangibles, it is when they are aggregated together and sold as a package via the online platform that they generate the overall value for the business. The companies co-develop and share the same technology, and therefore the final results strongly depend on the activities of all three companies.

The above would indicate that the transactional profit split method would be the most appropriate transfer pricing method for attributing the residual profits of the business to the legal entities in countries A, B and C.

The three companies are rewarded for routine activities (sales, back office activities etc.) using percentages of sales or cost-plus mark-ups that have been benchmarked externally.

The residual profit is then apportioned between the three companies based on a formula that reflects the value contributed by the SPFs in each jurisdiction in creating the content, along with the ownership and development of the brands and technology.

We would like to thank you again for providing us with the opportunity to comment on the discussion draft and look forward to being included in the discussion process.

Yours faithfully

Dominic Mathon
Catherine Harlow
Selena Ferrari

Paris, September 15, 2017

OECD/CTPA

Tax Treaties, Transfer Pricing and Financial Transactions Division
2 rue André-Pascal
75775, Paris, Cedex 16
France

Submitted by email to: TransferPricing@oecd.org

Subject: Discussion Draft on the Revised Guidance on Profit Splits

Dear Working Party No. 6,

Thank you for the opportunity to comment on the Discussion Draft: BEPS Action 10 – Revised Guidance on Profit Splits, issued on June 22, 2017 (the "discussion draft").

The main purpose of this written contribution is to provide detailed examples of practical implementation aspects of a profit split model.

Profit split models are often discussed only conceptually or with very high-level numerical examples. A more detailed set of examples may be helpful to identify complexities, weaknesses, critical aspects, but also opportunities for simplifications. In addition, a relatively detailed numerical example allows to test the practical consequences of different approaches: in particular, a split of anticipated profits vs. a split of actual profits and the use of a lump sum vs. a sales based royalty.

This written contribution focuses on a practical example and two variations of the same example (best case and worst case); the example is kept as simple as possible, but tries to identify and discuss all the key factors of a profit split model.

The analysis and conclusions focus in particular on two areas:

1. Describe the mechanics, practical implications, administration issues and simplification alternatives of a profit split model; and
2. Identify concerns about a method based on anticipated profits and a method based on actual profits.

I am fully available to provide clarifications or further analyses if needed.

Sincerely,

Alberto Pluviano

SATIS RES Consulting

Introduction

1. The analysis in this document is developed around a "Base case", which assumes a scenario similar to the one described in example 9 of the discussion draft. Example 9 has been chosen because it provides a scenario compatible with the analysis and comparison of a split of anticipated profits and a split of actual profits. The figures in the Base Case and its variations have been developed to be broadly compatible with both an anticipated profits and an actual profits scenario: in real life, the weight of each party's contributions could be different in one or the other scenario, however the different weights would not modify the general observations that can be derived from the analysis presented in this document.

2. The reference to example 9 in the discussion draft is limited to the respective roles of the two entities (Company A and Company B) as described; in fact, example 9's explicit reference to the retail fashion industry doesn't seem to fit well to the features of such industry, which tends to be characterized by the existence of independent comparables (in particular for the phase of development of new markets) and/or by very centralised business models, for which one-sided methods are often more appropriate.

3. The Base Case focuses on a scenario of split of anticipated profits, while the Best Case and Worst Case highlight certain implications of a model based on actual profits; they also highlight concerns related to the choice of one or the other method (anticipated vs. actual profits).

4. In order to simplify the example, it is assumed a useful life of 5 years for the intangible contributed by Company A. The financial projections are therefore limited to 5 years and all amounts in years 2 to 5 are discounted using an interest rate of 8%. The column NPV shows the net present value ("NPV") of the amounts of each line.

Base Case

Table 1: Base Case

P&L forecast	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
Company B						
A. Sales	100.0	110.0	121.0	133.1	146.4	480.4
B. Routine Costs	-15.0	-16.4	-17.8	-19.4	-21.2	-70.7
C. Residual-driving Costs	-12.0	-13.1	-14.3	-15.5	-16.9	-56.6
Company A						
D. Routine Costs	-35.0	-38.2	-41.6	-45.3	-49.4	-165.1
E. Residual-driving Costs	-20.0	-21.8	-23.8	-25.9	-28.2	-94.3
F. Trademarks and know-how costs	-3.0	-3.3	-3.6	-3.9	-4.2	-14.1
G. Net (system) Profit	15.0	17.4	20.0	23.0	26.4	79.6
Profit % of sales	*15.0%*	*15.8%*	*16.5%*	*17.3%*	*18.0%*	*16.6%*

H. Trademarks and know-how value	100

5. Table 1 above illustrates the "Base Case" P&L forecast for the two entities: Company A and Company B. The following assumptions have been made for each line:

- A. Sales: this line shows the customer revenue of Company B; sales are assumed to grow at a rate of 10% per year.
- B. Routine Costs: this line shows all Routine Costs of Company B, assumed to be essentially costs related to sales and distribution activities. All cost lines (from B to F) are assumed to grow at a rate of 9% per year: a lower rate than revenue growth, to take into account the (stabilizing) impact of fixed costs.
- C. Residual-driving Costs: this line shows all costs of Company B related to activities considered to be entitled to a residual profit allocation.
- D. Routine Costs: this line shows all Routine Costs of Company A, including, in particular, manufacturing costs.
- E. Residual-driving Costs: this line shows all costs of Company A related to activities considered to be entitled to a residual profit allocation, including, in particular, products development and centralized marketing activities.
- F. Trademarks and know-how costs: this line includes all costs of Company A related to maintenance and protection of the intangibles whose value is shown in line H.
- G. Net (system) Profit: this line shows the net consolidated profit generated by the Group (Company A and Company B) from Company B's sales to third party customers.
- Line "H. Trademarks and know-how value": this line shows the assumed value of trademarks and know-how contributed by Company A. For simplification purposes, the amount is assumed to represent the value at the start of the transaction. This paper does not discuss in details the valuation issues related to the determination of the intangibles' value, however it is important to stress the importance of avoiding "circular references" which could affect the profit split calculation: in particular, a valuation based on a discounted cashflow ("DCF") analysis would require solutions to avoid assumptions on the profitability of the parties that would influence the profit split results.

Table 2: Base Case profit allocation

Profit allocation	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
K. Company B routine: B x 5%	0.8	0.8	0.9	1.0	1.1	3.5
L. Company A routine: D x 5%	1.8	1.9	2.1	2.3	2.5	8.3
M. Total routine profit: K + L	2.5	2.7	3.0	3.2	3.5	11.8
N. Residual profit: G – M	12.5	14.6	17.0	19.8	22.9	67.8
P. Company B residual: C / (C+E+H)						23%
R. Company A residual: (E+H)/(C+E+H)						77%
S. Company B residual: N x P	2.8	3.3	3.8	4.5	5.2	15.3
T. Company A residual: N x R	9.7	11.3	13.2	15.3	17.7	52.5
Company B profit: K + S	3.6	4.1	4.7	5.4	6.2	18.8
Company A profit: L + T	11.4	13.2	15.3	17.6	20.2	60.7
U. Transfer Price of goods: D + E + L	56.8	61.9	67.4	73.5	80.1	267.6
V. Royalty: F + T	12.7	14.6	16.8	19.2	22.0	66.6
Royalty % of Sales	*12.7%*	*13.3%*	*13.9%*	*14.4%*	*15.0%*	*13.9%*

6. Table 2 above illustrates the "Base Case" profit allocation for the two entities: Company A and Company B. The various steps are illustrated by the formulas shown in each line. The following assumptions have been made for the profit allocations and for the transfer price calculations:
    - The routine profit of Company A and Company B is calculated as 5% of their respective routine costs.
    - The residual profit is allocated in proportion to the residual driving costs of each Company, plus the value of Company A's intangibles: this is an oversimplification and an unrealistic assumption and it is taken only in order to simplify the illustration (in fact, comparing the value of the intangible with the NPV of costs would require more sophisticated analyses to bring their values to a comparable basis).
    - For simplification purposes, it is assumed that the Transfer Price of goods from Company A to Company B will recover all routine and residual-driving costs of Company A, plus its entitlement to routine profit; on the other hand, the Royalty will recover only the costs specific to maintenance and protection of the intangibles, plus all Company A's residual profit.

Table 3: Base Case P&L's

Company A P&L	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
U. Transfer Price of goods: D + E + L	56.8	61.9	67.4	73.5	80.1	267.6
V. Royalty: F + T	12.7	14.6	16.8	19.2	22.0	66.6
D. Routine Costs	-35.0	-38.2	-41.6	-45.3	-49.4	-165.1
E. Residual-driving Costs	-20.0	-21.8	-23.8	-25.9	-28.2	-94.3
F. Trademarks and know-how costs	-3.0	-3.3	-3.6	-3.9	-4.2	-14.1
Company A profit	11.4	13.2	15.3	17.6	20.2	60.7

Company B P&L	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
A. Sales	100.0	110.0	121.0	133.1	146.4	480.4
U. Transfer Price of goods: D + E + L	-56.8	-61.9	-67.4	-73.5	-80.1	-267.6
V. Royalty: F + T	-12.7	-14.6	-16.8	-19.2	-22.0	-66.6
B. Routine Costs	-15.0	-16.4	-17.8	-19.4	-21.2	-70.7
C. Residual-driving Costs	-12.0	-13.1	-14.3	-15.5	-16.9	-56.6
Company B profit	3.6	4.1	4.7	5.4	6.2	18.8

7. Table 3 above shows the resulting profit and loss statement ("P&L") of Company A and Company B, including their intra-group transactions: Transfer Price and Royalty represent the revenue of Company A and a charge for Company B; this leads to the desired split of total profit as calculated in Table 2.

8. However, the P&L's in Table 3 assume a royalty percentage which is different each year, following the evolution of the profitability (the royalty rates are shown in the line "Royalty % of Sales" at the end of Table 2): this is unlikely to be a common practice between unrelated parties. A simple solution is represented by using for all years the royalty percentage calculated in the NPV column. Table 4 below shows the results of using a 13.9% royalty rate for all years: the profit distribution is different by year, but the total NPV for the 5 years is identical.

Table 4: Base Case P&L's with stable royalty rate

Company A P&L	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
U. Transfer Price of goods: D + E + L	56.8	61.9	67.4	73.5	80.1	267.6
Royalty: 13.9% of Sales	13.9	15.3	16.8	18.5	20.3	66.6
D. Routine Costs	-35.0	-38.2	-41.6	-45.3	-49.4	-165.1
E. Residual-driving Costs	-20.0	-21.8	-23.8	-25.9	-28.2	-94.3
F. Trademarks and know-how costs	-3.0	-3.3	-3.6	-3.9	-4.2	-14.1
Company A profit	12.6	13.9	15.3	16.8	18.5	60.7

Company B P&L	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
A. Sales	100.0	110.0	121.0	133.1	146.4	480.4
U. Transfer Price of goods: D + E + L	-56.8	-61.9	-67.4	-73.5	-80.1	-267.6
Royalty: 13.9% of Sales	-13.9	-15.3	-16.8	-18.5	-20.3	-66.6
B. Routine Costs	-15.0	-16.4	-17.8	-19.4	-21.2	-70.7
C. Residual-driving Costs	-12.0	-13.1	-14.3	-15.5	-16.9	-56.6
Company B profit	2.4	3.5	4.7	6.2	7.9	18.8

9. The Base Case has been developed taking into account the wording in the discussion draft; in particular, par. 107 of the discussion draft states that: *"the application of the transactional profit split should be based on the profits anticipated to be generated by Company B from commercialising the products over an appropriate period (e.g. using a discounted cash flow valuation technique …)"*. For this reason, the Base Case shows an example of NPV calculation. This provides some insight of the uncertainties which are embedded even in a relatively simplified model, in particular: the accurate estimate of each revenue and cost element, their forecasted growth (positive or negative), the useful life of intangibles, the discount rate, etc.

10. Such uncertainties do not necessarily represent a weakness, but are indicative of the fact that it cannot be assumed that a profit split model will provide a perfect answer. Knowing such limits (which would affect also dealings between independent parties) one dimension that should not be forgotten is the tolerance for reasonable approximations and simplifications which could be adopted by independent parties dealing at arm's length.

11. Another important subject in relation to simplifications is the analysis of costs and benefits of introducing valuation techniques in the model. As mentioned at par. 9 above, the Base Case example includes the NPV calculation of anticipated revenue and cost items in order to reflect the wording of par. 107 of the discussion draft (quoted above). It is clear that such type of analysis is necessary if the objective of the model is the calculation of a lump-sum, i.e. the amount of 66.6 in line V.

12. However, a significant simplification can be envisaged if the objective is the calculation of a sales based royalty percentage. Let's assume that, estimating that a five years forecast is too unreliable, Company A and Company B identify a more reliable time horizon in three years. In addition, considering also the expected stable proportion of values, it may be assessed that a simple sum of the three years' values does not create major distortions vs. a NPV calculation. Table 5 below summarizes the results of a simplified analysis based on the following parameters (using the same data of Table 1):

- P&L forecast limited to the simple sum of the first three years' forecast;
- Allocation of the intangible's value in a proportion of 1/5 to each year (however, considering the lack of consistency with the fact that values are not discounted, a rudimentary adjustment is made, increasing the value of the intangible of 10% per year, in year 2 and year 3, i.e. the same ratio of revenue growth).
- Royalty calculation based on the same model of Table 2, on the three years' sum of values.

Table 5: simplified royalty calculation

P&L forecast	Year 1	Year 2	Year 3	Sum
Company B				
A. Sales	100.0	110.0	121.0	331.0
B. Routine Costs	-15.0	-16.4	-17.8	-49.2
C. Residual-driving Costs	-12.0	-13.1	-14.3	-39.3
Company A				
D. Routine Costs	-35.0	-38.2	-41.6	-114.7
E. Residual-driving Costs	-20.0	-21.8	-23.8	-65.6
F. Trademarks and know-how costs	-3.0	-3.3	-3.6	-9.8
G. Net (system) Profit	15.0	17.4	20.0	52.4
Profit % of sales	*15.0%*	*15.8%*	*16.5%*	*15.8%*
H. Trademarks and know-how value	20.0	22.0	24.2	66.2
Profit allocation				
K. Company B routine: B x 5%				2.5
L. Company A routine: D x 5%				5.7
M. Total routine profit: K + L				8.2
N. Residual profit: G - M				44.2
P. Company B residual: C / (C+E+H)				23%
R. Company A residual: (E+H)/(C+E+H)				77%
S. Company B residual: N x P				10.2
T. Company A residual: N x R				34.0
V. Royalty: F + T				43.8
Royalty % of Sales				*13.2%*

13. As shown in table 5 above, the simplified royalty calculation leads to a royalty rate of 13.2% instead of 13.9% in the more sophisticated calculation of Table 2, i.e. a less than 5% difference.

14. The key observation, in my view, is that 13.9% cannot be considered a "perfect" result. Considering the uncertainties and complexities of any transfer pricing analysis, a unique perfect result cannot exist; therefore, the key question is whether the simplification reflects an approach that independent parties would consider reasonable. In addition, it would appear consistent with an arm's length behavior the calculation of a range of possible results (for example by applying different growth rates): the variance of less than 5% in the example seems quite likely to fall within a calculated range of acceptable results (the concept of

range raises also a concern about the interpretation of "actual profits" in the discussion draft, as discussed further in the conclusions of this document).

Best Case and Worst Case

15. Two alternative scenarios have been built to support the analysis of the differences between anticipated profits and actual profits and the analysis of the consequences of using a lump sum or a sales based royalty.
    - In the Best Case, Sales revenue is assumed to grow at a rate of 20% per year (instead of 10% in the Base Case); costs are assumed to grow at a rate of 18% per year (instead of 9% in the Base Case). All other parameters are the same as in the Base Case.
    - In the Worst Case, Sales and costs are stable for the 5 years (no growth). All other parameters are the same as in the Base Case.
16. The tables below summarize the P&L forecast and the profit allocation for the two Cases, using the same layout of the Base Case.

Table 6: Best Case

P&L forecast	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
Company B						
A. Sales	100.0	120.0	144.0	172.8	207.4	577.9
B. Routine Costs	-15.0	-17.7	-20.9	-24.6	-29.1	-83.6
C. Residual-driving Costs	-12.0	-14.2	-16.7	-19.7	-23.3	-66.8
Company A						
D. Routine Costs	-35.0	-41.3	-48.7	-57.5	-67.9	-195.0
E. Residual-driving Costs	-20.0	-23.6	-27.8	-32.9	-38.8	-111.4
F. Trademarks and know-how costs	-3.0	-3.5	-4.2	-4.9	-5.8	-16.7
G. Net (system) Profit	15.0	19.7	25.6	33.1	42.6	104.5
Profit % of sales	*15.0%*	*16.4%*	*17.8%*	*19.2%*	*20.5%*	*18.1%*
H. Trademarks and know-how value						100

Table 7: Best Case profit allocation

Profit allocation	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
K. Company B routine: B x 5%	0.8	0.9	1.0	1.2	1.5	4.2
L. Company A routine: D x 5%	1.8	2.1	2.4	2.9	3.4	9.7
M. Total routine profit: K + L	2.5	3.0	3.5	4.1	4.8	13.9
N. Residual profit: G - M	12.5	16.8	22.2	29.0	37.7	90.5
P. Company B residual: C / (C+E+H)						24%
R. Company A residual: (E+H)/(C+E+H)						76%
S. Company B residual: N x P	3.0	4.0	5.3	7.0	9.1	21.8
T. Company A residual: N x R	9.5	12.7	16.8	22.1	28.7	68.8
Company B profit: K + S	3.8	4.9	6.4	8.2	10.5	25.9

Company A profit: L + T	11.2	14.8	19.3	24.9	32.0	78.5
U. Transfer Price of goods: D + E + L	56.8	67.0	79.0	93.2	110.0	316.1
V. Royalty: F + T	12.5	16.3	21.0	27.0	34.5	85.5
Royalty % of Sales	*12.5%*	*13.6%*	*14.6%*	*15.6%*	*16.6%*	*14.8%*

Table 8: Worst Case

P&L forecast	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
Company B						
A. Sales	100.0	100.0	100.0	100.0	100.0	399.3
B. Routine Costs	-15.0	-15.0	-15.0	-15.0	-15.0	-59.9
C. Residual-driving Costs	-12.0	-12.0	-12.0	-12.0	-12.0	-47.9
Company A						
D. Routine Costs	-35.0	-35.0	-35.0	-35.0	-35.0	-139.7
E. Residual-driving Costs	-20.0	-20.0	-20.0	-20.0	-20.0	-79.9
F. Trademarks and know-how costs	-3.0	-3.0	-3.0	-3.0	-3.0	-12.0
G. Net (system) Profit	15.0	15.0	15.0	15.0	15.0	59.9
Profit % of sales	*15.0%*	*15.0%*	*15.0%*	*15.0%*	*15.0%*	*15.0%*

H. Trademarks and know-how value	100

Table 9: Worst Case profit allocation

Profit allocation	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
K. Company B routine: B x 5%	0.8	0.8	0.8	0.8	0.8	3.0
L. Company A routine: D x 5%	1.8	1.8	1.8	1.8	1.8	7.0
M. Total routine profit: K + L	2.5	2.5	2.5	2.5	2.5	10.0
N. Residual profit: G - M	12.5	12.5	12.5	12.5	12.5	49.9
P. Company B residual: C / (C+E+H)						21%
R. Company A residual: (E+H)/(C+E+H)						79%
S. Company B residual: N x P	2.6	2.6	2.6	2.6	2.6	10.5
T. Company A residual: N x R	9.9	9.9	9.9	9.9	9.9	39.4
Company B profit: K + S	3.4	3.4	3.4	3.4	3.4	13.5
Company A profit: L + T	11.6	11.6	11.6	11.6	11.6	46.4
U. Transfer Price of goods: D + E + L	56.8	56.8	56.8	56.8	56.8	226.6
V. Royalty: F + T	12.9	12.9	12.9	12.9	12.9	51.4
Royalty % of Sales	*12.9%*	*12.9%*	*12.9%*	*12.9%*	*12.9%*	*12.9%*

17. The resulting P&L's of Company A and Company B (with the same layout of Tables 3 and 4) are attached in the Appendix to this document. The tables below summarize the comparison of profits resulting from three different approaches:

    - Split of actual profits, as calculated in Table 7 and Table 9.

- Fixed lump sum, as calculated in the Base Case (Table 2), i.e. 66.6.
- Fixed percentage of royalty, as calculated in the Base Case (Table 2), i.e. 13.9%.

Table 10: Best Case summary (and comparison with the original Base Case)

BEST CASE	Actual Profits	Lump Sum	Royalty base case	Original Base Case
Company A	78.5	59.7	73.2	60.7
Company B	25.9	44.8	31.3	18.8
Total Profit	104.5	104.5	104.5	79.6
Implied royalty % of sales	*14.8%*		*13.9%*	*13.9%*
Implied lump sum amount	*85.5*	*66.6*		*66.6*

18. In the Best Case scenario, a profit split recalculation based on actual profits would imply higher profits for both Company A and Company B and also a higher royalty rate or higher lump sum, as shown in the column "Actual Profits".

19. In a profit split based on anticipated profits and a lump sum approach, the lump sum would remain unchanged, as shown in the column "Lump Sum". Conceptually, this approach appears to be the closest one to the concept of anticipated profits split, because the lump sum perceived by Company A is unchanged; however, it should be noted that Company A will face higher costs driven by higher than anticipated growth: this will reduce the amount of profit perceived by Company A. Company B will entirely benefit of the higher profits, because its lump sum payment is fixed.

20. In a profit split based on anticipated profits and a sales based royalty, the royalty rate will remain unchanged, but the royalty amount will grow due to the higher sales revenue. Therefore, in practice, this approach will be impacted by actual profits and bring to results which (as shown in the column "Royalty base case") may be close to actual profit split (depending also on the mix between fixed and variable costs).

21. In practice, in the Best Case example above, higher than anticipated growth brings to actual results that are always different from the anticipated ones, however there is a significant difference between the lump sum approach, leading Company A to results close to the anticipated ones, vs. the royalty approach, leading Company A to results close to a split of actual profits.

Table 11: Worst Case summary (and comparison with the original Base Case)

WORST CASE	Actual Profits	Lump Sum	Royalty base case	Original Base Case
Company A	46.4	61.6	50.4	60.7
Company B	13.5	-1.7	9.5	18.8
Total Profit	59.9	59.9	59.9	79.6
Implied royalty % of sales	*12.9%*		*13.9%*	*13.9%*
Implied lump sum amount	*51.4*	*66.6*		*66.6*

22. In the Worst Case scenario, a profit split recalculation based on actual profits would imply lower profits for both Company A and Company B and also a lower royalty rate or lower lump sum, as shown in the column "Actual Profits".

23. In a profit split based on anticipated profits and a lump sum approach, the lump sum would remain unchanged, as shown in the column "Lump Sum". Conceptually, this approach appears to be the closest one to the concept of anticipated profits split, because the lump sum perceived by Company A is unchanged; however, it should be noted that Company A will face lower than anticipated costs driven by the absence of the anticipated growth: this will actually increase the amount of profit perceived by Company A. Company B will entirely suffer the impact of lower profits, because its lump sum payment is fixed. In this example, Company B is even suffering an overall loss: this may still be an arm's length result if all the conditions are met to strictly apply a method based on the split of anticipated profits; however the risk of challenge by (Country B's) Tax Authorities could be very significant in all cases where the choice of the methodology may be controversial.

24. In a profit split based on anticipated profits and a sales based royalty, the royalty rate will remain unchanged, but the royalty amount will decrease due to the lower sales revenue. Therefore, in practice, this approach will be impacted by actual profits and bring to results which (as shown in the column "Royalty base case") may be close to actual profit split (depending also on the mix between fixed and variable costs).

25. In practice, in the Worst Case example above, the absence of the anticipated growth brings to actual results that are always different from the anticipated ones, however there is a significant difference between the lump sum approach, leading Company A to results close to the anticipated ones, vs. the royalty approach, leading Company A to results close to a split of actual profits.

Transfer Pricing adjustments

26. A literal interpretation of the concept of "split of actual profits" may lead to the conclusion that retrospective adjustments will be required in all cases. For example, exploiting the same data from the scenarios above, Table 12 below shows the actual vs. anticipated transfer price of goods of year 2 in case the Best Case or Worst Case materialize, i.e.: in year 2 the transfer price applied amounts to 61.9 but the calculation based on actual results done after the closing of the year shows that the transfer price should have been 67.0 (in the Best case) or 56.8 (in the Worst case).

Table 12: transfer price adjustments

Transfer pricing of goods	Year 1	Year 2	Delta vs. Base Case	% delta
Base case	56.8	61.9		
Best case	56.8	67.0	5.1	9%
Worst case	56.8	56.8	-5.1	-9%

27. In my view, a rigid interpretation imposing a retrospective adjustment of transfer prices would not be in line with the approach that would be taken by unrelated parties.

28. In fact, considering the complexities, administrative burden and costs (consider, for example, the implications of correcting thousands of invoices and related customs/VAT declarations), it is likely that unrelated parties would agree to adjustments to be made within the next period's pricing and to be calculated in order to recover the previous period's delta, at least when deltas remain limited within a certain range.

Conclusions

29. Based on the analyses presented above, I would suggest to consider the development of further guidance to clarify the interpretation of the concept of "anticipated profits" and "actual profits". Taking the example of the lump sum payment vs. a sales based royalty in a scenario of split of anticipated profits, if the Best Case described above materializes, Country B's Tax Authorities could take the position that, interpreting literally the concept of "anticipated profits", only the lump sum approach is an acceptable method, because the royalty is impacted by actual results; on the other hand, Country A's Tax Authorities may take the position that a sales based royalty is equally applicable, based on the wording of par. 108 of the discussion draft (which could be read as indifferently allowing the two approaches). This type of situations could lead to significant controversies.

30. It would be important, in my view, to acknowledge that intermediate situations exists, at arm's length, which cannot strictly be classified as a pure split of anticipated or actual profits and provide refined guidance on these situations.

31. Simplifications appear to be possible, and consistent with arm's length practices; in particular:

    - keeping a sales based royalty rate fixed for a number of years (considering the self adjusting nature of a royalty expressed as percentage of sales), and
    - implementing transfer pricing adjustments based on actual profits as adjustments to the next period's pricing rather than retrospectively.

32. Finally, I would suggest considering the inclusion within the profit split guidance of explicit wording reminding that a profit split analysis is not likely to identify a unique target result, but rather an arm's length range. The use of ranges seems to be obvious for the "routine" portion of a residual profit split analysis (i.e. considering the arm's length range provided by the method used to determine the routine profit allocation); in my view, the same concepts should apply to the residual profit allocation, consistently with the definitions and principles related to the arm's length range in section A7 of chapter III of the OECD Transfer Pricing Guidelines.

e-mail: alberto.pluviano@satisres.com

APPENDIX

Best Case P&L's

Best Case P&L's - actual profits

Company A P&L	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
U. Transfer Price of goods: D + E + L	56.8	67.0	79.0	93.2	110.0	316.1
V. Royalty: F + T	12.5	16.3	21.0	27.0	34.5	85.5
D. Routine Costs	-35.0	-41.3	-48.7	-57.5	-67.9	-195.0
E. Residual-driving Costs	-20.0	-23.6	-27.8	-32.9	-38.8	-111.4
F. Trademarks and know-how costs	-3.0	-3.5	-4.2	-4.9	-5.8	-16.7
Company A profit	11.2	14.8	19.3	24.9	32.0	78.5

Company B P&L	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
A. Sales	100.0	120.0	144.0	172.8	207.4	577.9
U. Transfer Price of goods: D + E + L	-56.8	-67.0	-79.0	-93.2	-110.0	-316.1
V. Royalty: F + T	-12.5	-16.3	-21.0	-27.0	-34.5	-85.5
B. Routine Costs	-15.0	-17.7	-20.9	-24.6	-29.1	-83.6
C. Residual-driving Costs	-12.0	-14.2	-16.7	-19.7	-23.3	-66.8
Company B profit	3.8	4.9	6.4	8.2	10.5	25.9

Best Case P&L's with stable royalty rate (same rate as Base-case)

Company A P&L	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
U. Transfer Price of goods: D + E + L	56.8	67.0	79.0	93.2	110.0	316.1
Royalty: 13.9% of Sales	13.9	16.6	20.0	24.0	28.8	80.2
D. Routine Costs	-35.0	-41.3	-48.7	-57.5	-67.9	-195.0
E. Residual-driving Costs	-20.0	-23.6	-27.8	-32.9	-38.8	-111.4
F. Trademarks and know-how costs	-3.0	-3.5	-4.2	-4.9	-5.8	-16.7
Company A profit	12.6	15.2	18.2	21.9	26.3	73.2

Company B P&L	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
A. Sales	100.0	120.0	144.0	172.8	207.4	577.9
U. Transfer Price of goods: D + E + L	-56.8	-67.0	-79.0	-93.2	-110.0	-316.1
Royalty: 13.9% of Sales	-13.9	-16.6	-20.0	-24.0	-28.8	-80.2
B. Routine Costs	-15.0	-17.7	-20.9	-24.6	-29.1	-83.6
C. Residual-driving Costs	-12.0	-14.2	-16.7	-19.7	-23.3	-66.8
Company B profit	2.4	4.5	7.4	11.2	16.2	31.3

Best Case P&L's with stable Lump-sum (same lump sum as Base-case)

Company A P&L	NPV
U. Transfer Price of goods: D + E + L	316.1
Lump sum	66.6
D. Routine Costs	-195.0
E. Residual-driving Costs	-111.4
F. Trademarks and know-how costs	-16.7
Company A profit	59.7

Company B P&L	NPV
A. Sales	577.9
U. Transfer Price of goods: D + E + L	-316.1
Lump sum	-66.6
B. Routine Costs	-83.6
C. Residual-driving Costs	-66.8
Company B profit	44.8

<u>Worst Case P&L's</u>

Worst Case P&L's - actual profits

Company A P&L	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
U. Transfer Price of goods: D + E + L	56.8	56.8	56.8	56.8	56.8	226.6
V. Royalty: F + T	12.9	12.9	12.9	12.9	12.9	51.4
D. Routine Costs	-35.0	-35.0	-35.0	-35.0	-35.0	-139.7
E. Residual-driving Costs	-20.0	-20.0	-20.0	-20.0	-20.0	-79.9
F. Trademarks and know-how costs	-3.0	-3.0	-3.0	-3.0	-3.0	-12.0
Company A profit	11.6	11.6	11.6	11.6	11.6	46.4

Company B P&L	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
A. Sales	100.0	100.0	100.0	100.0	100.0	399.3
U. Transfer Price of goods: D + E + L	-56.8	-56.8	-56.8	-56.8	-56.8	-226.6
V. Royalty: F + T	-12.9	-12.9	-12.9	-12.9	-12.9	-51.4
B. Routine Costs	-15.0	-15.0	-15.0	-15.0	-15.0	-59.9
C. Residual-driving Costs	-12.0	-12.0	-12.0	-12.0	-12.0	-47.9
Company B profit	3.4	3.4	3.4	3.4	3.4	13.5

Worst Case P&L's with stable royalty rate (same rate as Base-case)

Company A P&L	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
U. Transfer Price of goods: D + E + L	56.8	56.8	56.8	56.8	56.8	226.6
Royalty: 13.9% of Sales	13.9	13.9	13.9	13.9	13.9	55.4
D. Routine Costs	-35.0	-35.0	-35.0	-35.0	-35.0	-139.7
E. Residual-driving Costs	-20.0	-20.0	-20.0	-20.0	-20.0	-79.9
F. Trademarks and know-how costs	-3.0	-3.0	-3.0	-3.0	-3.0	-12.0
Company A profit	12.6	12.6	12.6	12.6	12.6	50.4

Company B P&L	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
A. Sales	100.0	100.0	100.0	100.0	100.0	399.3
U. Transfer Price of goods: D + E + L	-56.8	-56.8	-56.8	-56.8	-56.8	-226.6
Royalty: 13.9% of Sales	-13.9	-13.9	-13.9	-13.9	-13.9	-55.4
B. Routine Costs	-15.0	-15.0	-15.0	-15.0	-15.0	-59.9
C. Residual-driving Costs	-12.0	-12.0	-12.0	-12.0	-12.0	-47.9
Company B profit	2.4	2.4	2.4	2.4	2.4	9.5

Worst Case P&L's with stable Lump-sum (same lump sum as Base-case)

Company A P&L	NPV
U. Transfer Price of goods: D + E + L	226.6
Lump sum	66.6
D. Routine Costs	-139.7
E. Residual-driving Costs	-79.9
F. Trademarks and know-how costs	-12.0
Company A profit	61.6

Company B P&L	NPV
A. Sales	399.3
U. Transfer Price of goods: D + E + L	-226.6
Lump sum	-66.6
B. Routine Costs	-59.9
C. Residual-driving Costs	-47.9
Company B profit	-1.7

Silicon Valley
TAX DIRECTORS GROUP

2121 41st Avenue
Suite 301
Capitola, CA 95010
PHONE 831.465.8204
FACIMILE 831.465.9384

www.svtdg.org
info@svtdg.org

September 15, 2017

VIA ELECTRONIC TRANSMISSION

Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA
TransferPricing@oecd.org

Re: Comments on June 22, 2017 OECD Public Discussion Draft on BEPS Actions 8–10 *Revised Guidance on Profit Splits*

Dear Sirs or Madams,

The Silicon Valley Tax Directors Group ("***SVTDG***") hereby submits these comments on the above-referenced Public Discussion Draft ("***PDD***"). SVTDG members are listed in the Appendix of this letter.

Sincerely,

Robert F. Johnson

Robert F. Johnson
Co-Chair, Silicon Valley Tax Directors Group

I. INTRODUCTION AND SUMMARY

A. Background on the Silicon Valley Tax Directors Group

The SVTDG represents U.S. high technology companies with a significant presence in Silicon Valley, that are dependent on R&D and worldwide sales to remain competitive. The SVTDG promotes sound, long-term tax policies that allow the U.S. high tech technology industry to continue to be innovative and successful in the global marketplace.

B. Executive summary of comments

The PDD deals with clarification and strengthening of guidance on the transactional profit split method ("***TPSM***") set out in the BEPS Actions 8–10 *Final Report*. In particular, it sets out proposed revised guidance on application of the TPSM, together with three questions. In this letter we comment on the proposed revised guidance, and answer some of the questions.

The SVTDG believes the most reliable indicator of whether the TPSM may be a more appropriate method than a one-sided method is whether each of the parties to a controlled transaction contributes unique or valuable intangibles, or assumes risks that aren't comparable to risks assumed by uncontrolled parties in comparable circumstances and that are a key source of actual or potential profits. The SVTDG recommends the PDD be revised to make this clear. Some of our comments on the PDD follow from this indicator.

Regarding unique and valuable contributions of intangibles to a controlled transaction, the SVTDG recommends the PDD be clarified to explain why consideration of assumption of economically significant risks ("***ESRs***") relating to such intangibles is relevant to whether those intangibles are unique and valuable. Regarding highly-integrated business operations, the SVTDG recommends certain language in the PDD dealing with holistic valuation be changed to make it less confusing (as described below).

The SVTDG has three significant concerns about the PDD's description of risk triggers signaling possible application of the TPSM.

Our first concern relates to three requirements the PDD lists which, if all met, implies likely <u>non</u>-application of the TPSM. One of the requirements is that one party to the transaction doesn't assume ESRs. Consistent with our view of the most reliable indicator (above), the SVTDG believes this requirement should be expanded to be that one party to the transaction doesn't assume ESRs comparable to risks assumed by uncontrolled parties in comparable circumstances. That is, one party assuming ESRs, per se, <u>shouldn't</u> be read to signal possible application of the TPSM as the most reliable method.

Our second concern relates to the PDD assertion that a TPSM may be found to be the most appropriate method in a situation in which each party to a controlled transaction shares the assumption of one or more of the ESRs relating to the transaction. For reasons explained below, the SVTDG recommends the PDD be revised to take into account the point—consistent with *TPG* guidance—that in a two-party controlled transaction that's silent about risk sharing, and in which one party exercises most control over the risk, no risk sharing should be asserted. If these facts obtain, the TPSM shouldn't be found to be the most appropriate method.

Our third concern relates to "closely-related risks." The SVTDG recommends the PDD be revised take into account the directive in the *TPG* that for transfer pricing purposes an associated enterprise can't assume a risk over which it has no control. Accordingly, application of the TPSM in a "closely-related" risks situation would violate this directive if, as a consequence, an associated enterprise is allocated profits or losses relating to risks over which it has no control. Furthermore, the SVTDG respectfully asks that the definition of what makes ESRs "closely related" be further refined to add precision, and that *Example 3* likewise be augmented to better explain its conclusion. The presence of "closely-related risks" in a controlled transaction is a potential red herring if the risks are comparable to risks assumed by uncontrolled parties in comparable circumstances—in this case, the TPSM shouldn't be the most appropriate method.

The SVTDG recommends the Analysis in *Example 3* be revised to clarify confusion (explained below).

Finally, the SVTDG responds to Questions 1 & 2 posed in the PDD.

II. Specific concerns with the PDD

A. Unique and valuable contributions by each of the parties to the transaction

The SVTDG agrees with the PDD that the existence of unique and value contributions by each party to a controlled transaction is an indicator that the TPSM may be appropriate.

The PDD states that in a situation in which each party to a transaction "legally owns unique and valuable intangibles relevant to the transaction, it will also be necessary to consider whether . . . they each assume the [ESRs] relating to those intangibles . . . ."[1] This statement is potentially confusing for two reasons. First, for assets (including intangibles) the indicator depends on whether they're used in or contributed to the transaction. Intangibles being "relevant" to a transaction is a vaguer notion. The SVTDG recommends the statement be made

[1] PPD ¶ 17 (emphasis added).

more precise. Second, the relevant passage doesn't explain why consideration of assumption of ESRs relating to intangibles might relate to whether those intangibles are unique and valuable. If consideration of such intangibles risk is independent from uniqueness or the valuable nature of the intangibles, to avoid confusion we recommend this statement is perhaps better placed in § C.2.2.3, dealing with risks.

B. Highly integrated business operations

The PDD states that in a situation in which contributions by associated enterprises to a controlled transaction are highly inter-related or inter-dependent upon each other, "the evaluation of the respective contributions of the parties may be need to be done holistically."[2] The PDD explains this statement with an example:

> For instance, the contribution by each party may be unique and valuable, or may have a greater value when considered in combination with the particular contribution of the other party, even if it may not have such significant value on a purely standalone basis. See [*TPG* ¶ 6.94].

This statement is potentially confusing. The initial indicator for when a TPSM might be the most appropriate method is if each of the parties to the transaction makes unique and valuable contributions to the controlled transaction. Referenced paragraph 6.94 in the *TPG* makes the point that intangibles may have greater value in the aggregate rather than in isolation. But uniqueness of the contribution—whether or not the contribution is comparable to those made by uncontrolled parties in comparable circumstances—should be independent of whether the evaluation is holistic. If a party to a controlled transaction makes non-unique contributions, that should preclude the TPSM from being an appropriate method. The SVTDG recommends the above quoted sentence be modified to delete reference to uniqueness.

C. Risk sharing

1. The conditions for non-applicability of the TPSM should be revised

The PDD signals that a TPSM "typically would not be appropriate" if accurate delineation of the transaction determines that one party to the transaction (i) performs only simple functions; (ii) doesn't assume ESRs in relation to the transaction; and (iii) doesn't otherwise make any contribution that's unique and valuable.[3] *Example 4* concludes on its facts that the TPSM mightn't be the most appropriate method because the functional analysis determines the risks assumed by one party (Company B) aren't economically significant for the

---

[2] PDD ¶ 22.

[3] PDD ¶ 14.

business operation. That is, requirement (ii) is met (in addition, presumably, to requirements (i) & (iii)).

The three requirements listed for likely non-application of the TPSM wouldn't be met—thereby potentially allowing application of the TPSM, according to the PDD—if, for example, one of the parties performs only simple functions (satisfying (i)) yet assumes ESRs in relation to the transaction, regardless of the nature of the risks assumed. For example, the risks assumed could be non-unique in the sense that they're comparable to risks assumed by uncontrolled parties in comparable circumstances. The SVTDG believes that in this case the TPSM also typically would not be appropriate because a one-sided method would likely be the most appropriate method. The TPSM shouldn't be considered as an appropriate method if there's evidence of comparable risks assumed by uncontrolled parties in comparable circumstances, regardless of the nature of the risks (whether economically significant or not), or the extent of risk sharing between the parties.

The SVTDG accordingly recommends requirements (i)–(iii) be revised to reflect this. The problem can be remedied by including the sub-requirements of uniqueness and being valuable in requirement (ii). That is, the three requirements signaling typical inappropriateness of the TPSM would be that one party to the transaction (i) performs only simple functions; (ii) doesn't assume, in a unique way, ESRs in relation to the transaction; and (iii) doesn't otherwise make any contribution that's unique and valuable.

2. The conditions indicating appropriateness of the TPSM are ill defined—shared assumption of ESRs, or separate assumption of closely-related risks

a. Shared assumption of ESRs

The PDD states that a TPSM may be found to be the most appropriate method in a situation in which each party to the controlled transaction shares the assumption of one or more of the ESRs in relation to that transaction.[4] For this assertion the PDD cites *TPG* ¶ 1.95, which provides:

> Where two or more parties to the transaction assume a specific risk (as analysed under step 4(i)), and in addition they together control the specific risk and each has the financial capacity to assume their share of the risk, then that assumption of risk should be respected. Examples may include the contractual assumption of development risk under a transaction in which the enterprises agree jointly to bear the costs of creating a new product.

---

[4] PDD ¶ 25

As *TPG* ¶ 1.95 makes clear, a pre-requisite for shared assumption of an ESR relating to a transaction is an explicit agreement between the two parties to that effect. The SVTDG recommends the PDD clarify this point. Clarification is necessary lest the TPSM be asserted as the most appropriate method indiscriminately by a tax administration, for example in a situation in which one of the parties simply performs minor control functions relating to a risk, with no explicit intention of sharing the risk. The *TPG* are clear that in a situation in which several parties both exercise control over a risk and have financial capacity to assume the risk, "the risk should be allocated to the associated enterprise or group of associated enterprises exercising the most control."[5] In a two party controlled transaction that's silent about risk sharing, and in which one party exercises most control over the risk, no risk sharing should be asserted, and accordingly these facts shouldn't present a situation in which the TPSM is likely appropriate. The SVTDG respectfully requests that the PDD be clarified on that point.[6]

b. Separate assumption of closely inter-related risks

The *TPG* provide that an associated enterprise can't—for transfer pricing purposes—assume a risk over which it exercises no control.[7] Application of the TPSM in a situation in which associated enterprises separately share "closely-related" risks is contrary to this principle if, as a result of application of a TPSM, an associated enterprise is allocated profits or losses relating to risks over which it has no control. The SVTDG recommends the PDD be clarified to make this point.

The PDD states that a TPSM may be found to be the most appropriate method in a situation in which "the various [ESRs] in relation to the transaction are separately assumed by the parties, but those risks are closely inter-related such that the playing out of the risks of each party cannot reliably be isolated."[8] Defining "closely inter-related" risks to be those "such that the playing out of the risks of each party cannot reliably be isolated" is vague and provides little

---

[5] *TPG* ¶ 1.98.

[6] The PDD tangentially addresses this point in § C.2.2.2—dealing with highly integrated business operations—in ¶ 24, which provides that "[w]here a party contributes to the control of economically significant risk, but that risk is assumed by the other party to the transaction, this may, in some cases, demonstrate that it is appropriate for the first party to share in the potential upside and downside associated with that risk, commensurate with its contribution to control . . . . [See *TPG* ¶ 1.105]. However, the mere fact that an entity performs control functions in relation to a risk will not necessarily lead to the conclusion that the [TPSM] is the most appropriate method in the case." (Emphasis added).

[7] *TPG* ¶ 1.95 provides that "[i]f it is established . . . that [an] associated enterprise does not exercise control over the risk . . . then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk."

[8] PDD ¶¶ 13 & 23—in sections not nominally dealing with risk—refer to "closely related" risks.

helpful guidance to taxpayers. The SVTDG respectfully asks that the definition of what makes ESRs "closely inter-related" be further refined to add precision. *Example 3* concludes on the facts that the relevant risks "are closely inter-related and interdependent upon each other" but doesn't explain how this conclusion is reached—in particular, it doesn't explain why "the playing out of the risks of each party cannot reliably be isolated."[9] The SVTDG also recommends *Example 3* be clarified to explain the conclusion.

It's possible that a company performing routine functions for an associated enterprise also bears certain risks under this transaction, consistent with allocations of risk observed at arm's length. For example, a company performing distribution services may also bear a part of the downside resulting from product failure through losses on inventories of the product, or by bearing product warranty risks for the product. To the extent similar risks are borne at arm's length by unaffiliated distributors, a transactional benchmarking analysis may be used to establish the arm's length profit margin of the company. But the language of the current PDD may leave room for a tax administration to assert a TPSM as the most appropriate method for pricing payments to the distributor, on the grounds that product warranty risks are "closely inter-related" to product quality, which in turn is related to the development and marketing activities of the associated enterprise. That is, the tax administration might assert the playing out of risks of the principal and the distributor can't reliably be isolated. This example shows how imprecision in the definition of "closely inter-related" risks can work to taxpayers' detriment. This example also shows that—regardless of how "closely inter-related" ESRs are defined—the TPSM shouldn't be considered an appropriate method if such risks are comparable to risks assumed by uncontrolled parties in comparable circumstances. The SVTDG recommends that the PDD be revised to clarify this.

III. RECOMMENDATIONS FOR CHANGES TO *EXAMPLE 3*

In section II.2.b, above, we explained how the analysis in *Example 3* was conclusory and unhelpful in explaining why the relevant risks were "closely inter-related." *Example 3* is also troublesome because of confusing language:

> The performance of each of the parties and the outcomes of each of their respective risks have a very significant influence on the other <u>and the contributions of Company A and Company B are unique and valuable</u>. Under these circumstances, the [TPSM] is likely to be the most appropriate method for determining the profits of Company A and

---

[9] *Example 3* introduces, without definition, the concept of "inter-dependent" risks—presumably as distinct from "inter-related" risks. This introduces some confusion. The relevance of this new term is unclear from the *Example*.

> Company B from the sales of the products as both parties to the transaction assume closely related risks that are economically significant for their business operations.[10]

We also pointed out in section II.2.b, above, that shared assumption by both parties of ESRs, or separate assumption of closely-related ESRs, shouldn't be an indicator of whether the TPSM is an appropriate method if those ESRs are comparable to risks assumed by uncontrolled parties in comparable circumstances. Under those circumstances a one-side method is more likely to be the most appropriate. The statement in the passage above that "the contributions of Company A and Company B are unique" could be taken to mean that the risks assumed by Company A and Company B are unique—i.e., there are no comparable risks assumed by uncontrolled parties in comparable circumstances. If that's what was meant, then the conclusion holds, but only because of a necessary further reason: not only are the risks "closely related" and economically significant, but there are also no comparable risks assumed by uncontrolled parties in comparable circumstances. The SVTDG recommends *Example 3* be revised to make this clear.

IV. ANSWERS TO SPECIFIC QUESTIONS POSED

> **Question 1. The discussion draft addresses situations in which profit splits of anticipated profits or profit splits of actual profits are appropriate. Where it is established that the transactional profit split is the most appropriate method, please comment on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used.**

SVTDG response: With the assumption that the TPSM is the most appropriate method, the SVTDG believes in general it's preferable that a split of actual profits should be used. The PDD notes, for example, if—with this assumption—each party shares assumption of ESRs, "it is likely that a split of actual profits, rather than anticipated profits, will be warranted since those actual profits will reflect the playing out of the risks of each party. That is, the transfer pricing outcome—a sharing of actual profits—should align with the accurate delineation of the transaction."[11]

In transactions between independent parties involving intangibles, for example, it's common to observe contingent payment forms—e.g., royalties contingent on sales, or units sold.[12] A contingent payment shifts certain risks to the transferor, but the transferee also bears

---

[10] PDD ¶ 82 (emphasis added).

[11] PDD ¶ 27.

[12] *TPG* ¶ 6.179.

risks if the transferred intangibles fail.[13] Risks are thus split. The parties each exercise control over risks they bear.[14] The SVTDG believes that the relevant risks are generally economically significant. The SVTDG also believes this mirrors the situation in many controlled transaction situations in which a contingent payment form is chosen. The SVTDG accordingly believes a contingent payment form chosen for a controlled transaction generally accords with a split of actual profits. If a TPSM is thus chosen as the most appropriate method, and the associated enterprises chose a contingent payment form or otherwise share assumption of ESRs, a split of actual profits is warranted. The SVTDG recommends the PDD be revised to make this clear.

> **Question 2. A number of profit splitting factors are addressed in the discussion draft. Comments are particularly invited on:**
>
> **a. Whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained, and if so, what factors need to be taken into account for its selection and application as a reliable profit splitting factor.**
>
> **b. Should headcount of similarly skilled and competent employees be included as a potential profit splitting factor, and if so, in what circumstances would it be relevant?**
>
> **c. Given the existing guidance in Chapters I and IX of the TPG, should adjustments for purchasing power parity be made for profit splitting factor amounts, and if so, in what circumstances?**
>
> **d. What other profit splitting factors should be included in the guidance, and in what circumstances?**

SVTDG responses: The SVTDG agrees with the PDD that, assuming the TPSM is the most appropriate method, arm's length parties generally split profits on the basis of their relative contributions to the creation of those profits.[15]

Regarding capital or capital employed, the current TPG explain:

---

[13] The transferor risks getting paid less than it would if lump-sum or installment payment forms were chosen; the transferee retains risks that its efforts in exploiting the intangibles won't be successful.

[14] The transferor, for example, may take steps to make the license agreement terminable after a certain period of time, or if the license is non-exclusive, the transferor may license another party. The transferee/licensee controls risks associated with its exploitation of the licensed intangibles.

[15] PDD ¶ 54.

> . . . [C]apital-based allocation keys can be used where there is a strong correlation between . . . capital employed and creation of value in the context of the controlled transaction.[16]
>
> One possible approach . . . is to split the combined profits so that each of the associated enterprises participating in the controlled transactions earns the same rate of return on the capital it employs in that transaction. This method assumes that each participant's capital investment in the transaction is subject to a similar level of risk, so that one might expect the participants to earn similar rates of return if they were operating in the open market. However, this assumption may not be realistic.

The SVTDG agrees the assumptions underlying the use of capital, or capital employed, are questionable, and are unlikely to be met in most controlled transactions. The SVTDG accordingly believes explicit mention of capital or capital employed needn't be retained. As the *TPG* presumably won't be revised to provide an exhaustive set of allocation factors, dropping explicit mention of this factor doesn't preclude its application under rare but appropriate facts and circumstances.

The SVTDG believes use of (just) headcount of similarly skilled and competent employees potentially ignores characteristics of employees that are directly relevant to determining employee contributions to creation of profits. For example, in a controlled transaction involving intangibles, a tax administration might argue for fungibility of R&D engineers employed by transferor and transferee on the grounds of having roughly comparable nominal education and levels of work experience. This can ignore critical characteristics relevant to determining the value-add provided by the engineers, such as decision-making responsibility and the qualitative nature of the sorts of tasks performed (e.g., higher-level design and product architecture, compared with less complex implementation or bug-fixing). For this reason, the SVTDG believes (raw) headcount of similarly skilled and competent employees as a profit-splitting factor is potentially subject to mis-use. The SVTDG notes that, in controlled transactions involving intangibles, the actual costs—which in an MNE can be expected to reflect holistic management decisions on value drivers—is likely to be a more accurate profit-splitting factor if the TPSM is the most appropriate method.

The SVTDG also notes that in controlled transactions involving intangibles, factors other than those relevant to intangible profit creation (e.g., other than R&D costs) may also be relevant. For example, a transferee of intangibles may—in addition to adding value through R&D contributions—also contribute resources or capabilities in its exploitation of products or services using the intangibles. In this case it would be necessary to measure the transferee's such

---

[16] *TPG* ¶ 2.142.

contribution, in addition to its R&D contribution, when splitting profits. A combination of factors would likely be applicable in this situation.

> **Question 3. Additional examples of scenarios in which a transactional profit split is found to be the most appropriate method due to the high level of integration of the business operations are sought, together with an explanation as to the reasoning thereto.**

SVTDG response: the SVTDG has no further comment on this issue.

Accenture
Activision Blizzard
Acxiom
Adobe
Agilent
Amazon
Apple
Applied Materials
Atlassian
Autodesk
Bio-Rad Laboratories
BMC Software
Broadcom Limited
Brocade
Cadence
Chegg, Inc.
Cisco Systems Inc.
Dell Inc.
Delphi
Dolby Laboratories, Inc.
Dropbox Inc.
eBay
Electronic Arts
Expedia, Inc.
Facebook
Fitbit, Inc.
Flex
Fortinet
GE Digital
Genentech
Genesys
Genomic Health
Gigamon
Gilead Sciences, Inc.
GitHub
GLOBALFOUNDRIES
GlobalLogic
Google Inc.
GoPro
Hewlett-Packard Enterprise
HP Inc.
Indeed.com
Informatica
Ingram Micro, Inc.
Integrated Device Technology
Intel
Intuit Inc.
Intuitive Surgical
Keysight Technologies
KLA-Tencor Corporation
Lam Research
Marvell
Maxim Integrated
MaxLinear
Mentor Graphics
Microsemi
Microsoft
NetApp, Inc.
Netflix
NVIDIA
Oracle Corporation
Palo Alto Networks
PayPal
Pivotal Software, Inc.
Plantronics
Pure Storage
Qualcomm
Qualys, Inc.
salesforce.com
Sanmina-SCI Corporation
Seagate Technology
ServiceNow
ShoreTel
Snapchat, Inc.
SurveyMonkey
Symantec Corporation
Synopsys, Inc.
Tesla Motors, Inc.
The Cooper Companies
The Walt Disney Company
Theravance Biopharma
TiVo Corporation
Trimble, Inc.
Twitter
Uber Technologies
Veeva Systems
Veritas
Visa
VMware
Western Digital
Xilinx, Inc.
Yahoo!
Yelp

15 September 2017

Via E-Mail
TransferPricing@oecd.org

The OECD
To: Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

DISCUSSION DRAFT: BEPS Actions 8-10 – Revised Guidance on Profit Split (the "Draft")

Dear Madam/Sir

The business federation SwissHoldings represents the interests of 61 Swiss-based multinational enterprises from the manufacturing and service sectors (excluding the financial sector).

SwissHoldings is pleased to provide comments on the Draft which the OECD released on June 22, 2017.

Our comments to the Draft are hereinafter provided.

General Comments

1. We welcome and appreciate the OECD's effort to improve the content and comprehensiveness of the Transfer Pricing (TP) Guidelines, within the context of the BEPS Action Plans, and in this respect the revision of the Profit Split section within Chapter II is a key milestone achieved by WP6.

2. For both taxpayers and tax administrations, it is critical to have clear guidance about the proper application of the TP methods. Otherwise, there is an increased risk for controversy and double taxation.

3. We recognize and appreciate the removal of the previous Section C.3.4 "Value Chain Analyses" from the Profit Split Section within Chapter II.

4. We strongly believe that further practical guidance and clarifications are required for the key "terms, parameters and conditions" used in the Draft, such as:

    a. Unique and valuable contributions,
    b. Highly integrated business operations, and
    c. Anticipated versus actual profits

5. Moreover, in our opinion the current language of the Draft does not yet mirror the key latest principles developed by WP6 within Chapters I, V and VI. In particular, the **performance of "important functions"** and the **"assumption of economically significant risks"** is not adequately considered (as key conditions for the potential application of the Profit Split method (PSM)). These are two key conditions which need to be cumulatively met by at least 2 parties to the transaction delineated.

6. The potential selection of the PSM relies upon a set of indicia either not clearly defined in the Draft and/or whose relevance is questionable. At this stage, it is our opinion that these indicia do not fit the purpose pursued by WP6.

7. Furthermore, it would be helpful to clarify that the starting point of a tax assessment should be the selected TP method of the taxpayer (considering all facts and circumstances as documented in the master file and local file). The burden of proof for the selection of another method is the responsibility of the tax administration and must be based on a comprehensive analysis. Moreover, in this context it would be helpful to clarify that the taxpayer and tax administration have to apply only one method, therefore the use corroborative TP methods is not accepted.

8. Considering the specific conditions which must be met, in practice, a very limited number of transactions should be assessed using the PSM. We expected the Draft to further emphasize the fact that in practice the PSM is to be rarely used (and if applicable, limited usually to very few entities and transactions within a Group).

9. Furthermore, it should also be made clear that the mere absence of (perfect) comparables for the purpose of a one-sided TP method cannot be relevant for tax administrations to reassess a tax position according to Profit Split. Appropriate comparability adjustments should always be considered before concluding that there are no comparables.

10. Finally, the Draft should consider elaborating on the following important aspects:

    a. To stress the fact that the CBCR shall not be used as an indication for the potential selection of the PSM;
    b. To remind that the PSM shall not be opportunistically rejected because of losses incurred by one or several parties to the transactions. Accordingly, there cannot be situations where the PSM would apply if none of the parties to the transactions face important risks in the context of Chapter VI;
    c. To clarify how to manage the implementation of the PSM across the life of the transactions (including execution of required profit adjustments for the covered transactions and companies)?

In addition to our General Comments listed above, hereunder are listed our Specific Comments.

Specific Comments

Role of the Value Chain Analysis

11. We welcome the removal of the Section C.3.4 "Value Chain Analyses" from the previous Draft dated July 4th 2016 as the location of this previous draft section was limiting the review of the value chain to the sole PSM[1]. We believe that the value chain analysis is a process to delineate the transactions (within the framework of Chapter I of the OECD Guidelines and the master file) before even considering which TP method would be the most appropriate to one transaction. See para 1.34 of the 2017 OECD TP Guidelines.

12. Nevertheless, the bias (which is supposed to be resolved through the removal of the abovementioned Section C3.4.) still persists. The PSM remains the only method within Chapter II where reference to the TP Guidelines para 1.34 is directly made. To remove the persisting bias, we recommend that you either repeat the reference to para. 1.34 across the other sections of Chapter II or remove the reference to para 1.34 in the Draft para.12. Full alignment with the other TP methods is important to avoid misinterpretation from both tax administrations and taxpayers.

Latest Principles developed in Chapter, I, V and VI not properly considered

13. Instead of discussing the strengths and weakness in detail, the Draft should in particular further clarify the key conditions and requirements to be met for the PSM to be the most appropriate method.

14. Unfortunately in our view, the new BEPS TP framework is not properly considered in the Draft.

    a. Chapter V, combined with Chapter I: The identification of the key drivers of business profits and main contributors to value creation within an MNE, when combined are tools to identify which parties in the MNE have the functional capability and the financial capacity to have management and control over the **"important functions**" performed, risks borne and assets used for the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) of the **Intangibles (IP)**; and

    b. Chapter VI provides guidance on what IP and important functions (and related risks) are for TP assessment purposes.

15. The assessment of the appropriateness of the PSM needs to consider the TP framework mentioned above. More precisely it is of our opinion that the Draft should provide that the below conditions a. and b. must be cumulatively met by at least two parties to a delineated transaction, for the PSM to be potentially selected:

[1] For the purpose of our comments, the Residual Profit Split shall be understood as being part of the Profit Split Method, the Residual Profit Split consisting in applying the Profit Split Method to a residual profit base.

a. Have the functional capability and the financial capacity to have management and control over the **important functions** previously mentioned, and
b. **Assume the economically significant risks** in relation to these important functions.

16. Irrespective of our previous comments 14 and 15, the term “highly integration” is not clearly enough defined, which might lead to controversy in future tax audits.

    a. As correctly mentioned in the Draft para. 19, most MNEs perform (with various levels) integrated operations and/or functions/activities within the whole value chain which are dependent upon each other. Referring to a “high” level of integration of business operations and /or dependency for PSM selection purposes (either as a stand-alone condition or combined with others) cannot be sustained without further clarifications.

    b. Joint performance of important functions, joint ownership of important assets and in particular joint of assumption of economically significant risks exist yet are rare in practice. This again is an indication that the application of the PSM is limited as the conditions are rarely met (and /or are only limited to few transactions within the Group).

    c. In all MNEs (even the most integrated ones or whose IP’s DEMPE is heavily fragmented), there is usually a very limited number of companies (one up to a handful) to whom Question 1 abovementioned would be positively answered.

17. Absence of comparables

    a. The absence of comparables for the use of the CUP method or a one-sided TP method cannot be selected as an indicia in favour of the selection of the PSM.

    b. Experience shows that the TNMM is well designed to cover the lack of (perfect) comparables. The TNMM comparability criteria are less sensitive to differences in products/ services and functions as compared to any other one-sided TP method. Should the current Draft remain as is, it will further open the door to opportunistic tax controversies where the tax administration would just need to challenge the taxpayer’s one-sided benchmarking analysis to look for a higher (local) tax burden based on the PSM.

18. Unique and valuable contributions: Irrespective of our previous comments 14 and 15, regarding the “unique and valuable contributions” it should be clarified (between the Draft para. 16 and 24) that “the existence of unique and valuable contributions should be analysed in relation to the business operations of which the transactions are a part rather than in respect of their importance to the individual enterprise”. This sentence already appears in the Draft para. 26 related to the economically significant risks. Moreover, it should be clarified that the performance of unique and valuable contributions for the purpose of the PSM selection is closely connected to the performance of important functions in the meaning of Chapter VI.

19. Economically significant risks

c. Irrespective of our previous comments 14 and 15, clarification is also needed with respect to "economically significant risks": The wording of this concept may lead taxpayers and administrations to conclude that the level of contribution required with respect to risk assumption is lower than the level of contributions qualifying for "unique and valuable contributions". Alignment of these two concepts ("unique and valuable contributions" and "economically significant risk assumption") should be further considered by the OECD in order to avoid situations where the PSM is applied in situations where the risks assumed are not similar to "unique and valuable contributions".

d. In the Draft para. 8, it should be reminded that *risk management* does not necessarily mean *risk assumption* and vice versa. A reference to para. 1.63 of the 2017 OECD Guidelines is therefore recommended. Should this clarification be also missing under the other TP methods' sections within the 2017 OECD TP Guidelines, it should be added there as well.

20. Long-term arrangements

e. In the Draft para. 21, if not already addressed, it is recommended to emphasize the fact that in the context of long-term arrangements (like construction or engineering work) where completion will take several years, tax administration should accept that the arm's length assessment using the PSM may only be made once the arrangement or a key milestone has been completed in its entirety (rather than at the end of each fiscal year). This approach is in line with the content of the Draft para. 22 when it comes to assessing the respective contributions (and therefore the share of profits/losses to be allocated to the respective parties) in a holistic manner.

f. Moreover, it should be clarified that long-term arrangements *per se* do not qualify for the application of a PSM.

Splitting factors

21. In the Draft para. 32, we believe that another condition is missing, and therefore we recommend the conditions to be stated as follows:
"[…] the profit splitting factors should:
- Be consistent with functional analysis of the controlled transaction under review, and in particular reflect the **parties' respective unique and valuable contributions**[or performance of important functions in accordance with our comments 14 and 15] **and assumption of economically significant risks, and**
- **Reflect the weight of the drivers of business profits in making these unique and valuable contributions and/ or in assuming the economically significant risks**, and
- Be capable of being measured in a **reasonably feasible and reliable manner**".

22. Moreover, the control and assumption of risks are requirements for all entities where the PSM should be applied and not only by at least one party. A clarification that this is a necessary condition is required.

Other considerations

23. We wish to draw your attention to the fact that the content of the Draft does not align with the content of Chapter II, Section C of the July 2017 OECD TP Guidelines. Differences in content can be noticed (for example) between para. 1 ad 2 of the Draft and para. 2114 of the July 2017 Guidelines. In this example, the differences are quite significant.

24. For some examples, the selection of the PSM as the most appropriate method is questionable. In many cases other methods could the most appropriate one (e.g.: CUP method using of royalty rates based on internal /external comparables).

25. It should be emphasized in **Example 10** that the fact pattern is a good example of situations where a residual profit split could be applied, whereby (i) the distribution-related activities of the respective Companies A and B could be tested using a one-sided TP method with comparables relevant to their respective markets, and (ii) the remainder of the Companies' activities would be subject to a residual profit splitting.

26. The application of the PSM is very difficult. To minimize administrative burden and reduce further complexity, the requirement to consider *purchase power parity adjustments* should be avoided. Also from a theoretical perspective, we doubt that it would improve the quality of the arm's length outcome.

27. The same comment applies to location savings, newly introduced in the Draft para 67. This concept is already covered in Section D.6 of Chapter I and there is no need to cover it again in this Draft. Location savings are a comparability factor, not a value driver. Moreover, discussing location savings in this section of Chapter II may wrongly lead to assume that the potential existence of location savings automatically triggers the selection of the PSM.

28. In the Draft para. 16, first sentence: (i) and (ii) shall be reversed, because the absence of (perfect) comparables shall not be interpreted as the prior reason for a contribution to be "unique and valuable".

*****

We kindly ask you to take our comments and proposals into due consideration.

Yours sincerely

SwissHoldings
Federation of Industrial and Service Groups in Switzerland

Dr. Gabriel Rumo
CEO

Martin Hess
Senior Policy Manager

cc - SwissHoldings Board

- Nicole Primmer, Senior Policy Manager, BIAC
- William Morris, Chair of the BIAC Tax Committee
- Krister Andersson, Chair BUSINESSEUROPE Tax Policy Group

DISCUSSION DRAFT ON THE REVISED GUIDANCE ON PROFIT SPLITS

Taj Comments

15/09/2017

Introduction

- We are very happy to have the opportunity to contribute to this new request for comments from the OECD. Since the last version of the draft, our experience is that National Tax Administrations have increasingly used profit splits or profit split based reasoning, trying to assess the "fairness" of how the profit of a multinational firm is split between its subsidiaries. Within the framework of the BEPS project aiming at "aligning taxable basis with value creation", the lack of clear guidance from the OECD on the proper use of profit splits has created strong uncertainties for business firms. It is therefore urgent and important that guidelines of application should be finalized to clearly set the new rules of the game.
- Our Comment is structured as follows:
    - Chapter 1 describes the analytical framework we are going to use and makes some general comments on profit splitting.
    - Chapter 2 presents our answers to the 6 questions asked by the OECD

I Analytical Framework and general comments

- In this new public discussion draft, the OECD is asking questions concerning the circumstances where profit split is the most appropriate method, or concerning the allocation keys that can be practically used to split the profit when this method is selected. In order to answer these questions, we intend to strictly follow the arm's length principle and use the behavior of third parties interacting over a market as our reference point. Following that approach, we will consider that the circumstances where a certain type of profit split should be considered acceptable are those where third parties in the same situations would also use a profit split. Likewise, acceptable profit splitting keys are those that would be used by comparable third parties trying to put together a profit split contract.
- Before answering the OECD's question, we would like to make a preliminary general comment. We believe that there is still an ambiguity in the guidelines concerning the standard upon which profit splits should be based, which should be clarified by the OECD as it currently creates significant uncertainty for the taxpayers. Indeed, reading the current guidelines, it looked to us that two types of profit split standards were intertwined: (i) the arm's length principle and (ii) a standard of international tax equity.
    - According to the arm's length principle, transfer pricing should replicate the functioning of the market, therefore profit splits should be used as a transfer pricing method between two subsidiaries of a MNE when two, otherwise comparable, independent firms would be willing to engage into a profit split. Likewise, the profit splitting mechanism used between those subsidiaries should replicate as closely as possible the pricing arrangement that would be negotiated by the two independent comparable companies.
    - According to a standard of international tax equity[1], profit should be split between subsidiaries in a manner that is consistent with the value of their contribution to the overall profit of the group. Subsidiaries that perform the most critical functions, or that

[1] See for instance: Brooks, Kim, Inter-Nation Equity: The Development of an Important but Underappreciated International Tax Value (October 30, 2008). TAX REFORM IN THE 21ST CENTURY, Richard Krever, John G. Head, eds., Kluwer Law International,

contribute a unique asset or know how should therefore capture a large portion of the consolidated profit.

- These two standards are very different and they are likely to yield very different outcomes in terms of the geographical allocation of profit of a Multinational Firm. However, the current version of the guidelines seems to refer to both standards as if they were the same. On the one hand, there are clear references made to the arm's length principle, on the other hand the current description of the circumstances where a profit split can be considered the best method, as well as the profit splitting mechanism that are indicated are much closer to an international tax equity standard.
- Without repeating the comments we have already made for the previous version of the draft, we would like to quickly make a comparison between the current guidelines and the pure application of the arm's length standard when it comes to (i) the circumstances where a profit split is the most acceptable method and (ii) what splitting methodology should be used when a profit split is selected.
- <u>Circumstances where a profit split is the best method</u>.
    - The current guidelines are emphasizing three kind of circumstances where a profit split is warranted: unique and valuable contribution, highly integrated business operations and shared assumption of economically significant risks. It should be emphasized that these criteria are not relevant to identify the situations where a profit split is used by independent parties. For instance there are many examples of companies providing unique contributions at a fixed price[2] or companies very tightly integrated that also do not share their profit[3].
    - In a market environment, the main driver for the choice of a pricing scheme is the incentives it gives to both parties to the transaction[4]. If company A sells a product to company B at a fixed price, set up in advance, A will not behave in the same fashion as if it were paid a % of whatever profit B will generate using the provided inputs (in the latter situation, A will be incentivized to help B achieve its business objectives, not at all with a fixed price). A very good illustration of how incentives work is given by an article of Cheung[5] that tries to explain differences in contract types between landowners and tenants in China. The functional analysis of the relationship between a landowner and a tenant is very simple: the landowner owns a productive asset (a piece of agricultural land) and rents it to a tenant, who is performing routine agricultural work to grow crops and sell them on the market. In spite of this relative simplicity, Cheung noticed that three different schemes were used in practice :
        - A contract where the tenant is paid a fixed wage and where the landowner sells the crop and gets the residual return (equivalent to a TNMM with the landowner as the principal)
        - A contract where the tenant is paying a fixed rent to the landowner and where he gets the residual profit after selling the crop on the market (equivalent to a TNMM with the tenant as the principal)
        - A "sharecropping" contract where both parties are providing input and where the harvest is split between landowner and tenant (equivalent to an *ex post* profit split).

    What is interesting in this example, is that, even if pricing schemes are very different, the functional analysis stays the same under each contract. The only thing that

[2] For instance, the development of mobile internet comes from (i) the technology and infrastructure investment made by Telecom operators and (ii) the creation of "internet friendly" mobile handsets. It is clear that both telco operator and device manufacturer have contributed unique intangible to propose mobile internet subscriptions. However, device manufacturer have sold their products to telco operator at a fixed price, not on a profit splis basis.
[3] The automotive sector gives plenty of such examples, where OEM are integrating their productive assets in the car manufacturer line of production but still price their service on a cost plus basis.
[4] See for instance: Hart O., 1995. *Firms, Contracts, and Financial Structure*. Oxford University Press
[5] Cheung S., 1968. "Private Property Rights and Sharecropping. *Journal of Political Economy*, Vol. 76, No. 6, pp. 1107-1122

changes is the incentives that are given to the tenant and the landowner. With a fixed wage, considering how hard agricultural work can be, the tenant will have an incentive to shirk. On the contrary, when the tenant pays a fixed rent to the landlord and captures the residual profit, he will have strong incentives to grow as much crop as he can. When it is hard for the landlord to monitor the work of the tenant (for instance because the land is very large or hilly), it can be more efficient for the landlord to enter into a sharecropping contract, where he gives the tenant a share of the overall profit to create incentives for him to work hard and to make the appropriate investments. The landlord does not enter into a sharecropping agreement to compensate a "unique" contribution of the tenant, or because of the deep integration of management and agricultural work, he only does so because it is the most efficient contract *ex ante*, that is, the contract that will maximize the expected profit that he plans to derive from the use of its land.

Many other such examples could be listed, which lead to the conclusion that, between independent agents, profit splits are only used when they are the most efficient *ex ante* contracts, which is often a question on balance of incentives rather than a question of uniqueness of contribution or interrelation of operations, as currently stated in the guidelines.

- <u>What splitting methodology should be used</u>
  - The current guidelines are proposing several types of splitting methodologies (contribution analysis and residual analysis) and several types of splitting factors, including the relative value of the assets of each party, or the headcount or labor costs, etc. However, this kind of factors seems to follow from the application of a tax equity standard rather than from an analysis of the market practices. Indeed, *ex post*, when the consolidated profit of the group is known, the application of a standard notion of equity[6] would lead to sharing the consolidated profit between entities proportionally to the value of their contribution to the overall profit, using an easily computable proxy such as asset base or labor cost. On the other hand, profit split contracts based on asset value or labor costs are never seen between third parties (cf. examples in the next chapter), these factors are therefore not compliant with a pure application of the arm's length principle.
  - It is to be noted that the arm's length standard and the tax equity standard are generally inconsistent since the operation of the market does not necessarily lead to *ex post* equity. Quite the opposite: complex profit splitting contracts signed between third party commonly lead to an "unfair" allocation of profit *ex post*. This can be mostly explained by three factors:
    - In real life, markets are imperfect and certain firms benefit from market power. Two firms negotiating the terms of a profit split agreement will bargain to obtain the bigger share of the pie and the firm that has the best bargaining position (because its reservation utility is higher or because it has less liquidity constraints for instance) will most likely end up with the biggest share. An example for that is the situation where a large internet company wants to purchase a startup because potential synergies are very high. The acquirer would be willing to pay an acquisition price up to the difference of value between the discounted stream of future profit of the merged entity (acquirer + target) and the discounted stream of future profit generated by the standalone acquirer. Setting up an acquisition is *de facto* a profit split (an *ex ante* profit split) of the synergies between the acquirer and the target. This split will not depend upon the relative contribution, or relative asset base of

[6] See for instance Moulin H., 2004. *Fair Division and Collective Welfare*. The MIT Press

the target and the acquirer but purely about the relative bargaining position of the buyer and the seller. If the startup is really unique and several large companies are competing to buy it, the target will get the largest part of the extra value, on the contrary, if there are several competing startups and one large buyer, the acquisition price will be lower and most of the synergies will accrue to the buyer.

- Economic agents that negotiate with each other are not necessarily concerned about equity. While setting up a profit split agreement between firm A and B, each firm tries to maximize its own profit, taking into account (i) the total profit that will be generated by the collaboration between A and B and (ii) the share of that profit that each will firm capture. It can be optimal for A to accept a small share of the overall profit if that agreement leads to a higher overall profit. An example of that situation is given by the "lockstep" methodology that is used to share the profit between partners within a law firm (which can be considered as an *ex post* profit split). Under the lockstep, each partner will have an equal share of the profit, whatever the value of his real contribution. The reason for the choice of this kind of system is, again, related to incentives: splitting the profit creates an incentives to collaborate (share clients), which can maximize the overall profit (as opposed to a "eat what you kill" compensation scheme where each partner compensation is based on his own performance).[7] *Ex post*, it is therefore very customary to obtain an "unfair" allocation of profit between partners of a law firm, since both the hard workers and the free riders all have the same share of profit.
- Because of the uncertainty about future events, an equitable ex ante contract (i.e. a contract that gives equitable expectations of profit to both parties to the contract) can very well end up with a totally unequitable allocation of profit *ex post*. An insurance contract where a company is paying a premium each year to insure itself against a risk of accident is a good example for the ex ante/ ex post difference. Assuming the insurance market is competitive, the contract is *ex ante* equitable for both parties. *Ex post*, either the accident does not take place and the policyholder pays a premium against no service, or the accident takes place and the insurance company repays to the policyholder an amount that is much higher than the insurance premium. In each case, the exchange is not *ex post* equitable.

- As a conclusion, it appears that the objective of splitting "equitably" the profit of a MNE between key subsidiaries and the objective of aligning intracompany pricing with the market practices are almost contradictory. It also appears that there are currently very little reference made in the current guidance to the actual practice of independent firms. On the contrary, the current guidance seems more driven by an objective of splitting "equitably" the profit of a MNE between its subsidiaries. We believe it is extremely important to clarify this point in the final guidance, so that the theoretical basis on which profit splits can be used are perfectly clear.

[7] See Gilson R. and Mnookin R., 1985. "Sharing among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits". *Stanford Law Review*, Vol. 37, No. 2: 313-392

II Answers to the questions

II.1 Question 1

Before answering the question, it might be useful to give some additional details of the key differences between *ex ante* and *ex post* profit splits:

- Profit split *ex ante (*or profit split of anticipated profits). If company A owns a patent that can be used by a potential buyer, company B. to calculate the price of the patent, A and B might want to build a business model for company B using the patent, based on which total future profits generated by B will be calculated. Then A and B can agree that the patent should be sold for x% of the total discounted projected profits. The transaction will take place at this price and *ex post*, **company A bears no financial risk** related to that transaction (it gets a certain payment) **while company B bears 100% of the financial risk** (i.e. its profitability will be impacted by any difference between reality and the business plan).
- Profit split *ex post* (or profit split of actual profits). On the other hands, company A and B can decide to sign an agreement according to which A will license its patent to B against a royalty that is calculated as a % of B's profit. Contrary to the previous example, **A and B are all bearing financial risk in this case** (in proportion to the royalty rate %). Any difference between reality and the business plan will impact both A and B's profit.

We are asked to comment on the factors which should be taken into account in determining whether a profit split of anticipated profits (*ex ante*) or a profit split of actual profits (*ex post*) should be used. Following the arm's length principle, we will try to identify the factors in which independent firms would be likely to enter into an *ex ante* or an *ex post* profit split agreement.

According to the most widely accepted economic theory[8], there are two main parameters that will determine whether *ex ante* or *ex post* profit split would be chosen for a transaction: (i) incentives and (ii) risk aversion.

- Incentives to perform non contractible actions. When a firm A is providing a service or a good to a firm B, there are certain characteristics of the good that can be easily contracted *ex ante* (e.g. the color of the good, its chemical composition, etc.) because it is easy to make an *ex post* check whether A has complied with its contractual obligations or not. Conversely, certain things are not easily contractible, because it would be too costly to monitor, for instance if company A is a sales agent for company B, B would like that A's sales representatives do their best sales effort and work long hours to get new distribution contracts, but it is impossible for B to make sure that A complies with this kind of provision because it cannot possibly follow each sales representative. Therefore, sometimes the only way for B to make sure that A will exert an appropriate level of effort it to provide him with the right incentives through an optimal compensation scheme.
    - Based on this*, ex post* profit splits (or related pricing schemes) are seen in real life when it is important to give incentives to perform a non-contractible action that have an important and measurable impact on the business. For instance, certain consulting firms offer to optimize the sourcing strategy of their clients to reduce their purchasing costs. They would typically work in close collaboration with the client and be paid with a success fee calculated as a % of the extra profit they will help generate for the client, which is a good way to ensure that they will do their best to maximize the gain for the client. Another example is the creation of a Joint Venture for the development of a new uncertain business. The success of such a venture generally depends upon

[8] See, for an introduction: Williamson O., 1985. *The Economic Institutions of Capitalism*. The Free Press. Lafontaine F. and Slade M., 2007. « Vertical Integration and Firm Boundaries: The Evidence ». Journal of Economic Literature, vol. 45: 629-685 and Hart, *op cit*.

the capacity of both parties to collaborate and modify their plan based on the occurrence of unexpected events. As it would be very hard to set up a contract that forces one party to collaborate with the other (and engage new costs that were not planned at the inception of the project), it is more efficient to share profit since it aligns the incentives of both parties and makes them more willing to collaborate.

  - On the contrary, *ex ante* profit split can only exist in situations where it is not important to give the seller any incentives to perform non contractible actions. Indeed, considering the result of an *ex ante* profit split is a fixed price, there will be no incentive for the seller to do anything more (and engage more cost) than what is contracted. *Ex ante* profit splits would therefore rather be seen in a context of a spot transaction with no follow-up, for a good or an asset for which there is no efficient market (e.g. a firm or an intangible asset that will not require any complex input from the buyer after the transaction). Since there is no market price for such asset, an *ex ante* profit split can be used as a basis for the negotiation, along with other method such as cost plus pricing, comparable transactions, or rate of return for instance.

- Risk aversion. As described above, the variability of the profit of both parties to a transaction is very different with *ex ante* and *ex post* profit splits. The profits of both parties to an *ex post* profit split are variable every year, whereas with an *ex ante* profit split, the seller has a certain profit and the buyer bears all the financial risk related to the difference between the expected profits and the actual profit. Difference in risk aversion between the buyer and the seller can explain why two parties would choose an ex ante vs. ex post profit split. Third parties can have different risk aversion, meaning that they value differently the level of uncertainty of the profit they will get out of a transaction9. For instance a very large firm might be willing to pursue a venture with a very high expected profit and a high risk, because it can afford to lose money, whereas a smaller firm, close to financial distress, might not be able to afford the loss and would rather choose a project with a lower expected payoff but a reduced risk. In the real world were insurance and financial markets are not perfect, differences in risk aversion sometimes explain the choice of the pricing arrangement between third parties. Risk adverse buyer would prefer *ex post* profit splits whereas risk adverse seller would prefer *ex ante* profit splits.
  - If we take the example of a company that rents a valuable IP to another entity, if the royalty rate is calculated as a lump sum using an *ex ante* profit split, the licensee will bear a cost for the use of the intangible however profitable its business is. On the contrary, if the rate is calculated as a % of the licensee profit (*ex post* profit split), there will be a payment only if the licensee is profitable. The variability of the profit of the licensee is therefore more reduced with the profit based royalty than with the lump sum royalty. Thus, when a large company wants to rent an innovative IP to a small, more risk adverse, company and the value of the IP is not certain at the time of the licensing, a profit based royalty (equivalent to an unilateral *ex post* profit split) can sometimes be seen because it is the only pricing scheme that would be accepted by a smaller, more risk adverse, licensee.
  - On the other hand, a small biotech firm with financing issues might want to sell a new molecule IP for a certain lump sum to a big pharma company (potentially calculated based on an ex ante profit split) rather than create a common venture and set up an ex post profit split with the pharma company. Indeed, in the latter situation, the small biotech might have to wait several years before it can start to make some profit, which it can presumably not afford due to its short term liquidity constraints.

[9] A risk neutral agent would be indifferent between (i) making a profit of 10 with a probability 50% and a profit of 0 with a probability 50% and (ii) making a profit of 100 with a probability 5% and a profit of 0 with a probability 95%, a risk adverse agent would prefer project (i) over project (ii)

In a transfer pricing environment, it is however a debatable topic whether it is possible to consider that different subsidiaries of the same MNE can have a different risk aversion

II.2 Question 2

Question 2.a)

We have not been able to identify any reference in the economics or management science literature of the existence of profit split contracts between independent parties, where the profit is split using capital asset value as an allocation key.

There are several reasons why such a contract should be very unlikely:

- From an *ex post* profit split perspective, using an allocation key based on value of the assets creates an incentive for each party to grow its asset base so as to increase its profit share. This is clearly non efficient as it would have a tendency to increase the overall cost base and reduce the consolidated profit.
- The value of an asset is related to the stream of profit it will generate in the future. Under an *ex post* profit split arrangement, this stream of revenue will depends on the profit allocation key between both parties. Therefore it creates a logical inconsistency (circular reference) to use the value of an asset to determine the profit split allocation key, since the profit allocation key determines the value of the asset.
- Using the construction cost as a proxy to the value of each party's asset would be very difficult to do for unrelated parties, since the historical costs are difficult to identify and each party would have an incentive to increase its historical cost base, and a difficulty to check the credibility of the other party's calculation.

In practice, the closest institutional arrangement to an ex post profit split contract is a joint venture. It would therefore be interesting to understand how partners in a JV share the profit and how they value their original contribution to the JV. An exhaustive analysis of that question is beyond the scope of this short note but can be found in a paper by Hauswald and Hege[10]; we can however underline the following conclusions:

- Independent parties do not split the JV profit using the historical cost of creation of the asset they contributed to the JV
- The way profit is split between partners of a JV again mostly depends on the nature of the incentives it is most efficient to give them. For efficiency reason, a vast majority of JV's equity is split 50/50 between the partners, even though the exact value of their contribution is unlikely to be equal.

As a conclusion, we can say that, if we want to purely follow the arm's length principle, capital asset value would not be an appropriate allocation key.

Question 2.b

The same kind of comments can be done than for question 2.a. We have not been able to find an occurrence where an *ex post* profit split has been contracted by two parties where the profit allocation key is based on headcount. Additionally, the existence of such contract is highly dubious for the same reasons as before.

[10] Voir notamment: Hauswald, Robert B. H. and Hege, Ulrich, Ownership and Control in Joint Ventures: Theory and Evidence (March 14, 2006). AFA 2004 San Diego Meetings. Available at SSRN: https://ssrn.com/abstract=302924 or http://dx.doi.org/10.2139/ssrn.302924

Question 2.c

Since it is very unlikely that independent firm should engage in a labor cost based profit split, it is even less likely that they should perform any adjustment to control for purchasing power difference. Such adjustment might improve the *ex post* equity of a labor cost based profit split (assuming wages in absolute term are not a good proxy for the value of the contribution of an employee) but they would not be seen between independent parties.

Question 2.d.

If the arm's length standard should also be applied to profit splits, it would be very useful to add to the guidelines all the profit split methodologies that are actually used by independent firms operating at arm's length.

Following that idea, we believe two categories of profit split methods could be added:

- "Profit split like" methods. Even if independent firms are generally very reluctant to use *ex post* profit splits *per se* (for reasons that are described in our 2016 comment), they do use many other types of pricing arrangements that are designed to come as close as possible to a profit splits. The possibility to use this kind of pricing arrangement could be considered by the OECD (a non-exhaustive list follows):
    - Royalties based on turnover with tiered structure (the % of royalty increases based on the success of the project)
    - Contracts with predetermined contingent payments made on specific milestones of the project (i.e. a payment of X M€ to buy a technology patent, with an additional milestone payment to be made to the seller when (and if) a prototype has been designed, another milestone payment at the time of the industrialization of the production, etc.) Contingent payments can also be decided if the licensee reaches a certain target profit or sales volume.
    - Revenue sharing contracts
    - Binomial prices (payment designed as p = a + b*q, where a is a flat fee, q is the quantity of goods sold and b is the unit price)
    - Supply contracts with a commitment from the buyer to buy a certain volume at a pre-determined price (potentially, with a decreasing price per volume)

- Simulation of bargaining. There is a very mature and very rich economic literature, with certain non-controversial results, which aim is to create models of how economic agents bargain, how the price of a good is set when there are a limited number of buyer and seller, and how rational agents would devise efficient pricing schemes. We believe that it is unfortunate that this wealth of methodologies cannot be used by taxpayers and tax administrations, whereas they are perfectly adapted to the case at hand. Without entering into too technical a discussion within the guidelines, it might be a very positive step to open the door to pricing methodologies based on cooperative game theory (Shapley value and core) and non cooperative game theory (Nash, Rubinstein or Kalai Smorodinsky bargaining solution).

II.3 Question 3

Judging by third party behavior, a high level of integration does not seem to be a relevant criteria to identify situations where we would see firms engaging into profit split contracts.

Indeed, there are numerous examples of third parties having their business very much integrated and however not entering into profit sharing agreements. The automotive sector gives very good examples of such situations, as it is very customary to have independent OEM install their equipment on the production line of an automotive manufacturer, working in a perfectly integrated fashion. However, profit sharing is hardly used in that industry and other types of agreements (cost + type) are customarily used. Conversely, some of the best examples of profit split contracts between third parties are to be found in the biotech/pharma sector where a small biotech firm licenses an innovative molecule to a big pharmaceutical company that will try to turn it into a successful drug. In this kind of setting, we sometimes observe a royalty scheme where the rate depends upon the overall profitability of the drug (coming therefore close to a profit split). Nonetheless, in this situation the activities of the biotech and of the pharma are far from being integrated since the biotech firm hardly works on the new molecule after having licensed it to the big pharma.

TAX EXECUTIVES INSTITUTE, INC.

8 September 2017

Jefferson Vanderwolk
Tax Treaties, Transfer Pricing and Financial
Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
and Development
Paris, France

Via email: transferpricing@oecd.org

RE: BEPS Action 10 – Revised Guidance on Profit Splits

Dear Mr. Vanderwolk:

The Organisation for Economic Co-Operation and Development (OECD) published final reports pursuant to its base erosion and profit shifting (BEPS) project on 5 October 2015. The reports were the culmination of the OECD's *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Plan) published in 2013. The Plan set forth 15 actions the OECD would undertake to address a series of issues that contribute to the perception of tax bases being eroded or profits shifted improperly. Included in the October 2015 final reports was a report under Actions 8-10 of the Plan, *Aligning Transfer Pricing Outcomes with Value Creation*. Subsequently, on 22 June 2017, the OECD issued a public discussion draft under BEPS Action 10 regarding *Revised Guidance on Profit Splits* (the Discussion Draft or Draft). The OECD requested comments from stakeholders regarding the Draft's proposed revised guidance on the application of the transactional profit split method, as well as responses to specific questions.

I am pleased to respond to the OECD's request for comments on behalf of Tax Executives Institute, Inc. (TEI). TEI also requests the opportunity to speak in support of these comments at the public consultation to be held in November 2017 in Paris.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organization has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax

1200 G Street, N.W., Suite 300 | Washington, D.C. 20005-3814 | P: 202.638.5601 | www.tei.org

policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 individual members represent over 2,800 of the leading companies in the world.[1]

TEI Comments

General Comments on the Discussion Draft

TEI commends the OECD for the additional guidance on the use of the profit split method set forth in the Discussion Draft. Tax authorities have increasingly used the profit split method to address transfer pricing issues and thus the attention paid to this method by the OECD is appropriate. That said, we recommend the OECD clearly state in final guidance that the Discussion Draft is not intended to change the manner in which tax authorities and taxpayers identify the best transfer pricing method. The OECD has at various occasions confirmed in discussions that the additional profit split method guidance in the Draft is not intended to promote the method to make it more prevalent, but rather to assist tax authorities and taxpayers in the method's application. In TEI's view, and we understand the OECD agrees, the comparable uncontrolled price (CUP) method continues to be the most reliable way to apply the arm's length standard. Thus, where the CUP or other transfer pricing methods are considered the most appropriate method to assess the arm's length nature of transactions, there should be no requirement to use the profit split method as an additional or corroborative method. Moreover, when tax authorities apply the profit split method, they should be subject to the same diligence requirements as taxpayers and should avoid simplistic approaches to splitting profits.

We also note that, as a whole, the Discussion Draft appears to imply that it is easier to apply the profit split method than other transfer pricing methods, in particular the CUP. To dispel this implication, TEI recommends that the OECD note in final guidance that when confronted with complex taxpayer operational structures and supply chains, applying the profit split method correctly is at least as problematic as applying another method.

In addition, the Discussion Draft and its examples appear to assume that either the entire transactional profit should be split between the parties or, if another method is more appropriate, none of the profit should be split. While that may be the case in many situations, there are other situations where the profit split is the most appropriate method, but should only apply to a portion of the profit. Parties to a transaction that make unique and valuable contributions also often have activities that are routine and do not constitute unique and valuable contributions to the value chain. For example, parties may conduct both research and development (R&D) activities and manufacturing. While the R&D may constitute a unique contribution, manufacturing may not. Therefore, it may be appropriate to first use a one-sided traditional method to calculate the profit attributable to manufacturing, and then apply the

[1] TEI is a corporation organized in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

profit split method to the residual profits. Because the Draft does not discuss these frequent situations, TEI recommends the OECD include such a discussion in final guidance.[2]

The phrase "unique and valuable" is often used in the Discussion Draft. It would be helpful if the OECD clarified the meaning of this phrase in final guidance, especially given that the references and descriptions used for the phrase within the Draft are somewhat inconsistent. For example, in Paragraph 16, the phrase is narrowly defined implying a high threshold for a contribution to be described as "unique." However, Example 9 implies a lower threshold.

Another definitional issue arises in Paragraph 1, which states that the profit split method "first identifies the profits to be split from the controlled transactions—the relevant profits . . . ." However, nowhere in the Draft is the term "relevant profits" clearly delineated. Additional guidelines on the meaning of this term, as well as a discussion of how to take into account certain costs (*e.g.*, restructuring costs, foreign exchange costs), would be helpful.

TEI commends the OECD for recognizing in Paragraph 1 that losses should also be split. We recommend that the final guidance include examples that split losses.

In TEI's opinion, the OECD sometimes over generalizes the advantages of the profit split method. For example, Paragraph 6 states that "since those contributions are 'unique' and 'valuable' there will be no reliable comparables information which could be used to price the entirety of the transaction in a more reliable way . . . ." TEI suggests this sentence should be amended as follows: "since those contributions are 'unique' and 'valuable' <u>it is less likely for</u> there ~~will~~ to be ~~no~~ reliable comparables information which could be used to price the entirety of the transaction in a more reliable way . . . ." As another example, Paragraph 8 states that "Another strength of the transactional profit split method is that it offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises." TEI recommends this sentence should be amended to read "Another strength of the transactional profit split method is that it <u>may sometimes</u> offer~~s~~ <u>more</u> flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises."

With respect to Paragraphs 10 and 40, greater emphasis should be placed on the need to determine the profits to be split between group entities using a common accounting standard. Tax authorities may often utilize local statutory or taxable profits and dismiss international or group accounting standards. However, local statutory accounting financial statements may vary significantly from group or international accounting statements. While most of these variances are timing differences (*e.g.*, depreciation expense, pension expense, unrealized currency gains and losses), they can be substantial and result in large differences on a year-over-year basis. Thus, splitting profits that are not determined under the same accounting standards and methods would not lead to an arm's length result, would likely increase controversy and litigation, and in the end would be essentially meaningless. The Draft should

---

[2] An example of such a scenario is set forth below in response to the OECD's specific question number three on page two of the Discussion Draft.

therefore highlight and further emphasize the need for common financial accounting standards for measuring profits.

Paragraph 10 also posits that taxpayers and tax authorities may have difficulty accessing information. In TEI's view, even though it may be challenging, access to information determined under a common accounting standard in most instances should be less of an issue within most multinational groups. A supplemental difficulty may reflect a lack of trust in a group's financial statements by tax authorities, which is reflected in the additional assurance they may require that the data was audited by independent accountants. This may not always be feasible, however. Whatever the case may be in a specific factual situation, TEI urges the OECD to clarify in Paragraph 41, addressing financial accounting and other financial data, that it expects profit splits to be made based on the harmonized accounting standard the multi-national group applies for its consolidation in an overwhelming majority of the cases. TEI also recommends deleting the word "tax" in "harmonized tax accounting standards" in Paragraph 10, or to provide a definition of what the OECD means by this phrase.

TEI agrees with the statement in Paragraph 10 that identifying appropriate profit splitting can be challenging. However, despite this difficulty, the standard to prove that the chosen profit splitting factors are appropriate should remain reasonable, *i.e.*, factors should be deemed acceptable if the results attributable to the group entities are within the arm's length range.

The Discussion Draft implies (*e.g.*, in Paragraphs 13 and 19) the profit split method is more likely to be appropriate to horizontally integrated entities and operations. The previous iteration of this Draft document used the phrases "horizontal integration" and "vertical integration." It would be more appropriate to revert to using these phrases. In addition, guidance should be provided on what level of integration should be considered when using the profit split method as too wide a level could result in non-arm's length results. In that regard, it would be helpful to include explanations and/or examples of situations in the final guidance where the use of the profit split method would clearly not produce an arm's length result.

Paragraph 15 states that for purposes of applying the profit split method it may be relevant to consider industry practices. TEI notes, however, that the use of profit splitting approaches between independent parties is likely to be confined to industries where joint ventures are common practice, such as oil & gas, chemical, automotive, pharmaceutical and perhaps a few others.[3] Even in such industries, data on profit splitting between independent parties may be difficult or impossible to find. Thus, the final guidance should note that it may be difficult to find comparable profit splits (or other methods of dividing the profits from a joint venture) among unrelated parties, depending on the industry.

Paragraph 27 notes that if a profit split is the most appropriate method, "it is likely that a split of actual profits, rather than anticipated profits, will be warranted since those actual profits will reflect the playing out of the risks of each party." Besides being unusual between

[3] The Discussion Draft mentions certain industries in Paragraph 52.

independent parties, this appears to assume that a taxpayer can initially use anticipated or forecasted profits during the year and then utilize a "true-up" at the end of the year to accurately account for actual profits. However, such a true-up may raise customs and indirect tax issues, among others, that create additional problems for taxpayers. The OECD should note and discuss these collateral effects in the final guidance.

The Discussion Draft in Paragraph 33 states that "[i]f the 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 . . . to be agreed in advance of the transaction . . . ." We note that determining the lifetime of an arrangement may not be simple. Of course, arrangements may have a single, fixed term. However, in the intra-group context, many arrangements, after an initial fixed term, may include a clause providing for automatic one year renewals, unless terminated by one of the parties. Whether such arrangements should be considered long term or perpetual arrangements may depend on past practice or other contractual provisions. Moreover, in such arrangements, the parties should be able to change transfer prices periodically to reflect changes in the business and economic environment, as well as revised profit expectations.

With respect to Paragraph 53, TEI agrees that when there is no reliable evidence of how independent parties would split profits, the only practicable approach is to split profits based on the relative contributions of the parties. Here the Draft indicates that such contributions are measured by functions performed, assets used, and risks assumed. Assets used can be easily measured by their value on the balance sheet of the parties, or in the case of self-created intangibles which do not have a book value, a value can be determined using valuation techniques. The Discussion Draft, however, should further clarify how functions and risks are to be measured, particularly in the context of *ex-ante* profit splits. For example, are functions to be measured simply by the costs incurred by the parties to perform such functions? What are the acceptable methods to measure risks? Risks like customer insolvency may be measured statistically. However, other risks may be difficult to measure, such as the risk that a new product or technology will not be successful in the market. Further guidance in this area would be helpful.

Paragraph 61 states that "it may be necessary to draw up transactional accounts that identify . . . expenses that are related to the controlled transaction at hand and those that should be excluded from the determination of the profit splitting factor." In TEI's view, when related parties enter into numerous transactions together, or if there are multiple entities involved in the transactions, analytical financial data may not be available at the transactional level. Indeed, obtaining such information may be extremely complicated and cumbersome, and may not be reliable because of how costs are allocated. Instead, data at a higher level may be more accurate, for example at the entity or product family level, for use in a profit split. TEI recommends the OECD address this situation in final guidance.

TEI agrees with the statement in Paragraph 68 noting when expenses are incurred and when value is created or realized, these events often take place in different periods. TEI notes

that expenses can also be volatile from one year to another: R&D costs during the life of a project and marketing and advertising expenses associated with new product launches are seldom linear. Using pools of costs incurred over several years may be a way to reduce the impact of time lags and volatility, as is using notional amortization of such pool of costs. TEI recommends that the OECD consider these approaches as it moves forward with its profit split guidance.

Comments on Certain Examples in the Draft

Although presented with limited facts, the number and diversity of the examples is helpful. Examples 8 and 10 provide some limited discussion on the determination and selection of appropriate profit splitting factors. This discussion should be expanded – adding a similar discussion to examples 1, 2, 3, 5, 7, and 9 would greatly improve the Discussion Draft. In addition, Example 9 is the only one addressing splitting profits on an actual versus anticipated basis. Discussing this issue in other examples or adding a few additional examples addressing it would also be helpful.

TEI also recommends the OECD conform the conclusions in its examples to the guidance provided in the body of the Discussion Draft. For example, instead of stating that "the transactional profit split method is likely to be the most appropriate method", the OECD would be better served by stating that "under certain circumstances, the transactional profit split method may be the most appropriate method". This would also align the wording to the examples where the OECD concludes that "the transactional profit split method *may not be* the most appropriate method", and would avoid the impression that the report is biased towards the application of the profit split over other methods.

Example 1. It is not clear from the example why the profit split method is the most appropriate method. The value of Company A's patent license to Company S could potentially be valued under a traditional transfer pricing methodology at the time of license. Once Company A licensed the patent rights to Company S, Company A does not appear to share in significant ongoing risks (*i.e.*, Company S is wholly responsible for the subsequent development of the products, including costs associated with the development) – other than if the license was based on ongoing percentage of revenue, then its license fee may be reduced if Company S is not successful. On the other hand, if the license fee was in the form of an upfront lump sum, there would be no risk to Company A at all. Further, it is clear in the pharmaceutical field that the basic research performed by Company A is nearly always more risky (*i.e.*, has a higher chance of failure) than the clinical trials performed by Company S to obtain the authorizations by the relevant regulatory bodies. It is also not clear in this example how losses could be split should the product not obtain the authorization from the relevant regulatory bodies, or fail commercially. In TEI's opinion, this example is therefore more appropriately dealt with under the OECD's guidance for hard-to-value intangibles.

Example 2. It is not clear from the example why the profit split method is the most appropriate method and why the tea sold by A Co to B Co cannot be valued under a traditional transfer pricing methodology. The facts in this scenario could justify the use of the profit split

method in almost any situation (*e.g.*, A Co manufactures Product X using extensive proprietary manufacturing know-how and B Co owns the tradename and trademark, which are both unique and valuable). For this reason, TEI strongly recommends the OECD withdraw this example.

Example 5. For reasons similar to those noted with respect to Example 1, it is not clear from the example why the profit split method is the most appropriate method. The value of Webco's contribution could be determined under a traditional transfer pricing methodology at the time of license. Once Webco transferred the program to ScaleCo, Webco does not appear to have any further involvement or share in significant ongoing risks – other than if Webco's compensation is in the form of an ongoing license based on percentage of revenue, then its license fee may be reduced if ScaleCo is not successful. On the other hand, if the license fee was in the form of an upfront lump sum, there would be no risk to Webco at all.

Example 10. Further clarification is needed as to why an asset-based profit split factor is appropriate, as opposed to gross or operating profit of Company A and B (or some other factor). If an asset-based profit split factor is appropriate, it would be helpful to provide additional guidance regarding what would be included in the asset base. For example, should it include inventory, plant & equipment, intangibles (if self-developed, may need to value), and/or working capital?

Responses to Specific Questions

Question 1. The discussion draft addresses situations in which profit splits of anticipated profits or profit splits of actual profits are appropriate. Where it is established that the transactional profit split is the most appropriate method, please comment on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used.

As in Example 9, a split of anticipated profit is more likely to be appropriate where parties make distinct contributions (*e.g.*, with respect to trademarks) and one party would not be able to generate profit without the other's contributions.

That said, while Paragraphs 43 through 46 and Example 9 address a transactional profit split of actual or anticipated profit, further clarification is needed on when a transactional profit split using anticipated profits should be used. The use of transactional profit split using anticipated profits seems to apply to scenarios where one of the parties may have made a unique and valuable contribution but does not share in significant ongoing risks. It is unclear from the Discussion Draft why a transactional profit split is applicable in such a scenario and the lump sum payment/sales based royalty cannot be determined using traditional transfer price methodology. For instance, in Example 9, Company A's intangibles do not qualify as hard-to-value intangibles; therefore, the assumption should be that the value of Company A's contribution can be determined with a traditional transfer price methodology. It is not clear why Company A should share in anticipated profits of Company B when it does not share in significant ongoing risks.

Attempting to distinguish scenarios between when a transactional profit split should use actual versus anticipated profits can cause additional confusion. It may make sense in certain circumstances for taxpayers to initially use anticipated profits to estimate profit split and adjust them to actual – it may just be a continuum of where the taxpayer is in its profit cycle. If there is no history available, because the parties are launching a new disruptive technology, adopting a new business model, or starting a new business, determining transfer prices based on anticipated profits would seem the only practical option. If the parties use anticipated profits, then those projections should be revised periodically and transfer prices reset accordingly, perhaps every one to three years. In such a case, the changes should be prospective, rather than retrospective true-up adjustments based on actual profits when they differ from anticipated profits. Historical data may not be predictive of future profits due to a number of factors, some of them beyond the control of the related parties; in such a case, future profit projections may be more reliable than past actual profits.

Question 2. A number of profit splitting factors are addressed in the discussion draft. Comments are particularly invited on:

a. Whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained, and if so, what factors need to be taken into account for its selection and application as a reliable profit splitting factor.

Reference to capital or capital employed as a potential profit splitting factor should be retained as this is an important factor regard to financial services given the role of capital in that industry. Some of the factors to consider prior to selecting capital/capital employed are: (i) the entities' involvement in the performance of valuable functions with respect to the transaction; (ii) the importance of capital contributions/investment to the transaction, with reference to comparable third party transactions; and (iii) the reliability of the profit splitting factor to yield reasonable results without adjustments.

Further, as noted in Paragraph 56, the use of capital or capital employed may be appropriate where the relative contribution of the parties are important drivers of the business' profit (*e.g.*, in a capital intensive industry). The use of the taxpayer's audited balance sheet to determine capital or capital employed has the advantage of verifiability, reliability and simplicity. However, as noted in Paragraphs 60 and 61, self-developed intangibles and other assets may not appear on the balance sheet and the determination of their market value will require a separate evaluation. In such a case, TEI recommends adjustments only be made where they are material.

b. Should headcount of similarly skilled and competent employees be included as a potential profit splitting factor, and if so, in what circumstances would it be relevant?

Headcount may be an appropriate profit splitting factor if it is one of the key profit drivers of the business. In practice, delineating headcount among similarly skilled and competent employees may be difficult and may be subject to dispute unless a more general approach using departments or job categories can be used.

c. Given the existing guidance in Chapters I and IX of the Transfer Pricing Guidelines, should adjustments for purchasing power parity be made for profit splitting factor amounts, and if so, in what circumstances?

In theory, it would be useful for accurate adjustments to purchasing power parity to be made for profit splitting factor amounts. However, given the challenge with data availability, the reliability of adjustments made and the results obtained from the adjustments may be called to question. Moreover, adjusting for purchasing power parity would complicate an already complex process.

d. What other profit splitting factors should be included in the guidance, and in what circumstances?

The guidance should provide flexibility to use profit splitting factors that drive the economics of the business/transaction. The final guidance should also make clear that the profit split factors in the guidance are only examples and that the key profit drivers in a business should be considered or used. If such profit drivers are not used as factors, explanation should be made as to why they are not being used.

TEI notes that it is important to select factors that are measurable, easily identified, and can be tracked in the parties' enterprise resource planning software; otherwise the profit split could become extremely difficult to determine, and would not be reliable. In addition, in TEI's view, while sales can be a useful factor when applying the profit split method, it should be used sparingly and only in cases where it is a key profit driver.

Question 3. Additional examples of scenarios in which a transactional profit split is found to be the most appropriate method due to the high level of integration of the business operations are sought, together with an explanation as to the reasoning thereto.

TEI suggests the following as an additional example of a scenario in which a transactional profit split is the most appropriate method due to high integration:

<u>Example X</u>: Company A and Company B are members of the same multi-national enterprise (MNE) group. Product X and Product Y are different but highly integrated products.

Company A is the parent company and operates in Country A as follows: (i) it manufactures Product X in Country A for global sales (assume there are no significant manufacturing intangibles); (ii) it performs R&D in Country A for Product X, assumes the economic risks related to the R&D, and owns the title to the MNE's global intangibles; (iii) it sells Product X and Y in Country A and the rest of the world, except for Country B; and (iv) it is responsible for global marketing of both Product X and Y (assume there are no significant marketing intangibles).

Company B is a subsidiary of Company A and operates in Country B as follows: (i) it manufactures Product Y in Country B for global sales (assume there are no significant manufacturing intangibles); (ii) it performs R&D in Country B for Product Y, assumes the economic risks relating to the R&D, and has exclusive right to exploit the MNE's global

intangibles regarding Product X and Y in Country B; (iii) it sells Product X and Y in Country B; and (iv) is responsible for global human resources, legal, billing and other finance functions.

Reasoning: Even in a highly integrated operation, there may be routine functions. Those functions would need to be separated and comparable returns for them determined using traditional transfer price methodology (*e.g.*, routine manufacturing, or low value added functions such as human resources, legal, billing and other finance functions, or other value added functions that have comparables, in the above example this would include marketing with no significant marketing intangibles). Assuming no better methodology is applicable, a transactional profit split may then be used to allocate the residual profit.

Conclusion

TEI appreciates the opportunity to comment on the Discussion Draft regarding revised guidance on profit splits. As noted above, TEI requests the opportunity to speak in support of these comments at the public consultation to be held in November 2017 in Paris.

These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Giles Parsons. If you have any questions about the submission, please contact Mr. Parsons at +44 (0)1455 826561, Parsons_Giles@cat.com, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 464 8353, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.

Robert L. Howren
International President

TP&C
Transfer Pricing & Controlling

Organisation for Economic Cooperation and Development
c/o Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA.
2 rue André Pascal
75775 Paris Cedex 16
France

31 August 2017

Via email: TransferPricing@oecd.org

Dear Sirs

Request for Input on Discussion Draft on BEPS Action 10 - Revised Guidance on Profit Splits

We appreciate this opportunity to contribute some general thoughts to the important Discussion Draft on the revised guidance on profit splits.

The guidance on the profit splits is of great importance for transfer pricing practitioners. In day-to-day practice, some practitioners tend to shy away from the profit-split method due to fear of an increased likelihood of being challenged by tax authorities. Challenges targeted at the selection of the profit split method as the best available method are prone to drastically alter the allocation of economic benefits (residual profits) and systematically imply higher tax risks compared to challenges to one-sided methods, which are mostly limited to operating margins realized by routine entities. Pragmatic and reliable guidance for the application of the profit-split method would allow transfer pricing practitioners to take advantage of the flexibility and other conceptual advantages offered by this method – as accurately outlined in Section C.2.1 of the Discussion Draft.

We greatly welcome the initiative shown by the OECD in issuing the revised guidance, which reflects responsiveness to the previous public discussion on profit splits of September 2016 and constitutes a sensible next step towards improving the transfer pricing framework (i.e. by discarding the obfuscating differentiation between parallel and sequential integration and toning down the differentiation between application of the split on actual or anticipated profits). A crucial aspect that has not received an adequate response, however, seems to be the value chain analysis. Based on the previous public discussion, it was to be hoped that the guidance provided in section C 4.5 number 48 of the public discussion draft of July 2016 would been elaborated on further. As it turns out, however, the new revised guidance does not focus on this issue. This omission is regrettable, as the previous guidance seemed sensible in emphasizing the practical importance of the value chain analysis for determining the relevant factors to use in splitting profits, including determining the weighting of applicable profit splitting factors. Instead of providing examples or best practices (incl. safe harbor suggestions) on this crucial aspect, the current discussion draft instead focusses on individual profit splitting factors, which would seem to be of rather technical and ultimately secondary importance compared to reliable (consensual) guidance of performing a value chain analysis for transfer pricing purposes; i.e. with a focus on deriving the splitting factors from a respective analysis.

1. *Profit splits of anticipated profits vs. profit splits of actual profits.*

As stated in Section 4.1 (number 46), irrespective of whether profits are split based on anticipated or actual profits, the basis upon which those profits are to be split, including the applicable splitting factors, the calculation of profits to be split as well as any adjustments, must generally be determined based on information reasonably foreseeable at the time the transactions were entered (precluding the

use of hindsight). According to this provision, it would seem misleading to overemphasize the importance of conceptually differentiating between the application of the profit split method based on actual or anticipated profits. Both approaches target an allocation of profits that is commensurate with the value added contributed by the associated companies and it would thus be confusing to suggest that the approaches are mutually exclusive (this was partially addressed in section C.1, number 6, of the public discussion draft of July 2016 – for royalties based on actual sales, which, as discussed below, is also applicable to Example 9). It should also be considered that contractual provisions merging the two approaches can be found in arm's length transactions, i.e. caps or floors in license agreements. Hence, it seems sufficient to stipulate that the choice between anticipated and actual profits needs to reflect arm's length conduct in the context of a specific transaction. Generally, it should remain at the discretion of the taxpayer to make a respective choice.

To prevent any misinterpretation and to emphasize the preclusion of hindsight, it should also be clarified that the utilization of ex post data as presumptive evidence for non-arm's length transfer pricing will be considered as being inappropriate in the context of transactions not being characterized by HTVIs – respective cross-references to the guidance on the implementation of the HTVI approach should be integrated.

Applied to Example 9 contained in the Discussion Draft, this interpretation translates to the following implications (to keep the discussion focused, the following remarks explicitly relate to the licensing of the intangibles, which given the relevant facts and circumstances of the case, can be assumed to reflect the default approach for the transaction):

- Pursuant to paragraph 6.48. of the 2017 OECD Guidelines the arm's length allocation of profits in both scenarios should be governed by the respective value-added contributions of the parties, i.e. as determined in the context of a DEMPE analysis.
- Considering that in Scenario 1, Company A does not share in the assumption of any of the economically significant risks associated with the marketing and exploitation activities (including investments for market penetration), it can be assumed that *ceteris paribus* the arm's length remuneration (i.e. the royalty rate payable by Company B) should be significantly lower compared to Scenario 2.
- It does seem implausible, however, that Company A neither performs any DEMPE functions relating to the IP nor bears any of the economically relevant risks enumerated in paragraph 6.65 of the OECD Guidelines from 2017 (i.e. infringement risk). Hence, even when the intangibles do not qualify as hard-to-value-intangibles, the guidance provided in paragraph 6.69 of the OECD Guidelines from 2017ought to apply.
- While it seems sensible to apply the profit split (determine a royalty) in Scenario 1 based on anticipated profits, it hardly seems feasible to completely ignore the actual profits in a multiple-year analysis, i.e. when validating the arm's length nature of the royalty rate in subsequent years. Particularly, in case that Company B remains in a loss position there would most likely be some kind of adjustment or re-negotiation process. It should be noted, however, that the agreed adjustment would not be targeted at the past, but rather at the future, i.e. the parties would agree to reduction of the royalty rate allowing Company B to exit the loss position. It must be kept in mind, however, that when applying a transactional profit split, both parties to the transaction will be classified as entrepreneurs and can thus sustain genuine losses (paragraph 1.129 of the OECD Guidelines from 2017). In other words, there is no requirement to retroactively compensate Company B (licensee) for losses incurred.
- The relevant question ultimately to be addressed (referring to paragraph 6.69 of the OECD Guidelines from 2017) will be whether the projections, on which calculations of ex ante returns and compensation arrangements are based, did adequately take into account the risks and probabilities of different outcomes occurring. In case the deviations between anticipated and actual profits are due to the anticipated risks and probability there is clearly no need for an adjustment. Should the deviations fall outside the anticipated parameters, an adjustment of the nature outlined in the previous bullet may (!) be appropriate. Again, it should explicitly be

clarified that the utilization of ex post data as presumptive evidence for non-arm's length transfer pricing is not considered appropriate in this case.

In sum, we agree with the OECD abstaining from strictly differentiating between the application of the profit split on anticipated or actual profits, especially as the prior notions of sequential or parallel integration seemed overly complex and misleading.

2. Profit splitting factors:

Instead of discussing specific profit splitting factors, stronger (renewed) emphasis should be put on the defining characteristic of an arm's length application of profit split method, which as outlined in Section C.2.1 of the guidance, is to be seen in an allocation of profits that is "based on the contributions made by the associated enterprises, by reference to the relative values of their respective functions, assets and risks". While it is always commendable to provide a legislative framework that allows for simple and pragmatic transfer pricing solutions, we must be cautious to avoid oversimplification when it comes to application of the profit split method. To be sure, capital employed or headcount of skilled employees may in some cases constitute sensible profit splitting factors. Applying specific profit splitting factors should, however, always be subordinated to a functional and risk analysis. While this is implied in Section C.5.1 (number 54), the utilized wording ("helpful") maybe regarded as being too timid for ensuring the preeminence of the functional and risk analysis for determining the suitability of specific profit splitting factors. To be sure, the general guidance provided in Sections C.5.1, C.5.2 and C.5.3 is certainly sensible. Nevertheless, it would by worthwhile to explicitly state that application of a formulary apportionment type of profit allocation, i.e. the application of profit splitting factors that are not derived from a functional and risk analysis, will be considered as not being commensurate with the arm's length principle and should be disregarded for tax purposes. A respective additional safeguard seems required, as tax administrations will soon be in a position to utilize data from the country-by-country reporting to calculate profit splits on a one-size-fits all type of apportionment formula (i.e. the CCCTB). Ignoring the possibility of some tax authorities being inclined to abuse the profit split method for applying formulary apportionment through the backdoor would be naïve. In case the OECD remains seriously committed to sustaining the arm's length principle as the paradigm for transfer pricing, it needs to adopt a strong and unambiguous stance on this issue. One sensible way to proceed would be to amend Section C.5.1 (number 58) by adding a provision such as: "*Opposed to the information contained in the Master File, the data contained in the Country-by-Country Reporting does not relate to the important drivers of business profits and therefore must be disregarded as a source of information relevant to the determination of appropriate profit splitting factors*".

A further general note should be made in respect to the accounting perspective of transfer pricing. Irrespective of which splitting factors are eventually chosen, it must be ensured that the taxpayer remains free to exercise a reasonable degree of discretion in defining and calculating these factors, i.e. in drawing-up the transactional balance sheet pursuant to Section C.5.2. number 60. In a nutshell, it would seem reasonable to emphasize consistency and transparency rather than accounting acumen. Considering that the application of a profit split will naturally involve a comparatively high degree of subjectivity and "fuzziness", the taxpayer should not be unnecessarily inhibited by restrictions in respect to accounting. Ensuring that relevant assumptions are transparent and that the analytical process including the utilized data is consistent and not geared to exert a bias on the results seems sufficient and should be prioritized.

3.Additional examples of scenarios in which a transactional profit split is found to be the most appropriate method due to the high level of integration of the business operations are sought, together with an explanation as to the reasoning thereto.

One type of transaction / scenario meriting a more intense discussion are projects. Increasingly, business models evolve around assigning specialists from different legal entities to cooperate in performing complex interrelated services – construction or consulting projects being prominent examples. In many cases the high degree of integration within these projects will justify the application of the profit split method as the most appropriate method. While the ex-ante pricing of respective projects is traditionally based either on hourly rates (consulting) or a cost plus and resale minus mechanism (construction), the profit split method (ex-ante as well as ex-post) will generally be better suited to cope with the idiosyncratic features of projects, specifically the fact that the pricing will be based on an intertwined "package" of services. Also, projects will often stretch over multiple periods, especially in case maintenance or other after-sales services are included in the package. In order to ensure that the allocation of the total profits generated from the project is aligned with the contributions made by the associated enterprises, conducting a value chain analysis for determining an arm's length split of the profits seems to be the most reliable solution, especially when combining ex-ante and ex-post elements (i.e. adjustment mechanism).

An appropriately segmented project accounting will obviously be the precondition for applying the profit split method. Again, as pointed out above, ensuring that relevant assumptions are transparent and that the analytical and accounting processes are consistent with the business should be prioritized, while excessive accounting requirements should be avoided (i.e. in respect to the allocation of profits to a specific period in the case of long-term projects). Respective guidance from the OECD in respect to minimal standards and safe harbor rules would be welcome.

UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

September 14, 2017

VIA EMAIL
Jefferson VanderWolk
Head
Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2 rue Andre-Pascal
75775, Paris
Cedex 16
France
(TransferPricing@oecd.org)

Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 10 – Revised Guidance on Profit Splits ("Discussion Draft")

Dear Mr. VanderWolk,

USCIB[1] is pleased to provide comments on the OECD's Discussion Draft on BEPS Action 10 – Revised Guidance on Profit Splits ("revised discussion draft" or "discussion draft"). USCIB would be pleased to present comments at the public consultation.

General Comments

USCIB is concerned that the discussion draft moves in the direction of supporting routine application of the transactional profit split method to transactions without properly considering the other transfer pricing methods. Profit splits are highly complex and require numerous subjective judgments; they should seldom be the first – or even a common -- option.

USCIB believes that the guidance on profit splits should be high-level and not prescriptive because the realities of business are wide ranging, so the guidance needs to be flexible to accommodate the wide-ranging circumstances to which it might apply. The discussion draft generally avoids prescriptive guidance, so USCIB supports that general approach. To the extent

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

that the discussion draft uses languages such as “will” or “must”, that language should be revised to suggest more optionality. An appendix attached to this letter points out some of these cases and suggests alternative language that does not imply a prescriptive approach.

USCIB is concerned that the discussion draft undercuts the detailed guidance on the allocation of risk that was extensively debated as part of the BEPS project and recently finalized in the OECD’s 2017 Transfer Pricing Guidelines. We believe that paragraph 1.94 of Chapter I of that guidance, which is part of the general discussion of risk, provides that the contract should be respected as the accurate delineation of the transaction when the entity that is contractually allocated risk controls the risk and has the financial capacity to assume risk. As a consequence of respecting the transaction, the transaction should be priced as structured. That conclusion should not change merely because there may be other entities contributing to the control of risk. The point of allocating risk is to determine which entity is entitled to the upside (and downside) from the playing out of the risks of the transaction. Other entities may contribute to the control of that risk and should be appropriately compensated for those functions, but that should not change the allocation of the risk, and these risk control functions may be routine and will likely have comparables. Paragraph 1.105 should not override the proper allocation of the risk; rather, USCIB believes that paragraph 1.105 merely states that it may be appropriate to compensate another entity for its contribution to control of risk. That contribution to control does not entitle it to upside or downside, or to any assumption that the transactional profit split is the most appropriate method.

The discussion draft seems to expand the potential use of the profit split method from transactions in which risk is shared, which is a factor which may, with other factors, support the selection of profit split as the most appropriate method, to a broader category that would include closely related risks. This expansion is not appropriate. All businesses take on risk, some risks are controlled, some are accepted but not controlled. All business transactions expose the participants to some level of risk from the other party. To the extent that the risks relate to the overall business of an enterprise, risks might be considered “closely related”. Such a loose, undefined term could lead to the routine application of the profit split method. In any event, a well done TNMM analysis takes comparative risks into account without the need to resort to a profit split.

USCIB thinks the discussion draft is improved by some of the deletions from the prior discussion draft. These include: the discussion of value chain (although see the last sentence of paragraph 48, which we suggest below ought to be deleted); and the discussion of parallel vs. sequential integration. In addition, we believe that further deletions (see detailed comments below) can improve the draft, in order to focus more closely on the key determinant of when the profit split method will be the most appropriate transfer pricing method – when both parties make “unique and valuable contributions” (i.e., when both parties make contributions for which reliable comparables are generally not available. In particular, USCIB is concerned that there is too much emphasis on high levels of integration. High levels of integration are not unusual (are not unique and comparables may be available), are poorly defined in the discussion draft, and are not a reliable indicator that the profit split method should apply.

USCIB believes that the final guidance on transactional profit splits should contain an explicit rejection of global formulary methods. Chapter 1 of the 2017 OECD Transfer Pricing Guidelines contains a robust defense of the arm's length standard and rejection of global formulary apportionment. That guidance should be cross-referenced in the transactional profit split subpart of the revised guidelines. USCIB is concerned that a poorly applied transactional profit split or an inappropriate use of the transactional profit split in a context where an alternative analysis would be more appropriate, may achieve results that resemble global formulary apportionment. We believe that it is important that such applications be clearly rejected and, therefore, a cross-reference to the Chapter 1 guidance is appropriate.

The discussion draft, as pointed out below in our detailed comments, looks to macro conditions, which while relevant are subsidiary to the functional analysis of the actual transaction. The draft needs to improve its focus on the actual transaction and make clearer the relationship between the transaction and macro conditions. A focus on macro conditions is much more likely to result in generic profit splits or formulary apportionment.

USCIB believes that it is important to distinguish between taxpayers' ability to arrange their own affairs and apply a transactional profit split method and the tax authorities' ability to compel the use of a profit split on audit. In the first case, if the transaction is structured such that both parties make unique and valuable contributions or share risk in ways that are difficult to unravel, then the taxpayer may appropriately consider whether the transactional profit split is the most appropriate method and if so apply it to the transaction. If, however, the transaction as structured by the taxpayer (and as accurately delineated) does not have characteristics that would lead to the conclusion that the profit split method is the most appropriate method, then tax authorities should not be able to effectively restructure the transaction by imposing a method that shares risk when risk is not in fact shared pursuant to the accurately delineated transaction. Restructuring of transactions is likely to create double taxation because the tax authority on the other side of the transaction may not accept that restructuring – particularly if the taxpayer's actions were consistent with the structure. In that case, tax authorities will be pricing two different transactions. When different transactions are priced, the result will likely be inconsistent and result in more controversies, which will be difficult to resolve because the tax authorities view the transaction differently.

Further, the practical obstacles associated with properly applying a transactional profit split method also make such a method difficult to apply on audit since the information on the profit to be split and the allocation keys may be extremely difficult to construct if the taxpayer applied a different method. This is not to say that tax authorities could not apply the transactional profit split method if the taxpayer did not use it initially, but it is important to ensure that tax authorities only apply the transactional profit split method when it is the most appropriate method and not as a default method or to achieve an outcome that inappropriately puts more profit in a jurisdiction when the factual analysis does not justify its use. Tax authorities should be held to the same high standard as taxpayers in determining whether a method, including the profit split method, is the most appropriate method.

The Platform for Collaboration on Tax recently finalized a toolkit[2] on addressing difficulties in accessing comparables, which is focused on the needs of developing countries and suggests possible approaches that may be used to address the lack of comparables. The transactional profit split method is one option that the report discusses. While the discussion of the profit split method is generally in line with the guidance that has been provided by the OECD and others, the toolkit, in our view, overemphasizes the ability to apply the profit split method in the absence of comparables – generally ignoring that many if not most profit splits are residual profit splits and therefore require comparables for the initial allocation of profit and that allocation keys may be based on comparables. The widespread use of the transactional profit split method because comparables are lacking will likely "result in a fundamentally different outcome to the one supported by the accurate delineation of the transaction."[3] We raise the toolkit because we believe the guidance in the toolkit may be having an impact on the discussion draft. This will be discussed further in the detailed comments section of this letter.

Detailed Comments

USCIB supports the statement in paragraph 1 that the transactional profit split method seeks to establish arm's length outcomes for controlled transactions. This would also be a good place to cross reference the robust rejection of the formulary apportionment.

Paragraph 1 of the discussion draft uses the term relevant profits, rather than combined profits as was used in the prior discussion draft and the 2010 version of the Transfer Pricing Guidelines. USCIB does not read this necessarily as a change, but rather as a method of referring to the different ways that profits can be combined, which are detailed in section C.4 (beginning at paragraph 39). To avoid any confusion, USCIB recommends adding a cross-reference to section C.4.

USCIB generally supports the statement in paragraph 2 that where the transactional profit split method is the most appropriate method, it should apply equally to profits and losses. We note, however, that contrary to the discussion draft's statement that asymmetrical splits of profits and losses are "rare" at arm's length, in some industries, they are quite common (e.g., private equity). The discussion draft should make clear that the appropriateness of an asymmetrical profit split, as of any profit split, should depend on the evidence of analogous arrangements at arm's length or other supportive facts and circumstances.

Paragraph 6 provides that in the case of unique and valuable contributions there will be no reliable comparables information. While it may be the case that there would not be reliable numerical comparables, comparability extends to methods and there may be other methods

[2] http://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf. USCIB is also concerned that the toolkit, which is merely a product of the staff of the platform organizations, will be seen as having as much weight as the OECD guidelines, which are approved by countries, or other more authoritative forms of guidance. Countries and taxpayers are not and should not be bound by such informal guidance.

[3] OECD Public Discussion Draft Revised Guidance on Profit Splits 4 July – 5 September 2016.

that would be appropriate to the transaction under review. So, even in the case of unique and valuable intangibles, the transactional profit split method should not be considered a default method.

Paragraph 8 provides that the ability to vary profits with the actual outcome of the risk is a strength of the profit split method. While the transactional profit split method may allow for the determination of profits that vary with the actual outcomes of risks, this is not unique to the transactional profit split method. So it is not clear this is a particular strength of the profit split method.

Paragraph 9 should refer to evaluating both sides of the transaction, rather than to evaluating both parties to the transaction.

Paragraph 10 refers to "gross profits" and "operating profits". The glossary for the 2017 version of the OECD Transfer Pricing Guidelines defines "gross profits" but not "operating profits". A definition of operating profits should be added to the glossary.

Paragraph 10 acknowledges that "a weakness of the transactional profit split method relates to difficulties in its application." USCIB believes this understates the difficulties associated with the transactional profit split method, particularly if the tax authorities seek to impose it retroactively when the taxpayer did not consider it the most appropriate method and used another method. USCIB is also concerned that tax authorities' desire to use the transactional profit split method in the perceived absence of appropriate comparables will result in application of the profit split method without the necessary information with respect to the "relevant profits" and without making the necessary adjustments to achieve an accurate transactional profit split. In such a case, the profit split may look much more like the application of a global formulary apportionment.

One way to address the concern expressed in the prior paragraph would be to modify paragraph 40. Paragraph 40 discusses the need to put relevant financial data on a common basis and how a taxpayer would approach that process. Paragraph 40 should also address how a tax authority would approach that process.

Paragraph 12 of the revised discussion draft corresponds in some respects to paragraph 17 of the July 2016 discussion draft. Paragraph 17, however, contained a cross-reference and a summary of Example 1 in Section D.1 of Chapter I (paragraph 1.83). Based on the facts of the example, old paragraph 17 concluded that the profit split method would not be the most appropriate method to apply. This discussion is deleted from the revised discussion draft but should be reinserted. The facts of the example clearly illustrate that Company B performed contract R&D and did not share in the development risk with respect to the intangible being developed and therefore Company B should not be entitled to a return related to the development risk with respect to that transaction. This is consistent with paragraph 1.101 of the 2017 Transfer Pricing Guidelines, so deleting the discussion contained in old paragraph 17 may create an inference that the example and analysis were incorrect. To avoid this inference,

which must be incorrect since the example including the conclusion expressed in paragraph 1.101 remains in the 2017 Transfer Pricing Guidelines, the deleted portion of paragraph 17 should be added to paragraph 12 or an example based on the example in paragraph 1.83 could be included in the examples section of the guidance.

USCIB strongly supports the statement in paragraph 13 that "existence of unique and valuable contributions by each party to the controlled transaction is perhaps the clearest indicator that a transactional profit split may be appropriate." Even in this case, however, it is necessary to determine whether the profit split method is the most appropriate method.

USCIB objects to paragraph 13's expansion of "shared risks" to include the separate assumption of closely related economically significant risks. All MNEs and transactions bear risk. Because those risks relate to the same business, there may be a tendency for tax authorities to assume or assert that those risks are closely related. Such a broad standard could lead to the profit split method becoming a de facto default method.

Paragraph 14 addresses some of the same concepts that are addressed in paragraph 18 of the July 2016 discussion draft. In USCIB's view, this revised discussion draft is substantially weaker than the July 2016 discussion draft. The last two sentences of paragraph 18 read:

> 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 the adjustment … and interpretation … 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.

The deletion of the last sentence, which strongly supports pricing that comports with the "real deal", is inappropriate. If, in fact, one party performs simple functions, and risks are not shared, then a profit split is not appropriate and the guidance should clearly say that. USCIB is concerned that this has been revised to accommodate more expansive use of profit splits by some countries.

Paragraph 15 should be deleted because it incorrectly concludes that if unrelated parties use a profit split method that can be a "pointer" that it should be used in the related party context.

Paragraph 18 provides that the profit split method may be the most appropriate method in the case of transferred intangibles if there are not comparable uncontrolled transactions. The draft should also point out that comparable valuation methods may be considered for purposes of valuing transferred intangibles.

Paragraph 19 states that most MNE groups are integrated "to some extent," but that "a particularly high degree of integration in certain business operations is an indicator for the consideration of the transactional profit split method." Other paragraphs use a variety of similar adjectives, such as "interlinked," "highly inter-related," "inter-dependent," "a high degree of inter-dependency") to reach the same conclusion.

It is difficult to see why using several synonyms is helpful when no objective definition has been provided for the underlying term. Without explicit criteria outlining the difference between the integration which exists in "most" MNE groups and the "particularly high degree of integration" which makes the profit split method the best method, no useful guidance is provided and this section (paragraphs 19 through 24) should be deleted. Otherwise a tax authority can assert that there is a "high degree of integration" on an arbitrary basis to justify use of the profit split method in order to claim a larger share of an MNE's global profits. USCIB believes that large market jurisdictions may see high-integration as an avenue to achieve indirectly (a transactional profit split that allows the local affiliate to earn the return on the "unique and valuable intangible" of the market) what they could not achieve directly. The Transfer Pricing Guidelines do not treat a market as an intangible, although some countries argued for that position. Thus, the local affiliate in the market does not "own" an intangible, such that both sides to the transaction are contributing unique and valuable intangibles. If tax authorities in the market jurisdictions argue, however, that the manufacturing and sales functions are highly-integrated, then those tax authoriities may assert that that "indicates" that the transactional profit split is the most appropriate method. See example 3, paragraphs 77 through 82.

If these paragraphs are not deleted, they should be modified. The language to refer to a particularly high degree of integration should be standardized and better defined. Some of the situations described seem like they could be appropriately characterized as joint ventures.

Further, even if a definition of a highly-integrated business can be agreed upon, a particularly high-degree of integration should be a factor rather than an indicator. Integrated businesses may be engaged in activities – especially services – for which comparables are available, and one-sided methods may be appropriate.

USCIB agrees that the reference in paragraph 20 to the transactional profit split method for global trading of financial instruments is appropriate. However, taxation of the financial services industry frequently follows special rules, so the OECD should not extrapolate from the global trading rules to similar rules for other industries without first carefully considering whether the situations are similar.

Paragraph 21 illustrates a high-degree of interdependency with the example of long-term arrangements involving the contribution of assets. In some cases, these sorts of contributions may effectively create a joint venture and some form of profit split may be appropriate. In other cases, however, a contributed asset may have a known value and compensation for the use of that asset may be readily determined under a one-sided method.

Paragraph 23 contrasts situations in which the parties share risks to those in which the parties separately assume closely related risks. As noted above, USCIB believes that separately assuming closely related risks should not be an indicator that the profit split method is the most appropriate method. Assuming, however, that the profit split method is the most appropriate method in such a case, USCIB believes that a split of gross profit is likely to be more appropriate. Therefore, we suggest adding the following sentence at the end of paragraph 23: "A split of gross profit may be most appropriate in situations in which the parties separately assume closely related, economically significant risks."

Paragraph 24 raises the issue of the interaction of paragraphs 1.105 and 1.94. As discussed above, USCIB believes that paragraph 24 misconstrues how paragraphs 1.105 and 1.94 are intended to interact. In our view, the party who is contractually allocated the risk, controls the risk and has the financial capacity to bear the risk is entitled to the potential upside and downside from the realization of the risks. Other parties should be appropriately compensated for their functions, including those functions that relate to risk management, but are not entitled to share in the potential upside and downside associated with that risk. Therefore, paragraph 24 ought to be deleted. At a minimum, the paragraph should be more balanced. One way to achieve a more balanced approach would be to revise the second sentence of paragraph 24 to mirror the first sentence. The second sentence would then read: "However, the mere fact that an entity performs control functions in relation to a risk will not necessarily lead to the conclusion that the transactional profit split is the most appropriate method in the case ***or that the entity performing the control functions is entitled to upside or downside in the case."*** (Proposed language ***in bold and italicized.***)

Paragraphs 25 through 27 claim that the sharing of "economically significant risks" and the "separate assumption of closely related risk" are the appropriate criteria for determining whether actual or anticipated profits are to be split. The members of an MNE group as a general matter share all economically significant risks to a certain extent; it is not obvious what the asserted connection to any particular risk is. It appears that the concept of the sharing of risks between unrelated parties when they enter into a partnership is being confused with the reasons for using a profit split method as the most appropriate pricing method in related-party transactions. Consequently, we recommend deleting these paragraphs.

If these paragraphs are not deleted, paragraph 27 should be revised. Paragraph 27 suggests that if the parties share the assumption of economically significant risks or assume closely related economically significant risks, then splitting of actual profits is likely to better align with the accurate delineation of the transaction. This is not necessarily the case. A buyout – frequently seen in the area of development of technology, pharmaceuticals, and medical devices – may involve splitting of anticipated profits. Similarly, royalty arrangements are based in part on anticipated profits (the level at which the royalty rate is set) and in part on actual outcomes (the level of actual sales). The paragraph also ignores how the transaction allocates risks. A licensee will face more risk in a buyout than in a royalty transaction. In light of these concerns, USCIB believes that paragraph 27 ought to be revised to reflect that whether actual or anticipated profits should be split depends on how the transactions are actually structured.

Paragraph 28 seem to divide the world into two categories: one category includes those situations in which the profit split is the most appropriate method and the other category includes those methods that rely entirely on comparables. This oversimplifies the world. There are other methods that fall between these two poles and also ought to be considered, for example, methods that use regional databases. The distinguishing factor for the profit split method is the presence of unique and valuable contributions on both sides of the transaction.

USCIB agrees with the discussion draft's statement in paragraph 33 (first bullet) that if the profit split method is being applied ex ante then it would be reasonable to expect the life-time of the arrangement and the profit splitting factors to be agreed in advance. This assumes, however, that the relationship is static, while in practice relationships may be evolving. The bullet should, therefore, be revised to reflect that the factors should be revised to take into account subsequent changes to the relationship. The 2010 Transfer Pricing Guidelines were clearer on this point.

USCIB agrees with the discussion draft's statement in paragraph 33 (third bullet) that the determination of the relevant profits to be split and the profit splitting factors should generally be used consistently over the lifetime of a transactional profit split arrangement, unless the facts and circumstances support the use of different measures of relevant profits or profit splitting factors. In order to avoid ambiguity, the discussion draft should acknowledge that splitting profits on an asymmetrical basis (differently in profit and loss situations) does not contravene this rule if consistent with the parties' ex ante risk allocation and with analogous arrangements at arm's length. Again, the 2010 Transfer Pricing Guidelines were clearer on this point.

Section C.3.1 of the discussion draft (paragraphs 34 through 38) sets out two approaches to splitting profits: a contribution analysis and a residual analysis. Under the contribution analysis, relevant profits are divided on the basis of the relative value of the contributions by each of the associated enterprises participating in the controlled transactions. While the discussion draft notes that the division can be supported by external data where available, it allows use of "information internal to the MNE group" in the absence of such data. A contribution analysis that allows governments to rely solely on information "internal to the MNE group" to determine a split of profits invites governments to engage in formulary apportionment by asserting that certain types of factors should normally generate certain relative levels of profit. We believe a transfer pricing analysis must be based on information that shows either how independent enterprises actually price transactions or, in the absence of such information, on how they would price transactions in comparable circumstances.

Accordingly, we propose the following changes to paragraphs 35 and 36 (adding the bold italicized language and deleting the language shown in strike-through):

- "In the absence thereof, it should be based on the relative value of the contributions by each of the associated enterprises participating in the controlled transactions,

determined using information internal to the MNE group ***that provides evidence of how independent parties would have divided the relevant profits*** (see section C.5.2)."

- "In cases where the relative value of the contributions can be measured directly***, based on methods used by independent enterprises divide relevant profits,*** it may not be necessary to estimate the actual market value of each party's contributions."
- "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, assets used or contributed, capital invested) and assigning a percentage based upon the relative comparison using ~~and~~ external market data."

We also note that, when parties share profits from a combined activity, a key determinant of how risk should be shared is the contractual allocation of risks. We suggest adding the following sentence at the end of paragraph 35: ***'The contractual arrangements, and in particular how those arrangements (appropriately delineated) allocate risk among the associated enterprises, are key determinants for how independent enterprises would share profits in comparable transactions under comparable circumstances.'***

We also suggest amending the following sentence by adding the bolded/italized language: "Under a contribution analysis, the relevant profits, which are the total profits from the controlled transactions under examination, are divided between the associated enterprises in order to arrive at a reasonable approximation of the division that independent enterprises would have achieved from engaging in comparable transactions ***under comparable circumstances***."

The parenthetical should be removed from the second sentence of paragraph 37. Although the parenthetical only provides examples of cases in which a one-sided method may be applied, it may create the implication that one-sided methods are not appropriate in other cases. This is especially problematic given the loose definition of low versus high-integration, and that all of these factors may be present in transactions for which comparables exist.

The first sentence of paragraph 39 should be deleted or substantially revised. As it is written now, "the relevant profits to be split … are the profits of the associated enterprises relating to the controlled transactions in the associated enterprises are engaged." This could include other profits in the value chain of which the particular transaction is a part. The third sentence is a more accurate expression of the profits to be split. In our view, nothing is lost in deleting the first sentence and an ambiguity would be removed.

The last sentence of paragraph 42 should be modified to include the word "reasonable", so that it would read as follows: "Experience suggests that this initial stage in performing a profit split can in some circumstance be extremely complex, and the method of identifying the profits relevant to the transaction and any assumptions made in doing so need to be ***reasonable*** and documented."

USCIB strongly supports the statement in paragraph 46 of the discussion draft that "care should be exercised to ensure that the method is applied 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." USCIB would like to point out that profit split factors are often based on annual results, especially if the transaction is more of a service than an asset. An example of this could be barrels of oil pumped from a joint venture or billable hours by a service company. Additionally, in a transactional profit split of actual results, the profit splitting factors are often updated on an annual basis. An example would be a capitalized cost method that rolls forward the additional expense and amortization annually. So while the profit split framework may be established ex ante, the annual application will change as the taxpayer's underlying business inputs change.

Paragraph 48 deals with the measure of the profits to be split. The last sentence of paragraph 48 ought to be deleted. The discussion draft has eliminated most references to the "value chain". This sentence is carried-over from paragraph 40 of the 2016 discussion draft and now ought to be deleted given other references to "value chain" have been deleted. A new final sentence summarizing the paragraph ought to be added as follows: "Generally, it is appropriate to use any reasonable, reliable measure of the profits to be split, so long as that measure reflects the accurate delineation of the transaction and is consistent with comparable methodologies used by unrelated taxpayers if that information is available."

Paragraph 49 of the discussion draft explains that in appropriate circumstances, "gross profits" rather than "operating profits" should be split. It is also true that independent enterprises sometimes split revenues rather than profits. Accordingly, the discussion draft should be amended to permit the splitting of revenues. If revenues may be split, the following changes should be made to the discussion draft:

- The following sentences should be added to paragraph 2: "References to "profits" in this Chapter should include "revenues" where the transfer pricing method appropriately splits revenues based on an allocation metric. Unrelated parties may agree to split revenues (and sometimes expenses), without reference to "profits."
- The following sentence should be added at the end of paragraph 8: "The appropriateness of variable outcomes may support the use of a split of revenues or gross profits rather than operating profits."
- Revise the fifth sentence in paragraph 10 be adding the following language (in bold and italics): "Further, when the transactional profit split method is applied to operating profits ***rather than gross profit or revenue,*** it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises' other activities.

Paragraph 54 provides that: "The functional analysis and an analysis of the context in which the transactions take place (e.g. the industry and environment) may be helpful in the process of determining the relevant factors…." The draft should make clear that in determining the correct transfer price, the focus should always be on the accurately delineated transaction. The

macro environment is of secondary importance and can only inform the functional analysis of the accurately delineated transaction, not supersede that analysis.

USCIB is concerned that paragraph 58 references the Master File as a source of information under the heading of profit splitting factors. The value drivers that may be identified in the Master File are not transactional and therefore may have no relationship to the transactional profit to be split. Value drivers are also not necessarily measurable. The ability to use high-level value drivers to allocate transactional profit may, therefore, be limited.

Paragraph 59 discusses relying on internal data. USCIB suggests that if it is necessary to rely on internal data, then management's judgment concerning the relative value of contributions to the business ought to be taken into account. This could be accomplished by modifying the first sentence to read as follows (additions in bold and italics): "Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the relevant profits, consideration should be given to ***management's judgment about the relative value of contributions to the business, as well as to*** internal data, which may provide a reliable means of establishing or testing the arm's length nature of the division of profits.

Paragraph 60 references asset-based profit splitting factors and mentions that "some analytical work is needed … to draw up a transactional balance sheet". First, it should be emphasized that asset-based factors may not make sense if the assets cannot be clearly and readily valued. Second, drawing up a transactional balance sheet may be difficult, time consuming and expensive. It also may not, in the end, be accurate. USCIB would like to re-emphasize that because of these concerns, it is unlikely that a properly applied transactional profit split will be able to address the administrative concerns that are reflected in the recent toolkit on addressing difficulties in accessing comparables.

Paragraph 61 illustrates the complexity and difficulties of applying the profit split method even when using a profit splitting factor such as costs that seems more straightforward to apply. The profit split method should not be considered the primary method for determining transfer prices; tax administrations should generally evaluate other methodologies first and use the most appropriate method.

Paragraph 64 strongly supports the use of asset-based or capital-based profit splitting factors. As pointed out above in our comments on paragraph 60, asset-based factors may present substantial difficulties in application. USCIB supports the use of capital-based profit splitting factors in appropriate circumstances.

Paragraph 67 should be revised to delete the reference to the treatment of location savings. Location savings are not intangibles and the contribution of location savings to profits is not unique. The contribution of location savings to profits is mainly routine and local comparables are generally available. Singling out location savings in this way may imply that location savings should be routinely included in the profit to be split, rather than priced under a one-sided method.

Examples

USCIB believes the examples are generally unhelpful. The conclusions in the examples are based on descriptive language that presupposes the result rather than a factual analysis of a particular case. USCIB acknowledges that writing useful examples is very difficult and therefore the best result might be to delete the examples entirely.

If the decision is made not to delete all the examples, then the analytical process needs to be described in detail. It would also be appropriate to have more examples where profit split is not appropriate (eight of ten examples conclude the profit split method is the most appropriate method). We find that troubling as in practice the profit split method is rarely the best method; the examples seem to put a thumb on the scale in favor of use of the profit split method in most cases. One option would be to develop cases with "A" and "B" solutions, where profit split is appropriate and where it is not (examples 3 and 4 follow this format). Another option would be to include more examples where profit split is not appropriate (for example, example 1 in section D.1 (paragraph 1.83) could be included here).

Although the examples use anonymous descriptions of the related parties ("Company A" and "Company B") the facts of several of the examples bear a striking resemblance to the business models and arrangements of well-known U.S. companies. We believe that is inappropriate, and that even the appearance that the discussion draft is targeting American companies should be removed.

The following are comments specific to each example:

Example 1: The example does not sufficiently explain why the "important" development and enhancement functions and management of regulatory authorization are "unique and valuable" contributions. By using vague descriptors such as "important" to describe the functions, the example presupposes the conclusion it is trying to reach. Without additional facts, it is also possible that Company S is performing routine contract R&D services, where information on comparables may exist and a different transfer pricing method would be more appropriate than a profit split. Finally, given the vague facts of this example, the assertion that the profit split is "likely" to be the most appropriate method is an overextended recommendation. USCIB recommends that such normative conclusions be removed from this example as well as other examples, given the general nature of the assumptions made and facts presented.

Example 2: Like Example 1, it is again not immediately clear why certain functions performed by A Co. and B Co. are unique or valuable, including the routine assembly, marketing, and distribution functions performed by B Co. The simple functions by B Co. may be more appropriately benchmarked using a one-sided transfer pricing method than using the profit split method. Additional details are included which have no well-defined meaning in the example and do not help clarify why the functions of Company B are unique or valuable, such

as the descriptor "extensive" applied to three separate types of tangible/intangible property in paragraphs 72 and 73, and 75, and the "premium price" commanded by the tea product(s).

Example 3: Similar to Example 2, this example uses vague descriptors which do not point out why exactly a function is unique or valuable, such as "cutting-edge" global marketing activities in paragraph 79, "valuable" trademark and associate goodwill in paragraph 79, and "valuable" information for demand forecasting in paragraph 80.

Furthermore, the term “economic advantage” is not explained, but rather is an asserted characteristic about the activities performed by the Companies. Characterization of an entity as having economic advantage relies on a careful delineation of functions, risks, and assets, which require more assumptions than can be captured in this example.

Finally, this example also attempts to illustrate the interrelated and interdependent risk of the Companies, but the example provided is too broad. The division of R&D, marketing, and distribution functions across related parties where the performance of each party depends on the success of other parties is applicable to product supply chains in general. The example does not make clear which specific characteristics of the entities described make the entities strictly interdependent, other than the vague adjectives used to justify the “unique and valuable” contributions of the related entities.

Example 4: The example describes the marketing and distribution functions as "limited", "not a particular source of economic advantage", and "not economically significant", resulting in a conclusion that the profit split method is not the most appropriate method. As in Example 3, these vague descriptors presuppose the conclusion of this example, can take on different meanings depending on how a tax authority may interpret them, and fail to describe what characteristics of a transaction make the profit split a less appropriate method.

Example 5: Based on the facts provided, ScaleCo’s provision of “scaling-up” services are “unique and valuable” because the system would be unable to meet potential customer needs without them. While these services may be “valuable”, the facts are insufficient to conclude on whether the services are “unique.” In other words, it is also possible that the scaling-up services could be contracted to a third-party, and therefore the compensation to ScaleCo could be benchmarked against uncontrolled transactions.

Example 6: It is not clear from the facts presented why Company A and B are only “integrated to some degree” as well as why the risks assumed by Company B are not “economically significant.” Additional details in paragraph 91 indicate that Company B may own manufacturing intangibles, but these details are not considered in the conclusion that Company B does not make unique or valuable contributions to the transaction.

Example 7: Although comparables for the portfolio management services are available, the example does not explain why information on the comparables is unavailable to pursue a different transfer pricing method. Rather, the example only asserts that the information on the

comparables does not provide a way to split profits between the Companies. This assumes that the profit split is the most appropriate method without looking at how the information on the comparables may be used under another transfer pricing method as a more appropriate method. USCIB recommends that the normative conclusion be removed from this example. The addition of the following sentence at the end of paragraph 98 would also enhance clarity: "ASSET Co's management views the members of Company A and Company B as contributing equally to the performance of the funds."

Example 8: Given the lack of detail in this example, the profit split is a possible transfer pricing method, but it is also entirely possible that there are comparable uncontrolled transactions where an entity is contracted to develop and manufacture one component of a final product.

Example 9: The delineation of anticipated profits and actual profits split should be removed from this example. In paragraph 104, it is assumed that the contributions of both companies are unique and valuable, but this is not justified by the use of vague descriptors such as "enhanced" trademark value, "intensive" marketing activities, and "innovative" marketing activities.

Example 10: The example assumes that Company A and Company B are highly integrated because they both undertake manufacturing activities. This assumption is unwarranted, as participation in the same activity does not necessarily mean a high degree of integration. In paragraph 113, the phrase "complex web of intragroup transactions" is unnecessary, as it does not add meaning or a new assumption to the example. Finally, the conclusion that a profit split is the most appropriate method is unwarranted, as the example simply asserts that the companies depend on the capacity of one another for components. This assertion is based on the earlier unwarranted assumption that the Companies each developed unique and valuable manufacturing in paragraph 112.

In addition, in paragraphs 75, 87, 101, and 113, it is not clear that the tested company is at risk for failures. Paragraph 81, in contrast, addresses this issue directly ("In accordance with the risk analysis framework described in Section D.1.2.1 of Chapter I of these Guidelines, it is determined that Company A assumes the risks relating to . . . ."). USCIB strongly recommends that similar language be incorporated into the other examples, to confirm that risk allocations remain tethered to the TPG framework.

<u>Specific Questions for Commentators</u>

> *1. The discussion draft addresses situations in which profit splits of anticipated profits or profit splits of actual profits are appropriate. Where it is established that the transactional profit split is the most appropriate method, please comment on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used.*

Paragraphs 43 through 46 deal with this issue in a very general manner. Consistent with USCIB's positions that preserving flexibility is important and that the most appropriate profit split might be "bespoke", we do not have any suggestions on the considerations that should necessarily be taken into account for this purpose.

2. A number of profit splitting factors are addressed in the discussion draft. Comments are particularly invited on:

a. Whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained, and if so, what factors need to be taken into account for its selection and application as a reliable profit splitting factor.

USCIB supports the continued use of capital as a potential profit splitting factor in appropriate circumstances. For example, some transactions are structured to provide a specific return to capital (e.g., the hedge fund model, as described in the OECD's Report on the Attribution of Profits to Permanent Establishments, Part III, Section c-2(iv)).

The cost of capital or capital employed is a reflection of the economically significant risk. The cost of capital is not, however, observable on a transactional basis, so proxies are necessary to measure this. The frequent use of relative capitalized development costs of two intangibles as a residual profit split key is meant to provide a reasonable measure of the relative contributions of and risks taken by the two parties. Indeed, it is well known that the ex-ante value of an intangible contribution is proportional to the level of fixed funding commitment required to develop the asset (because fixed costs commitments increase risk and increased risk means increased expected value). Therefore, measuring relative contributions of value by a relative measure of the capitalized development costs (as a proxy) is not only meaningful, it is grounded in a correct application of basic financial economics concepts.

b. Should headcount of similarly skilled and competent employees be included as a potential profit splitting factor, and if so, in what circumstances would it be relevant?

USCIB believes that headcount may be an appropriate allocation key, for example if companies are sharing expenses such as IT and human resources. It might also be appropriate to split profit using headcount if the profits are heavily driven by function, seniority, time spent on a business etc. A headcount factor might be weighted based on the particular circumstances of the business activity. For example, developing new business may be more important than expanding existing business so that personnel involved in promoting new business may receive greater weight; the business may wish to move its customers to online transaction, so that personnel with responsibility for marketing online transactions may be given greater weight; and in the financial services and like industries, decision-makers may contribute more materially than line personnel, so that headcount could be weighted by title. The essential point is that the allocation key should split profits "on an economically valid basis that approximates

the division of profits that would have been anticipated and reflected in an agreement at arm's length."[4]

c. Given the existing guidance in Chapters I and IX of the Transfer Pricing Guidelines, should adjustments for purchasing power parity be made for profit splitting factor amounts, and if so, in what circumstances?

Purchasing Power Parity ("PPP") is an economic concept that compares different countries' currencies through a market "basket of goods" approach. Under PPP, two currencies are in equilibrium or at par when a market basket of goods is priced identically in both countries after exchange rates are computed. As such, it is an alternative to exchange rates. USCIB does not believe that this concept is useful for determining profit splitting factors, as asked in question 2 c. There are several problems with this idea.

First, as mentioned above, PPP is an alternative to exchange rates. When reviewing a related party transaction between two currencies, IFRS and GAAP always use exchange rates, not PPP. Use of PPP in a profit split factor would also necessitate use of PPP for all costs and revenues associated with the transaction, a major change in global accounting and tax standards. Second, calculating PPP is complex and unreliable, as a wide range of goods and services must be considered. The amount of data that must be collected and the complexity of drawing comparisons makes this process difficult. Consequently, there is no consensus on how to compute a reliable PPP. Note that several organizations that compute PPP, such as University of Pennsylvania, World Bank and the United Nations, often derive substantially different estimates depending on methodology. Third, exchange rates are superior to PPP as they account for relevant factors often omitted from PPP analyses, such as transportation costs, taxes and tariffs, political uncertainty and monetary policy.

Lastly, we note that the references to "purchasing power" in the OECD Guidelines are particularly broad and not meant for a specific calculation such as profit splitting factors.

d. What other profit splitting factors should be included in the guidance, and in what circumstances?

As emphasized above, USCIB believes that the guidance will be of most value if it avoids strict prescriptions. In particular, the list of profit splitting factors should be expressly illustrative rather than exclusive. Transactions for which a transactional profit split is most appropriate should involve unique and valuable contributions; accordingly, a bespoke allocation key, such as one based on measures used by the taxpayer internally to evaluate business performance, may better reflect relative value contributions than a single-factor key such as capital employed, headcount or compensation. Any such key must, of course, align with the accurate delineation of the transaction.

[4] Discussion draft, paragraph 32.

3. Additional examples of scenarios in which a transactional profit split is found to be the most appropriate method due to the high level of integration of the business operations are sought, together with an explanation as to the reasoning thereto.

> USCIB does not believe that determining whether there is a "high level of integration" is relevant for determining when the profit split method is the most appropriate transfer pricing method; consequently, no examples are needed.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)

Washington Office
1400 K Street, N.W., Suite 525
Washington, DC 20005
202.371.1316 tel
202.371.8249 fax
www.uscib.org

Appendix A

Provisions Using Proscriptive Terminology and Potential Corrections

The following sentences would be made appropriately less prescriptive by adding the language in bold italics, deleting the language shown in strike-through. We also explain why these changes are appropriate.

Paragraph 6:

- Revised Language: "Furthermore, since those contributions are 'unique' and 'valuable' there ***often*** will be no reliable comparables information which could be used to price the entirety of the transaction in a more reliable way, through the application of another method."

- Comment: It may be the case that a party that owns and makes unique and value contributions to a business will license from a third party, in exchange for a royalty, other unique and valuable intangible property. In those circumstances, the CUP method may be used to "price the entirety of the transaction."

Paragraph 12:

- Revised Language: "That is, the accurate delineation of a transaction ***may require*** ~~requires~~ a two-sided analysis (or a multi-sided analysis of the contributions of more than two associated enterprises, where necessary) irrespective of which transfer pricing method is ultimately found to be the most appropriate."

- Comment: It is not the case that such a two-sided analysis is always required to delineate the transactions. Where a contract limits the functions, assets and risks of a service provider to those of independent comparables for which data is readily available, and no facts or circumstances suggest that the service provider performs functions, uses assets or bears risks other than as set forth in the contract, analysis of the counterparty to the arrangement is not necessary or helpful. Our concern is that this language offers license to governments to assume a profit split is the right method until proven otherwise.

Paragraph 16:

- Revised Language: "Contributions (for instance functions performed, or assets used or contributed) ***may*** ~~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."

- Comment: Some operations within a business may have unique operating procedures that are "key" to its place in the value chain but that do not contribute meaningfully to profitability for the covered business as a whole.

Paragraph 42:

- Revised Language: "Similarly, if the associated enterprise engaged in European marketing and distribution buys products from other sources, it ***may*** ~~will~~ need to segregate its financial data in a way that reflects the revenues, costs, and profits relating to the goods purchased from the associated product supplier in the profit split."

- Comment: Whether third-party sourcing requires segmentation of associated profits can depend on materiality, on the TPM used to value the particular facet of the business (e.g., an application of the TNMM as part of a residual profit analysis may in fact be made less reliable by attempting to segment outcomes from third-party purchases), and on the availability of reliable data and assumptions on which to base the segmentation.

Paragraph 60:

- Revised Language: "In addition, certain assets, such as self-developed intangibles, may not be reflected on the balance sheet at all, and accordingly ***may need to be*** ~~must~~ be separately evaluated."

- Comment: Self-developed intangibles exist for every business. They typically need to be separately evaluated only if they are unique and valuable, and are not otherwise addressed by the selected TPM.

In many cases the use of "will" in the examples is inappropriate. The examples frequently state that Company A or Company B will be responsible for an activity. If the examples are retained, much of this should be rewritten to reflect the contractual obligations and the accurate delineation of the transaction. "Will" blurs these distinctions. The analysis should start with the contractual obligations and determine whether the transactions as accurately delineated are consistent with the contractual obligations.

Institute for Austrian and
International Tax Law Vienna
WU Transfer Pricing Center

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Mr. Jefferson VanderWolk
Head of the Tax Treaty, Transfer Pricing & Financial Transactions Division
Centre for Tax Policy and Administration
OECD

By email to: TransferPricing@oecd.org

Vienna, September 14, 2017

Subject: Comments on the Public Discussion Draft on BEPS Action 10 "Revised Guidance on Profit Splits"

Dear Mr. VanderWolk,

First of all, we would like to congratulate the OECD for the additional work done to revise the guidance on profit splits in the Public Discussion Draft on BEPS Action 10 "Revised Guidance on Profit Splits" (the "2017 Discussion Draft"), issued on 22 June 2017.

We are grateful for the opportunity to provide comments and we hope that our suggestions might provide valuable inputs for future improvements in the finalization of the guidance.

1. Introduction

In comparison to the 2016 Discussion Draft, the 2017 Discussion Draft has made a great leap by shedding light on when the transactional profit split method (TPSM) is likely to be the most appropriate method and how to apply the TPSM properly. Notably, the Discussion Draft has listed 10 examples for illustration purpose, covering many typical situations. Nevertheless, certain difficulties and challenges regarding the application of the TPSM still exist. Therefore, we would like to take this opportunity to provide our comments on the 2017 Discussion Draft. These comments are of a general nature (see section 2, below), as well as referring to the specific question concerning the TPSM of anticipated profits vs. the TPSM of actual profits raised in the 2017 Discussion Draft (see section 3, below).

2. General comments

2.1 The 2017 Discussion Draft presents great improvements

In general, we believe the OECD has achieved good progress in providing meaningful guidance on the application of the TPSM and we welcome the proposals in the 2017 Discussion Draft. Looking through the historical evolution of the OECD's work on the TPSM, the 2014 Discussion Draft - the first discussion draft on the topic of the TPSM issued by the

OECD in the context of BEPS Action 10 - was including many potential scenarios where it is believed that the TPSM is likely to be applicable with the effect of opening the "Pandora's Box" of many possibilities of applying the TPSM. Following the publishing of the 2014 Discussion Draft, the business community expressed its concerns, including, *inter alia*, the proliferation in the use of the TPSM and an implied adoption of the formulary apportionment approach. The business community was worried that tax administrations may misuse those features of the TPSM contained in the 2014 Discussion Draft. As a result, the 2016 Discussion Draft came out more conservatively by setting out clear restrictions on the scope of application of the TPSM. The mere lack of comparables, the exploitation of the global value chain and group synergies should not automatically enable the use of the TPSM. Now the 2017 Discussion Draft, in addition to clarifying the proper scope of applying the TPSM, is seeking to find the answers as to how to apply the TPSM more appropriately. The 2017 Discussion Draft focuses heavily on the determination of the combined profits and the profit splitting factors, for example.

Another significant feature of the 2017 Discussion Draft is that it is more prudent and less prescriptive in terms of determining the appropriate circumstances to apply the TPSM. The applicability of the TPSM is very specific to the facts and circumstances of the case. The 2017 Discussion Draft, given the fact that it is a guideline, cannot feasibly present all facts and circumstances in which the TPSM should be applicable. Being less prescriptive, the guidance allows the concerned parties to make their judgment and to take into account the specific facts and circumstances of the case. Under the condition that the actual controlled transaction is accurately delineated, the presence of indicators, i.e. unique and valuable contributions and highly integrated business operations and a shared assumption of economically significant risks or separate assumption of closely related risks, may evidence that the TPSM is likely to be applied. As underlined by the OECD, those indicators are just indicators and do not have deterministic power.[1] The TPSM may or may not be applicable when one or more of the listed indicators are present or absent.[2] In order to determine the applicability of the TPSM, the criteria of the most appropriate method apply.[3] It is possible that the control, rather than assumption, of economically significant risk may qualify the application of the TPSM to reflect its share of the upside and downside of risks, if any. It is also emphasized that the indicators are not mutually exclusive and, on the contrary, may often be found together in a single case.[4]

The listed examples further confirm this view. Example 3 demonstrates that the controlled companies each assume separate economically significant risks and make unique and valuable contributions in the meantime. While, in example 10, the controlled companies engage in highly integrated activities and contribute unique and valuable know-how. In both the examples, it is believed that the TPSM is highly likely to be applicable.

As a highlight and a change compared to the 2016 Discussion Draft, the 2017 Discussion Draft rightly leaves out the consideration of the form of integration, i.e. the sequential

[1] Para. 4 of the 2017 Discussion Draft.
[2] Paras 4 and 30 of the 2017 Discussion Draft.
[3] Para. 3 of the 2017 Discussion Draft, and para. 2.2 of the 2017 OECD TP Guidelines. The analysis shall fully take into account the respective strengths and weaknesses of each method, the appropriateness of the method in view of the nature of the transaction, the availability of reliable information, the degree of comparability of the controlled transaction and the uncontrolled transaction.
[4] Para. 13 of the 2017 Discussion Draft.

integration and the parallel integration, when deciding whether the TPSM is the most appropriate method. First of all, the reality of the MNEs may reflect a more complex way of integration, which falls outside the defined sequential and parallel integration in the 2016 Discussion Draft. Secondly, the highly integrated sequential operations in practice may indeed prove to be cases where the TPSM is the most appropriate method. For example, the concerned entities in many arm's length joint ventures[5] in which one entity performs the preliminary R&D work and the other is responsible for sale and marketing of the products in a sequential manner agree to share the joint profits generated in the end. Instead of focusing on sequential integration and parallel integration, the 2017 Discussion Draft introduces the very useful concept of inter-dependency,[6] together with inter-relation as an indicator to picture the level of integration. The new considerations in the context of integration are very useful in order to indicate to what extent high integration may come across the application of the TPSM.

Additionally, we very much appreciate paras 31-33 providing general guidance for the application of the TPSM, and the established links to other Chapters, i.e. Chapter I[7], II[8] and VI[9] in the 2017 OECD TP Guidelines, which make it one piece of coherent and consistent work.

2.2 Room for future improvements

By saying that "[r]eferences to 'profits' in this section should ***generally*** be taken as applying equally to losses",[10] the OECD tends to tone down the view on absolute equal treatment to losses and profits in the application of the TPSM. We sympathize with the view that splitting losses may be more difficult and challenging than splitting profits and therefore should be given special regard.[11] However, the guidance provided by the OECD appears too little to generate values in practice. It would be highly welcomed if the OECD would provide more guidance on this point and also some practical examples on splitting losses in the finalized work.

---

[5] A joint venture occurs when two or more firms pool a portion of their resources within a common legal organization and the participating firms claim ownership to the residual value and control rights over the use of the assets. Summarized by Kogut, there are three economic theories relevant to explain the motivations and choice of joint ventures. One is derived from the transaction costs theory developed by Williamson (2009 Nobel Prize winner). The second approach focuses on strategic motivation and consists of a catalogue of formal and qualitative models describing competitive behaviour. A third approach is derived from organizational theories. B. Kogut, *Joint Ventures: Theoretical and Empirical Perspectives*, 9 Strategic Management Journal (1988), 319-332. A full discussion on joint ventures is in "3. Specific comments".

[6] The inter-dependency can be created by asset specificity, according to Williamson's transaction costs theory. The asset specificity means the degree to which assets are specialized to support trade between only a few parties. A full discussion on the transaction costs theory is in "3. Specific comments".

[7] Para. 3 and Section C.2.2 of the 2017 Discussion Draft.

[8] Section C.2 of the 2017 Discussion Draft.

[9] Para. 60 of the 2017 Discussion Draft.

[10] Para. 2 of the 2017 Discussion Draft. In the 2016 Discussion Draft, it states "[r]eferences to 'profits' should be taken as applying equally to losses".

[11] A. Storck et al., *Global Transfer Pricing Conference: Transfer Pricing Developments around the World*, 24 International Transfer Pricing Journal 4 (2017), 270-279.

In our opinion, first of all the concerned parties may have a different perception on loss splitting compared to profit allocation. Taking the license agreement as an example, in some circumstances there may be minimum royalty stipulations or an upfront payment to the licensor. Such instruments incorporated in the license agreement provide an incentive for the licensee to work the licensed technology with its best efforts. Also, it guarantees the licensor with a minimum return on the exploitation of the licensed intangibles no matter whether the licensee makes a loss. However, a persistent or a significant loss would not sustain in reality, as a rational licensee/licensor would certainly drop out of the deal.

Secondly, the mechanism devised today, i.e. using value creating factors to allocate profits, may not be applicable in the same way for splitting losses. As a suggestion, splitting losses may need primarily to look at the entity who controls the risks as it normally has a negative perception of the result, or to look at the responsibilities that are perceived to give rise to risks realization.[12]

Moreover, the RACI model[13] and the bargaining analysis,[14] although employing certain subjectivity and possibly leading to manipulative results, in our view prove to be useful to generate reliable transfer pricing results, if dealt with properly in the application of the TPSM.[15] In particular, they rely less on external data, better represent the economic reality of the MNE and may even account for heterogeneous contributions (e.g. when RACI responsibilities follow management concepts but do not match the other contributions within the legal structures). Indeed, the RACI model and the bargaining analysis can be essentially relevant to evaluate the relative contributions of associated entities, and prove helpful to

[12] A. Storck et al., *Global Transfer Pricing Conference: Transfer Pricing Developments around the World*, 24 International Transfer Pricing Journal 4 (2017), 270-279.

[13] The RACI model is an approach aimed to identify the person(s) who is responsible, who is accountable, who is consulted and who is informed to perform a specific task (or a set of tasks). Accordingly, it highlights the person(s) who is assigned to do the work, who makes the final decision and has the ultimate ownership, who must be consulted before a decision or action is taken, and who must be informed that a decision or action has been taken. Furthermore, the RACI model may turn out to provide additional insights on identifying decision makers, a key to the "control over risk" concept in the BEPS Actions 8-10. For a discussion of the RACI model, please see Project Management Institute, *"9.1.2.1 Organization Charts and Position Descriptions", A Guide to the Project Management Body of Knowledge* (PMBOK Guide) (2013), 262.

[14] The bargaining analysis typically replays the negotiating process independent entities would encounter in the open market. The analysis firstly arrives at a range that the entities will potentially agree by taking into account their options realistically available and then locates the arm's length price within the range by taking into account the bargaining power of the involved entities, like intangible, market intelligence, the monopolistic power. In economics, the game theory, e.g. the Shapley value (worked by the Nobel Prize winner Lloyd Shapley), is useful to qualify the bargaining power of the concerned entities. The game theory provides a framework for quantitative analysis of the role of the entity in the game where each entity uses strategies to maximise its return and the bargaining power behind the role. For an example of how bargaining theory can be applied in a transfer pricing context, please see C. Shapiro, *Arm's Length Income Levels for Apple Singapore: A Bargaining Approach*, in *Apple Computer Inc. and Subsidiaries vs. Commissioner of Internal Revenue*, Docket No. 21781-90, June 28, 1993; Edward C. Rosenthal, *A Game-Theoretic Approach to Transfer Pricing in A Vertically Integrated Supply Chain*, 2 International Journal of Production Economics 115 (2008), 542-552.

[15] R. Petruzzi & X. Peng, *The Profit Split Method: Historical Evolution and BEPS Insights*, Transfer Pricing International 1 (2/2017), 44-54 (peer reviewed).

construct uncongenial profit splitting factors.[16] Hence, it is advised that the OECD consider the two approaches in the future guidance and recognize them as equally important as the traditional means of splitting profits.

The 2017 Discussion Draft leaves out the entire wordings on the value chain analysis, which was included in the 2016 Discussion Draft. The OECD's concern, in our guess, may be that a value chain analysis is sufficiently inherent in the functional analysis and a separate discussion in the context of the TPSM may lead to the confusion that the TPSM is automatically applicable in its presence. In our opinion, the value chain analysis is different from the (traditional) functional analysis, neither is it equal to an industry or environment analysis.[17] The merit of the value chain analysis is the embedded a holistic top-down approach.[18] It starts the analysis from the MNE group and ends at the individual entity level that is the focus of a (traditional) functional analysis. Within the broad picture of the MNE group, it identifies the weight of importance of functions, risks and assets, the key value drivers of the concerned business and the economically significant risks of the whole business. That is usually absent in a (traditional) functional analysis. Our suggestion would be to include those missing features of value chain analysis in D.1.2. in Chapter I, as they are useful in assisting to accurately delineate the actual transaction.

3. Specific comments

This section intends to deal solely with the first of the three specific questions posed in the 2017 Discussion Draft for public commentators.

3.1 Comments on the debate on the TPSM of anticipated profits vs. actual profits in the 2017 Discussion Draft

The new guidance establishes a link between the use of the TPSM of anticipated profits vis-à-vis actual profits and the assumption of (the same or separate albeit closely related) economically significant risks associated with the business opportunity.[19] The new guidance uses example 9 to illustrate this view. In example 9, Company A is the developer of know-how, trademark and associated goodwill via intensive marketing activities and it grants Company B the right to use the know-how and trademark while Company B performs innovative marketing activities. Given that both Company A and Company B make valuable and unique contributions, the TPSM is likely to be the most appropriate method in this case. The question arises then whether to split the anticipated profits or the actual profits. Taken the view of the OECD, the use of anticipated profits suffice when "Company A does not share in the assumption of any of the economically significant risks associated with the

[16] Manes and Verrecchia studied a centralized organization with given production capacities, market prices and variable costs. They divided the budgeted gross profit using the Shapley value, and then obtained transfer prices. For a full discussion, please see R. Manes & R.E. Verrecchia, A New Proposal for Setting Intra-company Transfer Prices, 46 Accounting and Business Research 12 (1982), 97-104.
[17] Para. 54 of the 2017 Discussion Draft.
[18] S. Gonnet, *Recent Developments on the Profit Split Method*, in *Transfer Pricing Developments around the World 2017* (M. Lang, A. Storck & R. Petruzzi eds., Kluwer 2016), *forthcoming*.
[19] Paras 27, 44 and 45 of the 2017 Discussion Draft.

marketing and exploitation activities of Company B related to the licensed intangibles".[20] While the use of actual profits applies when: 1) Company A and B (***contractually***) agree to split the actual profits, 2) Company A and B ***jointly perform*** the marketing and distribution activities, 3) Company A and B jointly assume the risks associated with the realization of the marketing and commercialization of the products by Company B.[21]

We fully agree with the OECD's opinion that the TPSM of actual profits is more appropriate when the accurate delineation of the actual transaction shows that parties indeed share the assumption of the same economically significant risks or separately assume closely related, economically significant risks. However, the example 9, together with the instruction in Section C.4.1., does not provide sufficiently clear guidance for use in practice. It seems that the OECD holds that, in order to validate the use of actual profits, Company A shall participate in the realization stage of the business, e.g. marketing, distributing and commercialization. However, in a vertical integration when Company A and Company B performs discrete activities, it is still possible that the company that has its responsibility only in the early stage wants a participation in the *ex-post* profits. That is the case when separate assumption of economic significant risks comes into play. Furthermore, it is unsure, for example, how to assess the three listed conditions in order to conclude that the TPSM of actual profits is more appropriate.

The way that the OECD tends to assess whether anticipated or actual profits to be used through (or heavily relying on) the intent of the companies may lead to manipulative behaviors by taxpayers or tax administrations. Contract, as an indication of intent of contractual parties, plays a significant role in the determination process, but contractual terms may be subject to manipulation. Simply put, the taxpayer, who has a better knowledge of the controlled transaction than the tax administrations, may possibly use the contractual terms to promote its (de facto) selection for the use of the anticipated profits vs. the actual profits. It is therefore suggested that the OECD illustrates some objective indicators when the concerned parties are more likely to assume economically significant risks and hence be willing to share actual profits. Our comments below intend to add value in this respect by providing some indicative facts when the TPSM of actual profits are more often used between independent parties and what we believe is useful to assess the controlled transactions between related parties.

Additionally, it seems that the guidance referring to para. 2.12 of the 2017 OECD TP Guidelines in para. 46 of the 2017 Discussion Draft can be misunderstood. Para. 2.12 of the 2017 OECD TP Guidelines is about the use of more than one transfer pricing methods, while para. 46 of the 2017 Discussion Draft concerns the avoidance of the use of the hindsight information.

On the other hand, we very much welcome that the OECD underlines the *ex-ante* nature of the TPSM in the 2017 Discussion Draft.[22] This statement should serve to reduce the likelihood that tax administrations may wrongly apply the TPSM of actual profits to perform retroactive adjustments when they dislike the transfer pricing outcome.

[20] Paras 106 and 107 of the 2017 Discussion Draft.
[21] Paras 109 of the 2017 Discussion Draft.
[22] Para. 46 of the 2017 Discussion Draft says that the TPSM "is applied on the basis of information known or foreseeable by the associated enterprise at the time the transactions were entered into, in order to avoid the use of hindsight."

3.2 Distinctions between the TPSM of anticipated profits and the TPSM of actual profits

In an ideal economic world, the anticipated profits derived from valuation techniques do not deviate from the actual profits realized ultimately, on a strict condition that the assumptions used effectively factor into all potential risks in order to accurately estimate the anticipated profits. However, this rarely happens in reality considering that not only the foreseeability is often limited, especially in a long run, but the difficulty of estimation may arise due to the nature of the transaction (e.g. as it is in the case of hard-to-value intangibles, etc.). Therefore, the use of anticipated profits, as a strategy of "playing safe", must go hand in hand with a lower level of share of assumption of risks in the realization phase, compared to the use of actual profits.

In light of example 9 in the 2017 Discussion Draft, the TPSM of anticipated profits and actual profits differs in the practical use. In the set-up of the TPSM of anticipated profits, one entity, usually in the early stage of the controlled transaction, receives a compensation, determined *ex ante* based on anticipated profits, while only the other entity, usually in the late stage, experiences the uncertainty regarding the compensation (profits) it will realize. In contrast, the TPSM of actual profits, while also agreed *ex ante* as would occur at arm's length, results in an *ex post* sharing of actual profits. Therefore, both of the parties experience more variable compensation that is contingent on uncertain outcomes and any potential losses as well.

In light of the practical experience, a split of anticipated profits is a prospective basis for setting a price, e.g. the royalty rate, while a split of actual profits is more likely to involve retrospective adjustments to the price of the transaction.[23]

3.3 Scenarios when the TPSM of anticipated vs. actual profits are likely to be applicable[24]

3.3.1 Contemporaneous assumption of economically significant risks

In our view, the choice between using anticipated profits and actual profits is likely to be linked to the form of cooperation the two parties conduct in the controlled transaction. If the concerned parties jointly engage in the controlled transaction, including the realization of the transaction (e.g., the products go to the market), this may indicate a strong intent of the two parties to share the fruits of their cooperation together. In other word, the two parties ***contemporaneously*** share the assumption of the economically significant risks associated with the business opportunity.[25] Hence, the TPSM of <u>actual</u> profits is more likely to match the level of risks jointly and contemporaneously undertaken by the two parties.

---

[23] Comments from PwC, *Comments Received on Public Discussion Draft BEPS Action 8–10, Revised Guidance on Profit Splits Part II (8 September 2016)*, 340.

[24] The following comments are built on the ground that the TPSM, compared to other transfer pricing methods, is already identified as the most appropriate method in the concerned scenario.

[25] S. Gonnet, *Recent Developments on the Profit Split Method*, in *Transfer Pricing Developments around the World 2017* (M. Lang, A. Storck & R. Petruzzi eds., Kluwer 2016), *forthcoming*.

3.3.2 Asset specificity and uncertainty over performance in vertical integration

One the other hand, when the concerned parties conduct the controlled transaction in a sequential manner, meaning that one party completes the early stage of the transaction and then the other party completes the rest of the transaction until the realization of the business, applying the TPSM of actual profits may still be justified. The use of the actual profits is preferred when the concerned transaction involves ***a high degree of asset specificity*** and ***uncertainty over performance*** given the transaction cost theory.[26]Under such circumstances, firms in an arm's length situation would choose to implement either ***equity joint ventures*** or ***long-term contracts with periodic adjustments***.

The equity joint venture is distinct from the long-term contract in term of equity participation, i.e. participating in the *ex-post* profits/losses. However, the instrument of periodic adjustment in the long-term contract can effectively approach and even close the gap between *ex-ante* anticipation and the *ex-post* outcome.

According to the transaction cost theory, the ***asset specificity***[27] is the key consideration when entities choose between the integration and the external market (the so-called "make-or-buy" problem). Asset specificity arises when assets are specific to each other such that their value is much less in a second-best use. A high degree of asset specificity leads to a high level of interdependency between the two entities. When the assets employed in the concerned transaction (or substitutes) are readily available in the market, the external market is preferable. The concerned entity can obtain economies of scale and risk-pooling benefits by pooling several firms' demands. Furthermore, the threat of ready replacement disciplines performance.[28] In contrast, when the assets employed are highly dedicated to the concerned transaction, the two parties are effectively locked into the bilateral relationship. In that case, the switching costs[29] would be very high if the two entities terminate their relationship.

Absent the external market, moral hazards may arise when the two entities commit to a bilateral relationship driven by the asset specificity. In the bilateral exchange, the two entities are no longer competing with a large number of players in the market, and the incentive of honest performance no longer exists. The moral hazards are likely to arise from the uncertainty over whether (for example) the downstream entity is providing information on market conditions, over whether both entities are sharing new technologies, or over whether the supplier is performing efficiently or with the requisite quality production and alike. In the absence of the ***capability of specifying and monitoring performance***, entities tend to behave to their advantages at the expenses of the other entity's benefits. That is when a governance mechanism can be designed to provide the incentive to better perform.

Equity joint venture

---

[26] O.E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 2 The Journal of Law and Economics 22 (1979), 233-261; O.E. Williamson, *Markets and Hierarchies* (Free Press, New York: 1975). It is worth mentioning that Williamson won the 2009 Nobel Prize because of his contribution to the transaction costs theory, which has been widely used to explain the vertical integration.

[27] To be noted, asset specificity is not a sufficient condition, uncertainty and frequency of the transactions are also necessary. Among the three conditions, asset specificity is of the paramount importance though.

[28] E. Anderson & David C. Schmittlein, *Integration of the Sales Force: An Empirical Examination*, The Rand Journal of Economics (1984), 385-395.

[29] For example, the expenses incurred for writing and enforcing contracts, for haggling over terms and contingent claims, for deviating from optimal kinds of investments in order to increase dependence on a party or to stabilize a relationship, and for administering a transaction.

A joint venture occurs when two or more firms pool a portion of their resources within a common legal organization and firms in the venture would claim ownership to the residual value and control rights over the use of the assets. In other word, the joint venture is featured with joint ownership and common control over the residual profits and the resources.[30]

In a joint venture, both parties share in the residual value of the venture without specifying *ex ante* the performance or behavior of each party. Instead, the initial commitments and rules of profit sharing are specified, along with administration procedures for control and evaluation. The joint venture creates a superior monitoring mechanism and alignment of incentives to reveal information, share technologies, and guarantee performance. Briefly, equity control reduces the problem of opportunism because it aligns the incentives of buyers and sellers. Thus, both parties gain or lose by the performance of the venture. In effect, this means to execute a split of actual profits from the perspective of transfer pricing.

Long-term contract with periodic adjustments

Non-equity contracts can also be devised to provide a similar incentive, namely the long-term contract with periodic adjustments. In the long-term contract,[31] entities focus on achieving future goals and are concerned with both current and future outcomes.[32] Unlike entities with a short-term orientation relying on the efficiencies of market exchanges to maximize their profits in a transaction, entities with long-term orientation rely on relational exchanges to maximize their profits over a series of transactions.[33] The relational exchanges obtain efficiencies through joint synergies resulting from investment in and exploitation of asset specificity and risk sharing.

However, the transaction costs theory suggests that due to the bound rationality and the costs of writing, negotiating and implementing a contract, complete presentation for the long-term contract executed under conditions of uncertainty would be extremely costly if not impossible.[34] In such incomplete contracts, the hazards of opportunistic behavior are greater because the termination of the relationship cannot be achieved easily. However, the hazards of opportunistic behavior in long-term relations can be mitigated or removed if the two parties agree to adapt to unanticipated contingencies in a mutually profitable manner. Confirmed by the neoclassical contract theory, the long-term contract is often designed with a range of processes and techniques to create flexibility to make up for the limitation of

[30] B. Kogut, *Joint Ventures: Theoretical and Empirical Perspectives*, 9 Strategic Management Journal (1988), 319-332; Jean-Francois Hennart, *A Transaction Costs Theory of Equity Joint Ventures*, 9 Strategic management journal 4 (1988), 361-374; J.A. Stuckey, *Vertical Integration and Joint Ventures in the Aluminium Industry*, Harvard University Press, 1983.

[31] Strictly speaking longevity of a relationship is not sufficient to capture long-term orientation. This paper relaxes in this respect, but the authors do not think it will harm the quality of this study. For a discussion in that topic, please see E. Anderson & David C. Schmittlein, *Integration of the Sales Force: An Empirical Examination*, The Rand Journal of Economics (1984), 385-395.

[32] S. Ganesan, *Determinants of Long-Term Orientation in Buyer-Seller Relationships*, The Journal of Marketing (1994), 1-19.

[33] E. Anderson & David C. Schmittlein, *Integration of the Sales Force: An Empirical Examination*, The Rand Journal of Economics (1984), 385-395.

[34] O.E. Williamson, *The Economics of Organization: the Transaction Cost Approach*, 87 American Journal of Sociology 3 (1981), 548-577; M.R. Ian, *Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law*, 6 Northwestern University Law Review 72 (1977-1978), 854-905.

foreseeability.[35]

In light of empirical evidence, the long-term contract, if occur, usually leads to periodic adjustments.[36] In practice, the price is firstly set up based on the anticipation, i.e. a split of anticipated profits, and the result would be adjusted periodically to reflect the change of environment conditions, i.e. a split of actual profits. In that case, a periodic adjustment is usually performed in practice to capture the gap between anticipated profits and actual profits.[37] This effectively leads to the fact that the profits split converges within a certain band to actual profits.

3.3.3 Examples and empirical evidences

Supported with empirical evidence, this section presents some specific scenarios when the use of actual profits is ***more likely*** to occur.

Raw materials and components in the extractive industry

In the tin and aluminum industries, the market for bauxite is narrow, as efficient bauxite refining requires that the bauxite refinery be designed specific to the characteristics of the ore. Since bauxite are heterogeneous, each refinery obtains its bauxite from a particular mine. Switching costs thus are very high. To organize such a bilateral relationship through spot markets would be hazardous, because after investments have been made, one party could hold up the other by unilaterally changing the price of bauxite. One way for traders to protect themselves is to write long-term contracts fixing *ex ante* the price of bauxite over a period of time which corresponds to the life of the plant. Because mining and refining bauxite require very large investments – an efficiently sized mine costs 0.5 billion dollars and a refinery between 500 million and a billion – such contracts typically run for 20-25 years.[38] Over such a long time span they cannot effectively protect the parties against changes in the environment, as it is difficult to specify *ex ante* all possible contingencies. Contracts thus remain incomplete, exposing parties to opportunistic renegotiations.[39] Aluminum firms must therefore use equity to control their supply of bauxite. Equity control reduces the problem of opportunism because it aligns the incentives of buyers and sellers of bauxite. Both can now be paid in proportion to the firm's global profits, thus attenuating incentives for bargaining and opportunism.

In addition, joint venture is also widely used in the market for crude in the oil industry. Oil refining is a capital intensive flow process, requiring a constant throughput. Storing crude oil is costly. As in the case of bauxite, refineries are custom-built to handle a particular type of crude. The market for crude tends, therefore, to be narrow and oil refiners have found it

[35] M.R. Ian, *Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law*, 6 Northwestern University Law Review 72 (1977-1978), 854-905.
[36] P.L. Joskow, *Contract Duration and Relationship Specific Investments: Empirical Evidence from Coal Markets*, 77 The American Economic Review 1 (1987).

[37] S. Gonnet, *Recent Developments on the Profit Split Method*, in *Transfer Pricing Developments around the World 2017* (M. Lang, A. Storck & R. Petruzzi eds., Kluwer 2016), *forthcoming*.
[38] Jean-Francois Hennart, *A Transaction Costs Theory of Equity Joint Ventures*, 9 Strategic management journal 4 (1988), 364-365.
[39] J.A. Stuckey, *Vertical Integration and Joint Ventures in the Aluminium Industry*, Harvard University Press, 1983.

necessary to integrate backward into crude exploitation and production.[40]

Another example is from the coal sector where a high level of transaction costs is also present.[41] The typical types of asset specificity existing between the coal suppliers and the electric utilities are site specificity and physical asset specificity, similar to the abovementioned cases. Generally, the sites of coal mines and electric plants are close to each other to minimize the inventory and transportation expenses. Once sited, it is highly immobile. In addition, the equipment and machinery that coal suppliers and electric plants with specific characteristics to the transaction are difficult to be employed for other use. The fact is that when coal-burning plants are built, they are designed to burn a specific type of coal. Deviations from expected coal quality may lead to a deteriorating in performance or requires costly retrofit investments. Therefore, the switching costs for coal supplier and the electric plants would be very high if they try to find replacement. In that case, the coal supplier and the electric plants are effectively locked into a bilateral relationship. The empirical evidence shows the solution would be to arrange long-term contracts determining the volume of coal to be sold but specifying a basis for setting a coal price (e.g. annually) without fixing such a price.

Tacit Knowledge

Knowledge *per se* is costly to exchange because of the buyer's uncertainty. The buyer of knowledge cannot be told prior to the sale the exact characteristics of the knowledge he is buying. By providing that information in order to educate the buyer on the value of know-how for sale, the seller would end up with transferring the know-how free of charge. The system of patent is devised to solve the problem. In exchange of disclosing his knowledge, the investor is granted a monopoly on its use.

However, some types of knowledge are difficult to codified and non-patentable. Polanyi has defined this as "tacit knowledge",[42] which includes a firm's experience in manufacturing and marketing a product, and for country-specific knowledge, the intimate knowledge of local customs, markets, politics and people that come from having lived in a particular country and etc. The tacit knowledge cannot be embodied in designs, specifications, and drawings, but instead is embedded in the individual possessing it. In other word, the significant feature of tacit knowledge is its exchange must rely on intimate human contact.

The problem with transferring tacit knowledge is that it is impossible for either party to know *ex ante* what the cost and the value of the transfer would be. It is often difficult for both parties to distinguish *ex post* between poor luck or poor performance. In those circumstance, moral hazards arise. Parties may take advantage of the contract incompleteness and the difficulty of assessing performance. Once the payment has been executed, the seller has little incentive to provide continuous support, and may provide less than promised. The buyer may have misrepresented his needs, or his capacity to absorb the information, in order to get better terms. He may then use the resulting difficulties as a pretext to withhold payment. Therefore, the exchange of tacit knowledge will be more efficient if the transferor and the recipient are linked through common ownership. The parties to the exchange are no longer rewarded by the quality of information transferred, but by their obedience to managerial directives. The incentive of both parties to cheat is less.

There is empirical support that the transfer of non-codified technological know-how is

[40] D.J. Teece, *Vertical Integration and Vertical Divestiture in the US Oil Industry: Economic Analysis and Policy Implications* (1976).
[41] P.L. Joskow, *Contract Duration and Relationship Specific Investments: Empirical Evidence from Coal Markets*, 77 The American Economic Review 1 (1987).
[42] M. Polanyi, *Personal Knowledge: Towards A Post-critical Philosophy* (University of Chicago Press: 1958).

executed through the equity control. In the alumina production, the crucial know-how is how to adapt the basic process to the characteristics of bauxite. That knowledge is obtained through experience and is tacit. The transfer of such knowledge is never licensed, but through joint ventures.[43] In Davies' study of the transfer of knowledge from British to Indian firms, it highlighted that joint ventures are used to transfer a wider range of knowledge, including the tacit knowledge.[44] It is also confirmed that the technology suppliers often sent technical and managerial personnel to their joint venture to transfer tacit know-how.[45]

The other two types of tacit knowledge that are difficult to transfer through contracts are marketing and country-specific knowledge. The characteristics of the two are that they are acquired by firms in a given industry and country as a byproduct of operating in that industry and country, yet are costly for the new entrant to obtain. Both are not patentable and difficult to codify. Their sale would incur high transaction costs. It is therefore expected that an equity links should be established for firms entering new industries or new countries with local entities. It is empirically found that US firms that engage in joint ventures abroad ranked "general knowledge of local economy, politics, and customs" the most important contribution of the local partner to the joint venture.[46] It is also found that joint ventures, rather than acquisition of a US company is more often used for firms investing into the US if the cultural distance between the investor's country of origin and the US is greater.[47]

Distribution

The distribution is another area suffering from high transaction costs. The first one arises when distribution is subject to economies of scale. An equity participation in the distribution in the distributor allows the manufacturer to avoid the resulting bargaining stalemates.

In another situation, there are many potential distributors facing a manufacturer, but effective distribution requires substantial up-front investments. The manufacturer may push down the price after the investment of the distributor is made. One solution is to obtain exclusive distribution rights for a period that is long enough to fully depreciate his investment. Such a contract, in theory, reduces the problem of opportunistic re-contracting. However, the uncertainty of the environment may break down the long-term contract. The distributor would minimize the investments dedicated to pushing, supporting and servicing the sale of manufacturer's products so as to reduce his loss should the manufacturer behave opportunistically. Therefore, the higher the level of the asset specificity, and the greater the degree of uncertainty, the more efficient it would be for the manufacturer to own all or part of the distributor.

The third inherent problem in subcontracting distributor is that of quality control. The value of trademark is assuring the quality of the goods to customers whenever the quality of the goods cannot be evaluated before purchasing. The incentives of independent distributors of trademarked goods to maintain the quality of the trademarked good they carry are weak. A distributor would tend to capture most of the cost savings from debasing quality, while the losses from this reduction in quality will be shared by all others using the trademark through

---

[43] J.A. Stuckey, *Vertical Integration and Joint Ventures in the Aluminium Industry*, Harvard University Press, 1983.
[44] H. Davies, *Technology Transfer Through Commercial Transactions*, The Journal of Industrial Economics (1977), 161-175.
[45] H. Davies, *Technology Transfer Through Commercial Transactions*, The Journal of Industrial Economics (1977), 161-175.
[46] L.G. Franko, *Joint Venture Survival in Multinational Corporations* (Praeger Publishers: 1971); J.M. Stopford & L.T. Wells, *Managing the Multinational Enterprise*, 15 Thunderbird International Business Review 2 (1973), 9-11.
[47] B. Kogut & H. Singh, Entering the United States by Acquisition or Joint Venture: Country Patterns and Cultural Characteristics, Reginald H. Jones Center, The Wharton School, University of Pennsylvania, 1985.

the fall in the trademark's global value. The larger the number of contractual stipulations that are needed to achieve that end, and the greater the difficulty of defining and enforcing contractual rules, the stronger the manufacturer's incentive to own his distributor.

Empirical evidence shows that manufacturers seek equity control of distributor when the products required expensive dedicated investments in distribution assets and when it is difficult to control quality debasement by distributors.[48]

License agreement

A firm in an MNE with valuable intangibles (e.g. manufacturing know-how, patents or trademarks) by having spent often large sums of money on development, as an alternative to exploit the intangibles on its own, may seek, by licensing it out: (a) to recoup part of the expenditure incurred on development, (b) to achieve this in the shortest period of time, and (c) to attempt to obtain a profit from each of the markets in which the intangibles will be employed to the gain of the licensee.

Due to the common equity benefits and the control concept, licensing intangibles between related enterprises provides a better insurance against the disclosure of corporate secrecy, or risks of competition from the licensee through making improvement to the licensed intangibles. As a result, when it comes to unique and valuable intangibles MNEs tend to license internally within the group rather than licensing out to a third party.[49]

Despite of having different roles in different stages, parities entering into a license agreement intend to share the profits derived from the exploitation of the licensed intangibles. Theoretically speaking, an arm's length license agreement is shaped by each party's expectations about costs, sales and the overall profit potential from the use of the intangible.[50]

However, the parties' expectations may differ from each other. Their expectations may differ remarkably from the actual profits realized. The actual division of the total profits will depend on each party's forecast of the total profits and on the relative bargaining strength of the two parties.[51]

It is possible that future events will leave one or both of the parties dissatisfied with the arrangement if several years of actual profits experience leads to a change in expectations about future profitability. The changes in the parties' expectations about future profitability concern both the licensor and the licensee.[52] Accordingly, they have strong intention to be

---

[48] A.D. Chandler, *The Visible Hand*, Harvard University Press (1993); G. Porter & H.C. Livesay, *Merchants and Manufacturers: Studies in the Changing Structure of Nineteenth-Century Marketing,* Ivan R Dee (1989); S. Nicholas, *Agency Contracts, Institutional Modes, and the Transition to Foreign Direct Investment by British Manufacturing Multinationals Before 1939*, 43 The Journal of Economic History 3 (1983), 675-686.

[49] United Nations, *Guidelines for Evaluation of Transfer of Technology Agreements* (New York: 1979).

[50] S. Gonnet, *Recent Developments on the Profit Split Method*, in *Transfer Pricing Developments around the World 2017* (M. Lang, A. Storck & R. Petruzzi eds., Kluwer 2016), *forthcoming*.

[51] Treasury Department & Internal Revenue Service, *A Study of Intercompany Pricing*, 6 (1988) (Discussion Draft), available at: https://archive.org/stream/studyofintercomp00unit/studyofintercomp00unit_djvu.txt.

[52] According to the equation, i.e. licensor's share of licensee's profits = royalty on sales price / profit on sales, for a given royalty rate, the licensor obtains a greater percentage of the profit on the product the lower the profitability of the product (and, vice versa, the enterprise gives away a smaller share of the profit to the licensor for a product of high profitability). For a full discussion, please see United Nations, *Guidelines for Evaluation of Transfer of Technology Agreements* (New York: 1979), at 40.

protected or to minimize the risk. A need of adjustment to approach the actual profit development arises. This is in line with the theory of neoclassical contract law, which states that the progressive increase in the "duration and complexity" of contract has resulted in an adjustment process of a more thoroughly transaction-specific, ongoing-administrative kind.[53]

The IRS performed an empirical study in 1988 on the unrelated party licensing agreements obtained from the files of the Securities and Exchange Commission with a total number of 60 agreements examined.[54] This empirical study generated interesting result showing that the contractual agreements between unrelated parties featured with long-term basis more often than not have some mechanism for adjusting the arrangement if the profitability of the intangible is significantly higher or lower than the anticipation.

According to the IRS empirical study, the termination clause is one way to provide certain protection. As an example, the licensor may exit the agreement if the licensee cannot meet the sale target when the volume of sale is not sufficient to realize the licensor's expected returns from the intangibles. In addition, the termination clause without cause, which allows the contractual parties to end the contract after giving the notice, is another way to get relief. Such clause, rather than leading to actual termination, instead may offer an opportunity for renegotiation if one of the parties think that its returns are inadequate. The inclusion of termination clause with or without cause effectively empowers the contractual parties to change the amount of remunerations if they are unhappy with the result when their expectations change. In the samples studied by the IRS, 55% of the licensing agreements included either a termination with cause (34%) or a termination without cause (21%). The existence of termination clauses shows that companies are concerned about their ability to predict the total profits from the exploitation of an intangible, namely the actual profits in a different word. However, another finding of the empirical study shows that irrespective of the existence of termination clause, agreements do get renegotiated in reality.[55]

Actual profits are generally the best indication available, absent comparables and reliable estimation, of anticipated profits that arm's length parties would have taken into account at the outset of the arrangement. In reality, the royalty rate is however set *ex ante* in the license agreement. One of the reasons is that the licensor needs to at least recoup the expenses it incurs for the development of the intangibles despite that the licensed intangible has not yet been commercialized. As a matter of long-term business strategies, unrelated parties may therefore renegotiate contractual arrangements even absent explicit renegotiation provisions to reflect revised expectations regarding the intangible's profitability.

---

[53] M.R. Ian, *Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law*, 6 Northwestern University Law Review 72 (1977-1978), 854-905.

[54] Treasury Department & Internal Revenue Service, *A Study of Intercompany Pricing*, 6 (1988) (Discussion Draft), available at: https://archive.org/stream/studyofintercomp00unit/studyofintercomp00unit_djvu.txt.

[55] There are two main reasons why the licensing agreement may not need a termination clause: (a) the licensee was required to make a substantial initial investment in order to make use of the intangible; (b) the licensed products have a very short lifespan. In the first scenario, the hypothesized argument is that the licensee would not enter into the agreement if the licensor could easily exit the deal. In the second scenario, the lifespan is so short that termination is not a useful option. Related to this group are agreements that are scheduled to end after a specific and relatively short length of time (less than five years). These agreements will automatically be renegotiated if the parties wish to extend the license.

However, if the taxpayer can demonstrate that it has comparable long-term, non-renegotiable contractual arrangements with third parties, the arm's length principle may preclude periodic adjustments to the related-party transaction.

Furthermore, if the transfer (sale) of intangibles in substance resembles the license agreement or a lump-sum payment is made rather than a royalty, then it should be priced with the TPSM of actual profits. The reason is to ensure the equal treatment irrespective of the form of transaction. Besides this, the work of the OECD on the TPSM should align with its work on hard-to-value-intangibles.

4. Conclusive remarks

In general, we welcome the remarkable work the OECD has done in the area of profit splits and developing guidance such as the 2017 Discussion Draft on the TPSM. However, we would appreciate if the described topics could be clarified in the finalization of the guidance.

Yours faithfully,

Prof. Dr. Alfred Storck
Managing Director of the WU Transfer Pricing Center
Institute for Austrian and International Tax Law
Vienna University of Economics and Business (WU)
Vienna (Austria)

Dr. Raffaele Petruzzi, LL.M.
Managing Director of the WU Transfer Pricing Center
Institute for Austrian and International Tax Law
Vienna University of Economics and Business (WU)
Vienna (Austria)

Xue Peng, LL.M.
Research and Teaching Associate at the WU Transfer Pricing Center
Institute for Austrian and International Tax Law
Vienna University of Economics and Business (WU)
Vienna (Austria)