Base Erosion and Profit Shifting (BEPS)

Comments Received on Public Discussion Draft

BEPS ACTION 10

Revised Guidance on Profit Splits
Part I

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# TABLE OF CONTENTS

Andrew Hickman .................................................................................................................. 5
ANIE ........................................................................................................................................ 22
Argentine Association of Tax Studies .................................................................................. 26
Association of Banks in Singapore ...................................................................................... 33
AstraZeneca .......................................................................................................................... 37
BDO ....................................................................................................................................... 42
BEPS Monitoring Group ........................................................................................................ 45
BIAC ....................................................................................................................................... 68
Brigitte Baumgartner ............................................................................................................. 87
BusinessEurope .................................................................................................................... 90
CMS ....................................................................................................................................... 95
Contrabass .............................................................................................................................. 99
Copenhagen Economics ....................................................................................................... 106
Deloitte Tax LLP ................................................................................................................... 116
Deloitte UK ............................................................................................................................ 140
EY ........................................................................................................................................... 147
Flick Gocke Schaumburg ....................................................................................................... 155
FTI Consulting ....................................................................................................................... 160
Grant Thornton UK LLP ....................................................................................................... 163
International Alliance for Principled Taxation ..................................................................... 169
ICAEW ................................................................................................................................... 195
International Chamber of Commerce ................................................................................... 196
Thank you for the invitation to comment on the discussion draft of 22nd June 2017 on the revised guidance on profits splits. These comments reflect my personal views and have not been prepared on behalf of or at the request of any other person or organisation.

Summary

My comments cover the relevance and practical application of the indicators for a profit split, and concerns in particular with “unique and valuable” as defined, the apparent undermining of potentially helpful guiding principles, the incorrect description of profit splits, the postponement of the distinction between a split of actual profits and anticipated profits, and absence of guidance on the difference between a profit split and a value chain analysis or a non-transactional allocation of profits.

The OECD has received much thoughtful, detailed, and stimulating input on the 2016 discussion draft and is now at an advanced stage in finalising guidance. Some of the input pointed in different directions, and delegates have had to make choices in the 2017 discussion draft. It is critical to try to judge whether the concerns raised in these comments about the 2017 draft are likely to be significant in interpreting the guidance consistently and in applying it effectively. In response, therefore, Section B contains an examination of the examples to test how well the draft guidance deals with the potential application of the transactional profit split method in relation to the facts in the examples. Several of the examples expose problems in applying the draft guidance. Those problems are then analysed in specific drafting points in Section C. However, first of all Section A contains a practical guide for the application of profit splits which puts the indicators into a framework that may provide a more helpful structure to the guidance or stimulate constructive exploration of an alternative structure. I provide this guide at the start since it also provides context for the comments in the subsequent sections.

These comments indirectly respond to the first specific question about 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. The key difference between the two is that a profit split of actual profits attributes to the associated enterprises the effects of risk and this would be consistent with Section D of Chapter I of the Guidelines only if the associated enterprises assume those risks or contribute to the control of those risks. Therefore, the guidance in paragraph 44 for the application of a profit split of actual profits, which refers to either sharing the assumption of the same economically significant risks or separately assuming interdependent, closely-related economically significant risks, is appropriate. Additionally, however, the guidance should also contemplate a profit split of actual profits for a party which contributes to the control of economically significant risks in the absence of reliable comparables to determine how compensation at arm’s length accounts for a sharing in the upside and downside associated with the risk. This point relates to paragraph 24 on which I comment. Conversely, a split of anticipated profits can be used to set a price for the contributions of the associated enterprises and is appropriate when neither associated enterprise assumes, or participates in the control of, economically significant risks associated with the business activities of the other.
A. Practical guide for considering appropriate application of a transactional profit split following the accurate delineation of the actual transaction.

1. The following guide attempts to summarise the practical steps in determining whether the application of a transactional profit split is likely to be reliable.

- **Do the economically relevant characteristics of the transaction indicate that reliable comparables can be used for the contribution, (including functions performed, assets used or contributed, and risks assumed) of at least one of the parties? (Note 1)**
  - Yes (Note 2)
  - No

- **Does the high degree of integration and interdependence prevent reliable comparison with uncontrolled transactions? See paragraphs 19-22.**
  - No
  - Yes

  - **Methods based on comparables, making adjustments as necessary to improve reliability, are likely to be appropriate. (Note 3)**
  - Profit split of anticipated profits is likely to be appropriate. See paragraphs 27, 43-46.
  - Profit split of actual profits is likely to be appropriate. See paragraphs 27, 43-46.

Note 1. The existence of unique and valuable contributions is an indicator that comparables may not be identifiable. See paragraph 16.

Note 2. Consider also the existence of industry practices that suggest independent parties do commonly use profit splitting approaches in similar situations. See paragraph 15.

Note 3. In applying any method its reliability should be kept under review. It may prove challenging to find reliable information or make reliable analyses to finalise the application of a method initially selected, and the application of a different method may be explored (see 3.5).
Comments on profit splits

2. The guide stresses that it follows from the accurate delineation of the actual transaction under phase 1 of a comparability analysis (see 1.37), since the profit split is a transactional method, and then starts by considering phase 2 of that analysis (see 1.39). Later comments in this note concern the importance of the transactional nature of profit splits, and the need to make distinctions from non-transactional allocations. The first step covers the concept of “unique and valuable contributions” but phrases it in a different, over-arching way, to try to avoid some of the problems perceived in applying the concept in relation to the examples (and raised by several commentators to the 2016 draft). In particular, the over-arching phrasing in this first step includes consideration of risks assumed since this is likely to be a significant relevance in determining whether reliable comparables can be identified (see discussion of Examples 1, 2, 3, 5, and 6 in Section B). However, “unique and valuable” could be retained as a short-hand expression of the over-arching indicator, as mentioned in Note 1 and discussed later in these comments in paragraph 17. The indicator of integration and inter-dependence is then used early in the practical steps, since it seems an indicator that could point to a profit split even if reliable comparables otherwise exist (see discussion of Example 7 in Section B). The guide then introduces the indicator relating to risk assumption and the consequence for the application of profit splits of anticipated profits or profit splits of actual profits, and it is useful and less confusing to introduce the different consequences early since a profit split of anticipated profits is a very useful approach and is not one that requires the risk sharing indicator to be present.

3. Notes 2 and 3 emphasise flexibility in the use of the guide in relation to industry practices and relative reliability of methods, but without undermining guiding principles.

4. The practical guide provides a framework for identifying how the indicators are relevant, without being overly prescriptive. Importantly, however, it does allow for a statement of guiding principles for the application of a transactional profit split method and should allow for the deletion of the incorrect and undermining statement in paragraph 30 (“the presence or absence of one or more of the indicators . . . will not necessarily lead to the conclusion that the transactional profit split will (or will not) be the most appropriate method”) and the undermining statement in paragraph 4 to the effect that a profit split may be appropriate notwithstanding that the indicators of appropriateness are not present.

Illustration of the practical guide.

5. Examples 1-10 of the draft could be adapted to illustrate the application of the practical guide. In particular, Example 7 illustrates how integrated, interdependent functions may make potential comparables unreliable. Example 5 could be adapted to illustrate inter-dependent, closely related risks. Example 8 illustrates shared assumption of the same risk. Example 9 can be improved to illustrate differences between a split of anticipated profits and of actual profits. The following illustration may also help to see how the guide provides a useful framework for indicating the application of a profit split method.

Scenario 1
Suppose Company A licenses rights to make, have made, and sell shampoo under its proprietary formula and trademark to Company B in relation to its territory. Company B engages a third-party manufacturer to make the product, and distributes the product to independent wholesalers and major
Comments on profit splits

retailers in its territory. Each company assumes its own development and exploitation risks, and there
is no inter-dependence.

Suppose reliable CUPs can be found. In such a case, a profit split would not likely be appropriate.

Suppose there are no CUPs, but in this case Company B performs functions typical of distributors, and
it is possible to find reliable comparables to measure its contribution. In this case, it is likely a TNMM
would determine the arm’s length profits of Company B. Again, a profit split would not be appropriate.

If Company B undertakes significant marketing spend, it is likely that adjustments can be made, if any
required, to the TNMM analysis, and it is doubtful that such intensity of functions would indicate a
unique and valuable contribution such that comparables are not reliable.

Even if Company B’s contribution were to be considered unique and valuable such that comparables
are not reliable, it may be less reliable to use a profit split than TNMM given the difficulty in
determining and equating respective contributions involving historic spend on the formula and
tradename by Company A and current spend on marketing by Company B. However, if a profit split
were to be reliably applied, it would be based on anticipated profits to set a price for the rights licensed
by Company A with a similar effect to a CUP or TNMM, since there is no sharing of risks.

Scenario 2
Suppose Company B sees a gap in its market and invites Company A to develop a different formula for
shampoo suitable, Company B estimates, for consumers in Company B’s territory; suppose that
Company B will develop and invest in a new tradename for the product, but will also use an umbrella
tradename licensed to it by Company A. Company A actively participates in the development of the
new tradename, in Company B’s marketing campaigns, and in setting price points for the product
in order to protect its interest in the umbrella brand. Company A develops the formula in conjunction
with Company B’s insights into its market, but bears development costs and retains ownership of the
intangible. Company A licenses the developed formula to Company B.

In this scenario, the integrated, inter-dependent functions of the parties may prevent comparables (either
potential CUPs or the application of a TNMM) being applied reliably. A profit split is likely to be
reliable. In this case, the two companies each have closely related, inter-dependent risks since Company
A may not recover its development costs if Company B has misjudged its market or if the marketing
campaign and new tradename does not attract consumers, Company B may not recover its marketing
investment if the formula is rejected by consumers, and the umbrella brand may be damaged if the
product is not appropriately marketed. A profit split of actual profits would likely appropriately value
the respective contributions and assumption of inter-dependent, closely related risks, and would
potentially have a different effect to a method that sets a price (as discussed in Scenario 1) since the
outcome will reflect the impact on each party of the playing out of risks they share.

B. Examples

6. This section contains an examination of the examples to test how well the draft guidance, as
currently worded, deals with the potential application of the transactional profit split method in
relation to the facts in the examples. In some cases, the examples suggest that the draft guidance is
Comments on profit splits

misleading and may produce inappropriate outcomes. In other cases, the examples need to be clarified.

Example 1
Example 1 is intended to illustrate the guidance in paragraph 16 on unique and valuable contributions. The example seems to be undermined by the final sentence in paragraph 71 which make the proviso that the transactional profit split is likely to be the most appropriate method provided that the parties in the example perform unique and valuable functions in the creation of the relevant profits. Therefore, the proviso oddly tends to question whether the facts in the example do indicate the presence of unique and valuable contributions on which the examples is based. However, it may be that the proviso is intended to make a different point. In the example, it is not stated whether the parties bear significant risks; they perform development functions, but it is not stated whether they both assume development risks, or whether one does, or, indeed, whether neither does. It is perfectly possible under the facts as stated that either Company A or Company B or both of them are paid for the functions they perform, and thus assume limited risks in relation to unsuccessful development. It is perhaps this point that the proviso makes; a profit split would only be appropriate if the unique and valuable functions are associated with assumption of significant risks. The example tends to support the concern, addressed in later comments in Section C of this note (and raised by commentators to the 2016 draft), that the concept of unique and valuable contributions cannot be assessed as an indicator in isolation of risks.

The example is also problematic in that it does not clearly set out the functions of the parties. It is puzzling to read in paragraph 69 that Company A designed the clinical trials leading to the granting of the patent. Usually the patent is sought at a very early stage in the discovery of a potentially interesting compound, and then pre-clinical trials will be conducted to find out more about the compound’s pharmacokinetics and safety prior to any clinical trials. Company A is likely to sponsor the clinical trials, but is unlikely to design them. It is unclear whether Company A sponsors all the clinical trials before transferring the rights. Because the stage at which the patent rights are licensed to Company S is unclear, it is also unclear what subsequent development Company S conducts, as stated in paragraph 70.

The example is confusing when it states in paragraph 71 that a profit split might be appropriate for determining the profits of “Company A and Company S from the sale of the patented product.” The wording suggests that both parties sell the product. If this is the case, then the facts should be made clear. However, I suspect that what is meant is that a profit split of the profits made by Company S from sales of the product using Company A’s intangibles might be appropriate for determining the royalty payable by Company S to Company A.

I suspect the example intends to explain that Company A conducts basic research, and takes the compound to a certain stage of development—perhaps Phase II clinical trials—at which point it licenses rights to Company S which takes the compound through Phase III clinical trials, leading to marketing approval. Company S does not perform the clinical trials itself, but provides funding and outsources the extensive trials to specialist contract research organisations.

If these are the intended facts, it is unclear why the transactional profit split method is likely to be the most appropriate method. If the main indicator of the appropriateness of the profit split method is that each party provides unique and valuable contributions, then it is doubtful that either party fulfils the
Comments on profit splits

requirement. Paragraph 16 defines unique contributions as not comparable to contributions made by uncontrolled parties in comparable circumstances and defines valuable as contributions whose use represents a key source of actual or potential economic benefits. A patented compound is, of course, unique, but it is possible to see uncontrolled parties licensing pharmaceutical compounds at similar stages of development. Therefore, there are some doubts whether Company A makes a unique contribution, as defined. Company B seems to make no unique contribution. Both companies make valuable contributions, but this definition is very loose.

Because the guidance requires both parties to make unique and valuable contributions for a profit split to be considered, the very first example does not clearly support a profit split under the terms of the guidance. Presentationally, this is unfortunate, but strategically it is worrying. The situation of Example 1 does cover the kinds of arrangements, subject to clarification about assumption of risks, in which a profit split of anticipated profits might well currently be used on its own or in conjunction with a CUP analysis, that may be regarded as relevant but somewhat imprecise, to set a price for the licensing arrangements. That profit split might well analyse the contributions of the parties to the at-risk costs of developing a marketable product, risk-weighted and adjusted for timing as appropriate. Unfortunately, it is not clear that such use of a profit split would be endorsed by the new guidance. However, if the intended facts were clarified, as suggested above, then the example could become serviceable and would illustrate the workings of the practical guide in Section A.

Example 2
Example 2 also intends to illustrate the guidance in paragraph 16 on unique and valuable contributions. However, as in Example 1, clarification about risk assumption is vital to support the case for the application of a profit split. The tea produced by A Co has a highly sought-after flavour and has won international acclaim for its unique taste and aroma. The example makes a good case that it may not be possible to compare the price at which A Co sells its tea to B Co with the price at which an uncontrolled party sells tea, since the product may not have the same features. A Co, therefore, does make a unique and valuable contribution. However, it is not clear what unique and valuable contribution is made by B Co. It owns the tradename and trademark, but they can only be used in relation to the tea supplied by A Co, and A Co’s tea is highly sought-after and has won international acclaim irrespective of the trademark. The branding makes it clear that the tea has been supplied by A Co. The brand seems to have no value independent of the tea provided by A Co, and B’s risks may be limited. It is not clear, therefore that B Co contributes something unique and valuable, or whether B Co simply capitalises on the high marketability of the product, and performs routine distribution functions and assumes routine risks. B Co activities in carrying out extensive advertising campaigns are not unusual.

It may be possible to use a profit split in this example, but it is not clear how one would determine any significant value to the ownership of the brand independent of access to A Co’s tea. A more likely method might be a TNMM to benchmark the packaging, distribution, marketing and selling activities of B Co in order to determine the price for tea from A Co as a residual figure. The line of reasoning and resulting approach would illustrate the workings of the practical guide in Section A.

Example 3
Example 3 is a potential example of unique and valuable contributions, since Company A has product intangibles and Company B has a trademark and other intangibles. Risks are mentioned in the example,
Comments on profit splits

Unlike the previous two examples, and Example 3 seems designed to highlight the feature of closely inter-related and inter-dependent risks. However, as currently worded the example seems merely to say that Company A is good at what it does, and Company B is good at what it does, and they each manage their own risks. The inter-relationships are not clear. In fact, the example seems to go out of its way to prevent inter-relationships. For example, paragraph 78 states that Company A decides on the levels of production, whereas Company B is able to forecast demand accurately (paragraph 80), but there is no indication that B’s capability affects A’s decisions. Company B obtains feedback from customers on the performance of the products, but there is no indication that B provides that input to A in order to improve the design of its products or to change development priorities. Such inter-relationships about demand forecasting and production levels and about product performance and design would help to demonstrate some involvement of each company in the business of the other. As it stands, the example is very misleading because it finds in paragraph 81 that Company A assumes the risks relating to the design, development and manufacturing of the product, and Company B assumes the risks relating to the marketing and distribution. Such a situation is common to most transactions between a supplier and a distributor, and if the product is a good one, or if the marketing is persuasive, then both parties are likely to benefit. But this does not mean that each party’s risks are closely inter-related and inter-dependent. Company B in this example could fail to recover its marketing campaign costs, although these are monitored monthly and so could presumably quickly be scaled back, but this risk is not closely related to Company A’s risks. Company A in this example could fail to recover its development costs, which might be a significant amount, but this risk is not closely related to Company B’s risks. As drafted, the example outlines a typical relationship between supplier and distributor and it is misleading to suggest without further detail that each party’s risks are closely inter-related and inter-dependent upon the other with the result that a transactional profits split method is likely to be the most appropriate method. The example does not sufficiently differentiate itself from the base case distributor in Example 4, the inclusion of which perhaps acknowledges the concern that Example 3 could be seen as a typical supplier/distributor relationship.

It may improve the example to think more about the nature of the product and the market, so that risks are better identified. For example, if the product were a new model of domestic refrigerator, for which there is a known and largely predictable market with several competing players, then it may be doubtful that the parties’ risks are closely inter-related and inter-dependent. However, if the product were a revolutionary communications device with no established market, and Company B invested in market research, fed back to Company A what consumers would seek in such a device and the appropriate price points, if Company A changed its development and design accordingly, if Company B invested in pre-production marketing in order to be well-placed to take advantage of, say, a period of 3 months following launch before competitors appeared, if Company A ramped up production and held significant inventory levels in advance of the launch, and if Company B entered into advance sales with wholesalers and retailers on a sale or return basis, then it is possible to see greater inter-relationships and inter-dependence than the current example demonstrates. In such a scenario, a profit split may well be an appropriate method.

In paragraph 82 it states that the profit split may determine the profits of Company A and Company B “from the sales of the products.” However, only Company B sells the products. What the profit split might be able to do is to determine the price at which products are transferred from Company A to Company B by splitting the profits of Company B.
Comments on profit splits

Example 5
Example 5 is stated in paragraph 18 to be an example of a transfer of a partially developed intangible. In fact, it could potentially be a good example of inter-related and inter-dependent risks since development from both parties is required to turn the development into a saleable product. However, the example contains no indications of assumption of risk by the parties. This is odd, since the fundamental point is that a profit split would likely be appropriate only in circumstances where WebCo and ScaleCo assume their own development risk, which in this example seems highly inter-dependent.

Example 5 contains the rather undermining proviso in paragraph 88 similar to that found in Example 1. However, here the point perhaps is that WebCo and ScaleCo are both involved in development only; there may be other group companies involved in marketing and selling the product, and thus contributing to the profits “from the sale of the system to customers” (paragraph 88). So, it may be that the proviso contemplates the possibility that the two companies perform routine development functions, and that profits are driven by the sales effort. In any case, it is impossible without information on how the product is sold to customers to conclude that the profit split could be used to determine the profits of WebCo and ScaleCo “from the sale of the system to customers.” In theory, the profit split could be used to determine the profits of WebCo and ScaleCo if the development profits could be segregated. The example shows the importance of being able to identify the relevant profits and relates to comments in Section C, paragraphs 8 and 9, of this note.

Example 6
Example 6 is an example of integration as described in paragraph 19, and illustrates the point that a group entity may be integral to the supply chain, but it does not make unique and valuable contributions. As a result, a profit split would not be appropriate. Although the example seems correct in its conclusion, it tests the ability to apply in practice the criterion of unique and value contributions. The manufacturing activity is a valuable contribution, perhaps not the most valuable contribution to the group’s business, but it could nonetheless meet the imprecise definition in paragraph 16 as a “key source” of economic benefits. Is it a unique contribution, according to the definition in paragraph 16 of “not comparable to contributions made by uncontrolled parties in comparable circumstances”? Company B has no other customer than Company A, and it has invested in machinery and tooling that is specifically adapted to the production of the Group’s products. Therefore, on the face of the definition, it may be challenging to say that what Company B does is comparable to contributions made by uncontrolled parties in comparable circumstances. However, what is missing in the example is consideration of risk. If Company B has not invested in dedicated machinery and tooling at its own risk, then it may indeed be possible to conclude as the example does, that comparable uncontrolled manufacturing services may be identified. However, the more risk Company B incurs, and the more inter-dependent those risks (for example Company B is dependent on orders from Company A to recover costs of machinery and tooling, and Company B’s production is dependent on a key component from Company A), the more difficult it will be reliably to identify a comparable uncontrolled party in comparable circumstances.

Example 7
Example 7 is an excellent example of a profit split between parties that share assumption of risks and operate in a highly integrated manner, as discussed in paragraph 20. It is noteworthy that a profit split is found to be appropriate notwithstanding that the parties are not making “unique and valuable”
Comments on profit splits

contributions. Therefore, the example tends to discredit the guidance that suggests “unique and valuable” contributions may be a primary indicator for a profit split.

Example 8
Example 8 is based on the parties sharing the assumption of the same risk. Such an indicator seems more of a primary one than unique and valuable contributions, unless the definition of unique and valuable is extended to cover risks.

Example 9
Example 9 is incorrectly framed in paragraph 105. The profit split does not determine the profits of Company A and Company B “from the sale of the products” since only Company B sells the products. The profit split does not determine the profits of Company A, but rather the price of the goods and intangibles transferred to Company B. It is assumed that Company A does supply goods to Company B, although this is not clearly stated, and it is a complicating factor in the illustration of the application of a profit split. Paragraph 108 seems to contemplate that the only transaction relates to the transfer of intangibles, and not goods.

It is unclear what the “innovative marketing activities” might be in paragraph 104. Most marketing seeks to be novel and different. The phrase seems to try to make the case that Company B makes unique and valuable contributions, and that, therefore, a one-sided method cannot be used to benchmark its contribution. Perhaps the example would be improved by focussing on the investment made by Company B, for example in virtual imaging which allows customers to see images of themselves wearing the clothes in specialist locations, and any clothes purchased are shipped directly to the customer’s home. Or the example could simply state that in the absence of comparables that would allow reliable benchmarking of the contribution of Company B, the relative value of the contributions made by Company A and Company B are used in a profit split.

Scenario 2 is unclear in that it is curious how Company A might jointly perform with Company B marketing and distribution activities in Country B. Perhaps the example could be improved by stating that Company A has experience in high-profile sponsorship and enters into a significant sponsorship arrangement in Country B. Even so, such fact pattern would not necessarily support a split of actual profits. The costs could simply be added to Company A’s contribution in determining the royalty under Scenario 1. A key difference between Scenario 1 and Scenario 2 should be the extent to which Company A determines how Company B runs its business and influences its profits, and whether the risks are shared or are closely related. For example, whereas in Scenario 1 it could be clarified that Company B is free to determine retail prices, mark-downs, promotional campaigns, and any sponsorship deals, in Scenario 2 retail prices and any mark-downs are set by Company A in the light of Company A’s concern to maintain brand value and to prevent parallel imports cannibalising its own market, and Company B is not allowed to conduct any promotional campaigns or sponsorship deals without consultation with and approval by Company A, and Company A in fact enters into sponsorship deals relating to Company B’s market. In such a scenario, Company A is directly influencing the performance of Company B and the profit opportunities Company B can achieve from the arrangements, including the profits contributed through Company B’s own development of and investment in the “innovative marketing activities,” and both companies share the assumption of risks, contribute to control of risks, and have separate but inter-dependent, closely related risks.
Comments on profit splits

As a matter of strict reading it does seem that the intangibles could meet the definition of HTVI in 6.189 under Scenario 1, and it is curious to see the definitive statement in paragraph 103 to the contrary. There does not seem to be any need to mention HTVI.

Example 10

Example 10 makes the case for both indicators of highly inter-dependent risks and unique and valuable contributions. Therefore, the example tends to discredit the guidance that suggests “unique and valuable” contributions may be a primary indicator for a profit split.

C. Comments on specific drafting

General description of profit splits

7. Paragraph 1 refers to profit splits being used to “test reported outcomes.” It is not clear whether this phrase simply means that the method can be used by the taxpayer to verify its reported figures, or whether it means that the profit split can be used to verify the application of other methods. If the former, then the preceding phrase “establish arm’s length outcomes” seems to cover it; if the latter then this is undoubtedly how a profit split, or something resembling a profit split, is used in practice and the guidance should be clear on whether such practice is appropriate. Paragraph 11 uses the phrase “establishing and/or verifying” arm’s length outcomes with similar ambiguity, and “establishing” alone seems adequate.

8. Paragraph 1 starts the incorrect description of a profit split found in many places in the guidance. A profit split does not first identify the profits “from the controlled transactions,” but rather first combines the profits of the enterprises. The profits to be split are wider than those from the controlled transaction, and will be derived from uncontrolled transactions (for example, sales to third-party customers). A profit split needs to start by combining the profits of the parties to the controlled transaction, but does not start with the profits from the controlled transaction—that is what the profit split ultimately seeks to value. The paragraphs listed as follows also describe a profit split incorrectly. Paragraph 6 states that independent parties “might effectively share the profits of the transaction” but this should be changed to something like: “independent parties might effectively price the transaction between them by reference to a sharing of the profits arising.” Paragraphs 34, 35, and 37 repeat the notion of splitting profits “from controlled transactions.” Paragraph 36 should refer to the contribution made to the relevant profits, not to the controlled transactions. Paragraph 39 should be amended to something like: “The relevant profits to be split under the transactional profit split method are the profits of the associated enterprises engaged in the controlled transactions under review and which arise in relation to or as a consequence of the controlled transactions.”

9. The following wording for paragraph 1 may help to frame the concept of transactional profit splits more accurately, and touches on why they are called transactional profit splits, a point that the draft should specifically cover (see later comments in paragraph 33 of this note):

“The transactional profit split method seeks to establish arm’s length compensation for contributions made in a transaction or transaction between associated enterprises by splitting commensurate with those contributions the profits arising to one or more of those enterprises as a consequence of those contributions and relating to the use or transfer of those contributions
Comments on profit splits

in the open market. Following the two phases of a comparability analysis set out in 1.37 and 1.39, the method can be applied by identifying the profits of the contributing associated enterprises arising from the use or transfer of the contributions in the open market, and then splitting them in accordance with the value of the respective contributions on an economically valid basis that approximates the division of profits that would have been agreed at arm’s length for those contributions. The transactional profit split method can be useful when the contribution of the associated enterprises to the controlled transaction cannot reliably be compared with a contribution in an uncontrolled transaction under the methods previously described in this chapter, but instead can reliably be valued by reference to its share in the profits arising. This section discusses the circumstances in which a transactional profit split is likely to be appropriate, and how it can be applied reliably.”

10. Paragraph 6 introduces the concept of pricing “the entirety” of the transaction. This concept is used also in paragraph 28, and seems to have intended significance, but is not explained. All methods seek to evaluate the entirety of the transaction, since leaving anything out may result in an incorrect delineation of the transaction. But perhaps the phrase is attempting to acknowledge that a profit split is likely to be appropriate when each party plays a part in the business of the other, through functional inter-dependencies and sharing of risks. As a result, the effect of the transaction between them spills over to further transactions with other parties, including independent parties. This is true and important, but if it is what the term “the entirety” is intended to convey, then it should be explored and explained.

11. In paragraph 2 it is stated that profit splits should apply in the same way regardless of whether the transaction results in a profit or loss. It supports this view by referring to the rarity of asymmetrical splits of profits and losses in analogous situations at arm’s length. It is unclear what these analogous situations might be. However, some of the uncontrolled arrangements mentioned in paragraph 52 (for example pharmaceutical collaborations) do have different terms depending on results and would not show symmetry. A similar point was made by commentators to the 2016 draft. The guidance effectively contends, therefore, that the relative value of contributions is constant when applied to maximise profits and when applied to minimise losses. However, if the losses reflect a change in the context within which the business operates, it is not obvious that the relative value of contributions would remain constant. Crucially, however, the basis for symmetrical treatment depends on the type of profit split. If it were a split of anticipated profits, perhaps in conjunction with a discounted cash-flow valuation technique, then the split is applied to the cash-flows over a period of time and would apply equally to a taxable period of losses as to a taxable period of profits. In addition, if the profit split of anticipated profits were used to set a price, for example, a royalty charge for the licensing of rights in intangibles, then the price should take into account the risk that anticipated profits may not materialise for the licensee and would not automatically adjust in the event the licensee incurred losses (although certain contingent pricing elements may have been included in the price agreed at the outset). However, if it were a split of actual profits, asymmetrical treatment, or at least different treatment, depending on whether there were combined profits or losses, may be justified. The first point is whether the profit split is based on anticipated splitting factors or actual splitting factors. For example, suppose Company A contributes technology intangibles and Company B marketing intangibles, and that the costs incurred, as appropriately adjusted, are determined to provide the basis for a profit split resulting in respective value of anticipated contributions in the proportion of 60:40. Suppose, however, that a competitor
Comments on profit splits

introduces a competing product with the result that actual marketing spend increases, and there are losses for a period. It perhaps makes sense for those losses also to be split 60:40, so that Company B’s additional contribution is shared. However, if the profit split is based on actual contributions (as seems to be envisaged in section C.5), and if, for example, the respective value of actual contributions becomes 30:70 as a result of Company B’s increasing its marketing expenditure and Company A’s technology expenditure remaining the same as anticipated, then it seems doubtful that Company B should suffer 70% of the losses when Company A’s unique technology is no longer a differentiator in the market. Perhaps the answer is not to insist on banning in all cases asymmetrical treatment, but to point out the different implications for different applications of the method, and to suggest that if the profit split is based on actual profits or losses and actual contributions, changes from profits to losses may reflect a change in the commercial context and lead to a need to reconsider the relative value of the parties’ contributions.

Indicators for when a profit split is likely to be appropriate

12. Paragraph 4 rather undermines the guidance. The word “deterministic” may not be the right choice, but there do appear to be certain conditions that would tend to suggest the selection of one transfer pricing method rather than another might be the appropriate effect. However, the undermining comes in stating that where the listed indicators are present, a profit split might not apply, and where they are not present, you can still apply a profit split in cases where you have somehow determined it is the most appropriate method, notwithstanding that the indicators of appropriateness are not present. This paragraph abnegates the responsibility to provide guidance about the particular circumstances in which a profit split is likely to be reliable, and is likely to be regretted if it is incorporated in the Guidelines. The practical guide offered in Section A of this note shows one way in which flexibility of application can be retained in conjunction with guiding principles.

13. The first sentence of paragraph 8 states that the profit split takes into account circumstances of the associated enterprise “that are not present in independent enterprises.” This very strong statement seems to acknowledge that a group of companies is different to independent enterprises, and therefore sets up the profit split as the only method that can reliably account for groupness. Such a reading would be unfortunate. The sentence could be clarified by amending the phrase to read: “that may not be present in comparable uncontrolled transactions.” The word “flexibility” in this sentence appears unnecessary. One could simply make the more neutral statement: “Another strength of the transaction profit split method is that is can take into account specific, possibly unique, facts and circumstances of the associated enterprises that may not be present in comparable uncontrolled transactions.”

14. The second sentence of paragraph 8 is important, but is only relevant to a split of actual profits. A split of anticipated profits in order to arrive at a price does not achieve the stated variation with actual outcomes (except to the extent the price includes contingent elements). The failure to distinguish the two kinds of profit splits at the outset makes the guidance less clear because some statements apply only to the one or the other, but not both. Similarly, the statement in paragraph 14 about the inappropriateness of a share of profits impacted by the playing out of risks is correct, but relevant only to a profit split of actual profits. Paragraph 23 mentions sharing of risks and how risk sharing will determine how a profit split should be applied, but the meaning is opaque without prior discussion of this crucial difference between a split of anticipated profits and a split of actual profits. Many commentators to the 2016 draft found the drawing out of the difference helpful,
Comments on profit splits

albeit with some clarifications required, and the postponement of its discussion in the 2017 draft

does not add clarity to the guidance.

15. Paragraph 9 would be improved by clarifying that what distinguishes a profit split is not that both

drives are analysed, because that is a necessary condition for any method, but that “the

contributions of both parties to the transaction are specifically identified and measured in order to
determine a price for the transaction.”

16. Paragraph 13 is a good summary of the indicators for the appropriate application of a profit split,

and importantly notes that all three indicators may often be found together. However, the paragraph
does seem to take the view that unique and valuable contributions represents the most important
indicator, and that the other two, integration and risk sharing, are optional. The statement that
unique and valuable contributions is perhaps “the clearest indicator” is ambiguous: does it mean
that such an indicator is the most definitive indication, or the one that may be most apparent? Given
the vague definition of “unique and valuable” (see paragraph 17 of this note), given the concern
about the examples that just look at unique and valuable contributions to establish the
appropriateness of a profit split, and given the guidance on establishing risk assumption in Chapter
I and the ability to discern integration in a functional analysis, it is not obvious that unique and
valuable is the clearest indicator under either of these meanings. I take the view that integration

and risk sharing are likely to be the key indicators of a profit split of actual profits, and may be

present even where the parties do not make unique and valuable contributions (as defined without
amendment in the current draft); and that the concept of unique and valuable may be more relevant
to a profit split of anticipated profits when comparables are not reliable. This seems to be supported
in paragraph 44 in which the imprecise “and/or” suggests that there need not be no unique and valuable

contributions, and by Example 7 in which the parties to the profit split do not make unique and

valuable contributions.

17. Paragraph 16 defines the concept of unique and valuable contributions, and is vague in its
description of “key source” of benefits, which could be interpreted very widely. The paragraph
seems to embed risks in the discussion following the definition, which is helpful and correct (and
advocated by commentators to the 2016 draft), but not in the definition itself. The paragraph seems
to acknowledge that the risks associated with the respective unique and valuable contributions
require to be considered. The example considers unique and valuable contributions in terms of
functions and assets, and the shared assumption of associated risks. However, the definition in the
first sentence does not mention risk. If the concept of unique and valuable contributions is retained,
and if it seems to be accorded some priority, then risks should be included in the definition. The
first sentence could add after “economic benefits” “and incurs economically significant risks.”
More preferably, however, the concept should be expanded to that set out in the practical guide in
Section A of this note: do the economically relevant characteristics of the transaction indicate that
reliable comparables can be used for the contribution, (including functions performed, assets used
or contributed, and risks assumed) of at least one of the parties. The phrase, unique and valuable,
could then be used as a shorthand expression of this concept.

18. Paragraph 17 continues to embed risks in the discussion of unique and valuable contributions of

intangibles, which is correct, even though risks are not included in the definition. The paragraph
seems to state that the unique and valuable contribution by the legal owner of an intangible is not
Comments on profit splits

sufficient without risk-taking. This is correct and helpful, and would support the addition of a reference to risk in the definition of unique and valuable contributions. However, the paragraph does not explain why it is important for the application of the profit split to consider whether the legal owner of the intangible assumes economically significant risks relating to those intangibles, and what the implications might be if the legal owner does not assume risk.

19. Paragraph 19 introduces the important indicator of integration. Such an indicator is highly relevant. However, the paragraph fails to make a clear contrast. The second sentence say a high degree of integration applies where interlinked functions cannot reliably be evaluated in isolation, and contrasts this with integration where contributions can reliably be evaluated. The contrast is not clear. The concept of parallel and sequential integration was an attempt to clarify the difference in the 2016 draft. Commentators had various views on the usefulness of the expression of the difference, and the concept has been dropped in the current draft. However, some of the wording in paragraph 21 of the 2016 draft may help to make the intended contrast clearer: for example, where discrete functions are performed it will often be the case that it is possible to find reliable comparables since the functions, assets, and risks involved in each discrete stage may be comparable to those involved in uncontrolled arrangements.

20. In paragraph 20 the reference to owning assets jointly may not cover the intended point, if it implies legal ownership. The point is that the same assets or assets are used by each party, irrespective of legal ownership.

21. In paragraph 21 it is not clear what “flexible pricing” means. Perhaps it means pricing varying with actual outcomes. If so, make the point clear.

22. Paragraph 22 does not offer clear guidance. It refers to 6.94 which explains the value of intangibles in combination. However, the paragraph and the reference do not seem to illustrate inter-relationship or inter-dependence. It is quite possible for intangibles to be developed separately by independent parties, and to be combined by another independent party. It is not clear why, if a party can combine another party’s intangible to good effect, it is claimed that such an intangible would not have significant value on a standalone basis—it does have value to that other party. It is not clear what is meant by a holistic evaluation. And it is not clear what this means for a profit split.

23. Section C.2.2.3 on shared assumption of risks, actually seems to start at paragraph 23 which marks a transition from integration to risks. Paragraph 25 should be expanded to include the first sentence of paragraph 26. As a result, the “relevance of such a factor” in paragraph 26 would apply both to shared risks and inter-related risks.

24. Paragraph 24 makes an important point, but fails to identify the criterion that allows distinction to be made between when sharing of risk leads to a profit split and when it does not. It would be a helpful improvement if the final sentence could add “, since there may be reliable comparables to determine how compensation at arm’s length accounts for a sharing in the upside and downside associated with the risk.”
Comments on profit splits

25. The final sentence of paragraph 26 expresses a difficult concept, but may, for example, refer to a case where one party is involved in hundreds of products, whereas the arrangements being analysed concentrate on just one. The concept might be clearer if the wording was amended as follows: “The economic significance of the risks should be analysed in relation to their importance to the actual or anticipated relevant profits, rather than in respect of their importance to any one of the associated enterprises whose business operations may extend beyond those covered by the relevant profits.”

26. Paragraph 27 is an important paragraph that would benefit from two additions. The penultimate sentence is not clear and would be improved to read: “That is, the transfer pricing outcome—a sharing of actual profits—should align with the accurate delineation of the transaction which determined that each party assumes the risks that significantly affect those profits.” The paragraph would also benefit from introducing a split of anticipated profits, and making the key distinction between the two kinds of profit split by adding: “Conversely, a profit split of anticipated profits will tend to concentrate the playing out of economically significant risks on one party.” However, for the reasons already mentioned, it would be less confusing if this distinction were made earlier in the guidance. The adoption of a practical guide, as suggested in Section A, would allow for the distinction to be made at the outset.

27. Paragraph 30 seems premature in drawing conclusions since at this stage the guidance has not taken all of the factors mentioned in 2.2 of the Guidelines into account. The guidance has concentrated on the appropriateness of the method in view of the nature of the controlled transaction, but, importantly, the guidance has not taken into account the availability of reliable information needed to apply the profit split. Determining contributions reliably, finding ways of equating them and making adjustments for timing and risk differences, and being able to identify the relevant profits reliably are all considerable challenges in being able to apply the profit split method reliably or at all. The relative merits and shortcomings of available transfer pricing methods mentioned in this paragraph, a concept that is very relevant, have not yet been discussed. In addition, paragraph 30 undoes the good work in the preceding paragraphs. It is wrong to state: “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.” This contradicts, for examples, paragraph 14, and the guidance in 18, 20, 21, 22, and 27. Like paragraph 4, paragraph 30 abnegates the responsibility of setting out the principles which govern the reliable application of a profit split method, and previous paragraphs which did seem to establish useful principles. The practical guide offered in Section A of this note shows one way in which flexibility of application can be retained in conjunction with guiding principles.

Guidance for application

28. In paragraph 32 is it unclear in the first bullet why a profit split needs to reflect the assumption of risks by only one of the parties. Surely assumption of risks by all of the parties needs to be reflected in the profit split. Or does it mean that only one party needs to assume economically significant risks if the profit split set a price based on anticipated profits?

29. In paragraph 33 the first bullet seems to explain the ex ante approach, but the wording is imprecise, since both profit split approaches set “transfer pricing in controlled transactions.” The following wording may be clearer: “If the transactional profit split method is used to set the price of the controlled transaction at the outset based on anticipated profits, it would be reasonable . . .” The
Comments on profit splits

third bullet point omits any reference to not using hindsight, and the explanation of providing a rationale for a change in the approach does not make it clear that this should be determined at the outset. As it stands, the bullet is inconsistent with the correct guidance in paragraph 46.

Different measures of profits

30. There seems to be no basis for saying in paragraph 47 that “generally, the relevant profits to be split under the transactional profit split methods are operating profits,” particularly when the guidance goes on to make it clear that the measure of profits will depend on the accurate delineation of the transaction and in particular the sharing of specified risks.

Valuation techniques

31. One of the potentially useful aspects of the 2016 draft was its extended explanation of how a profit split of anticipated profits could be used in conjunction with valuation techniques described in Chapter VI. This aspect has been lost in the current draft. This is a shame since it showed how valuation techniques, including valuation techniques based on projected cash flows, are central to the application of an approved method.

Value chain analyses and a transactional profit split

32. The 2017 discussion draft drops the section on value chain included in the 2016 draft. The value chain cat is out of the bag, and its markings seem to indicate some familial resemblances to profit splits. Commentators on the 2016 draft expressed mixed views on the section on value chain, but the value chain cat will not go back into the bag, and it seems that the OECD should give it a home and train it appropriately, rather than letting another party adopt it or allowing it to go feral. The 2016 discussion of value chain served two purposes: one was to explain that a value chain analyses can be used as a tool to delineate the actual transaction and relate contributions to key value drivers; the other was to separate a transactional profit split method from a value chain analysis and to prevent mis-use of the method. I believe that both purposes remain valid.

33. Additionally, the 2017 draft does not explain explicitly why the method is termed a transactional profit split. Like all methods, the transactional profit split depends on the accurate delineation of the transaction, including its terms and the specific contributions of the parties, including risk assumption. The discussion of value chain in the 2016 draft helped to explain how a more general evaluation of value drivers is not a profit split. However, it may continue to be useful to stress that a general analysis of respective contributions, perhaps in terms of people or assets, is not the application of a transactional profit split. That is what the second part of paragraph 28 in the 2016 draft attempted to do, and it seems that it remains important cautionary guidance:

“Application of the method will depend on the accurate delineation of the actual transaction, including the assumption of economically significant risks, the nature of the contributions of the parties, how those contributions drive profit outcomes, and the identification of the profits to be split, but the overriding objective should be to approximate as closely as possible the split of profits that would have been realised had the parties been independent enterprises. If the economically significant risks have not been specified, if the nature of the contributions of the parties has not been accurately determined, if an evaluation of how those contribution drive profit outcomes has not been made, if the profits to be split have not been reliably identified, or if the basis for splitting the profits has not been reliably determined, then it is doubtful that
Comments on profit splits

the overriding objective can be achieved and the application of the transactional profit split method would be unreliable.”

Thank you for considering these comments. I should be happy to discuss any points you think may merit development.

With best wishes

Andrew Hickman
15 September 2017
Tax Treaties, Transfer Pricing and Financial Transactions Divisions
OECD/CTPA
2, rue André Pascal
75775 Paris Cedex 16
France

cc: Laura Beretta; Gianni De Robertis

RE: Discussion Draft on the Revised Guidance on Profit Splits

Dear Sirs,

_Federazione Nazionale Imprese Elettrotecniche ed Elettroniche_ ("ANIE") thanks the OECD for the opportunity to comment on the OECD Centre for Tax Policy and Administration's Discussion Draft on the Revised Guidance on Profit Splits (hereinafter, also referred to as the "Discussion Draft").

ANIE greatly appreciates the work of OECD Working Party No. 6 on clarifying and strengthening the guidance on the transactional profit split method. This letter comments on certain aspects of the Discussion Draft and suggests areas for further enhancement and clarification. We hope that our comments may be useful in enhancing the effectiveness of the proposed new guidelines, with particular regard to the practical issues that may arise in the application of the profit split method.

Main Comments on the Revised Guidance on Profit Splits

ANIE welcomes the fact that the Discussion Draft (i) points out that profit split should be applied in order to align profits with the value of the contributions made by the participants and (ii) takes a balanced view of the transactional profit split method, indicating both its strengths and weaknesses and providing examples of where the use of the profit split method might or might not be appropriate.

We agree that it is necessary to support the application of the profit split method with a functional analysis and that, as stated in paragraph 28, a lack of valid comparables alone should not result automatically in the application of the profit split method. We believe this point to be very important and, therefore, that it would be appropriate to stress the concept even more strongly in the Discussion Draft.
ANIE believes that the revised guidelines on profit split should clarify even further that, in order to avoid double taxation, its application should not result in the mere use of formulaic divisions of profit unless the tax administrations of the countries involved agree on such formulas.

ANIE agrees with the general guidelines for the application of the profit split method, described in section C.3., and in particular agrees that the splitting factors should be consistent with the functional analysis and be capable of being measured in a reliable manner. However, in case it is not possible to identify reliable quantitative splitting factors (e.g. capital, headcount), it is important to receive further guidelines on the possibility/acceptability of applying the profit split method on the basis of qualitative drivers (attributing a weight to the functions/risks and assets used).

Further clarifications should be provided with respect to the interpretation of paragraphs 11 and 15, which appear to formulate concepts that do not tally completely. On the one hand, it is stated that the fact that the profit split method is rarely applied within a certain industry does not automatically mean that it is inappropriate for testing a controlled transaction; on the other hand, paragraph 15 seems to imply that the fact that a profit split method is commonly applied in an industry is not a pointer to its adequacy in the context of a similar controlled transaction. Therefore, further clarifications on the possibility of reliably referring to common industry practices should be provided.

ANIE agrees with the observation made in paragraph 19, on the fact that the profit split method should not be considered the most appropriate method in all cases where there is a high degree of integration. In particular, this may not be true in those cases where the parties manage their own portion of functions and risks and comparable controlled transactions are available in order to test at least one party to the transaction.

Based on the guidance set out in the Discussion Draft, and on the criteria for deciding whether actual or anticipated profits should be split, ANIE points out that the decision of the parties (as indicated in their contracts and by their conduct) should be respected. Indeed, it would be inappropriate to split the actual profits unless the parties have previously agreed to do so.

From an operating standpoint, ANIE notes that the data necessary for the splitting of actual profits are usually available at the end of the fiscal year. Therefore, this may result in difficulties in recording and managing potential year-end adjustments in the accounts. Any guidelines on how to practically address the issue would be appreciated.

**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 choice between a profit split of actual profits or a profit split of anticipated profits should be carefully evaluated on the basis of the functional and risk profile of the entities involved (as mentioned in paragraph 44).

The allocation of responsibilities is usually negotiated between the parties and reflected in the intercompany agreement, which, as mentioned in paragraph 46, should be the starting point for the delineation of any transaction.
Therefore, it should be left to the parties to decide whether a profit split of anticipated profits or actual profits should be used. If the parties have agreed to split anticipated profits and consequently to bear and manage the risk deriving from this agreement, an adjustment based on actual profits would result in using hindsight to set intragroup prices, which would be incorrect.

In addition, ANIE would like to highlight that there is a drawback in using the profit split of actual profits as, in certain jurisdictions, profits/losses necessarily need to be recorded in the year in which they arise. By definition, actual profits can be split only several months after the year end, once the final financial data of the year become available and the data have been analyzed and segmented for the transaction which will be subject to the profit split. By the time the profit split analysis is completed, it may be too late to record the profit/loss in the accounts of the year, already closed.

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

As a general comment, ANIE observes that it is not possible to indicate, in abstract terms, a list of factors that should be used in the application of the profit split method, since the factors will depend on the results of the functional analysis and on the specific facts and circumstances surrounding the transaction.

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.

Depending on the facts and circumstances, capital could be a factor. In particular, in accordance with sections 2.103 and 2.104 of the TP Guidelines, which describe the selection of the appropriate profit level indicator in relation to the application of the TNMM, capital could be an appropriate factor in cases where assets are a better indicator of the value added by the parties, e.g. in certain manufacturing or other asset-intensive activities and in capital-intensive financial activities.

However, as with every factor, it would be important for the data to be reported/calculated consistently across companies and countries.

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 could be a factor, as well as employee compensation. As already mentioned, it is not possible to provide a specific indication of the circumstances in which it would be relevant since any evaluation should be based on the particular case under analysis.

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?

ANIE believes that an adjustment for purchasing power parity would not be appropriate for profit splitting factor amounts. In addition, it may be too burdensome for taxpayers.

However, ANIE highlights that, in certain circumstances, the use of adjustments could be appropriate (e.g. to correct accounting or reporting differences).

d. What other profit splitting factors should be included in the guidance, and in what circumstances?
As already pointed out, ANIE considers that an abstract list of factors to be used in the application of the profit split method would not be useful and might create misunderstandings since such factors should be evaluated on a case by case basis. However, it may be worth indicating whether the profit split should necessarily derive from quantitative factors or could also be based on a more qualitative approach by assigning weights to the contribution of each party/function on the basis of the functional analysis.

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 thereon.**

Not applicable.

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We hope that the OECD will find our comments useful and that you will not hesitate to contact us should you wish to discuss the issues we have raised in this paper in more detail.

For further information, please contact Laura Beretta [laura.beretta@prysmiangroup.com] and Gianni De Robertis [gianniderobertis@kpmg.it], who have assisted ANIE in preparing this submission.

Yours faithfully,

Maria Antonietta Portaluri

About ANIE

The Italian electrical engineering and electronics industry association (ANIE) is one of the major industry associations in Italy, representing electrical engineering and electronics companies. It was founded in 1945 and is a member of Confindustria. It has more than 1,200 members, with a combined workforce of 410,000 and a combined turnover of €56 billion at the end of 2013.

ANIE brings together very large multinationals as well as small and medium-sized Italian enterprises; 65% of its member enterprises have less than 50 employees. Its members place high importance on research and innovation and account for over 30% of private Italian investment in research and development.

Nationally and internationally, ANIE and its network of members seek to encourage and strengthen entrepreneurial values, promoting their development in pursuit of the general interest of the country and acting to ensure transparent rules. ANIE is part of the European Engineering Industries Association.
Autonomous City of Buenos Aires, September 15, 2017

Mr. Tomas Balco  
Head of the Transfer Pricing Unit  
OECD’s Center for Tax Policy and Administration

E-mail Response: TransferPricing@oecd.org

RE: BEPS ACTION 10. DISCUSSION DRAFT ON THE REVISED GUIDANCE ON PROFIT SPLITS.

Dear Mr. Balco,

The Transfer Pricing Working Group of the Asociación Argentina de Estudios Fiscales (Argentine Association of Tax Studies – AAEF) is pleased to provide comments on the OECD’s discussion draft on the revised guidance on profit splits related to Action 10 of the BEPS Action Plan.

AAEF\(^1\) is a non-profit organization based in Argentina, whose active members are recognized tax experts from both, private and public sector. AAEF is the local branch of the International Fiscal Association.

We welcome the proposal to include additional guidance clarifying the application of transfer pricing rules related to the profit split method, in light of the specific methodology features and the concerns to prevent the tax base erosion and profit-shifting.

We comment on and assess the specific questions requested in the discussion draft, hoping that they can contribute to the better development of the subject matter.

General comments

The revised guidance on transactional profit split method is welcomed. It brings clarity and thus helps to reduce uncertainty in its application for both taxpayers and, at the same time, tax authorities, making the audit activity more efficient. We welcome the inclusion of examples, which are a good means to illustrate in a practical way the application of the method under analysis.

Nonetheless the profit split method has been included in the OECD transfer pricing guidelines and in several legislations around the world for many years, so far its usage has not been as wide as is the case of other methods.

We understand that a reason for this limited usage could be traced to some of the issues that arise in practice when an MNE tries to implement a profit split which is related to the lack of guidelines on

\(^{1}\) Created in 1953, the Argentine Association of Tax Studies has committed itself in its 65 years to promote research on fiscal law and related disciplines among its members.
accounting principles and aggregation rules, currency in which the results should be measured, treatment of the differences between accounting results for aggregation purposes and local GAAP results, etc. Unfortunately, the document does not provide any guidance in this regard. This issue could be tackled through a broad agreement between countries on how to deal with this practical issues. A good example on this approach would be the periodic guidance that the OECD release on how to understand and complete certain aspects of the Country by Country Report.

On the other hand, and as mentioned both in the OECD TP Guidelines and in this revised guidance, the profit split method is advisable in cases where unique and valuable contributions are made by each of the parties to the transactions, as well as where the business operations are closely integrated and cannot be evaluated on a separate basis. It is also very useful in situations where independent parties would have decided to carry out a profit-sharing scheme based on an allocation that considered their contributions to the profits.

Even though the profit split approach brings a consistent economic result from the Income Tax standpoint, it poses significant challenges for other tax and customs aspects. Significant efforts have been put in the new OECD TP Guidelines to deal with the actual delineation of the transactions. Nevertheless, when it comes to the application of the profit split, nothing is said on how to differentiate and allocate the method’s outcome to the different commingled transactions that might be evaluated throughout this method. The lack of definitions related to the treatment of the incomes and/or expenses that arise from the application of the profit split method is a critical issue, because, without these kinds of definitions, it will be difficult to find an extensive usage of the method. We consider that more guidance in this regard will be of great value.

For the sake of clarity on what we have expressed in the previous paragraph, below you will find further development of example 2 from the revised guidance on profit splits that shows the issues we have been trying to describe.

Example 2 of the revised guidance on profit splits shows that the most appropriate transfer pricing method for this business is the transactional profit split method, as a consequence of the fact that both companies are making unique and valuable contributions. The intercompany transaction under review would apparently be the export of tea from company A to company B, while the result of the aggregated activity (both the tea production and distribution) has to be split.

Under this scenario, if the result to be split in a fiscal year is profit, there will be a payment from Company B to Company A (in principle for the exported tea) and it will be easy to check whether the related profits should be considered or not taxable income at arm’s length in both countries in which the group is operating (i.e. country A and country B). Nevertheless, the right economic solution from the income tax standpoint might not be enough to define the correct treatment in areas other than transfer pricing (e.g. other aspects of income tax, value added tax, customs, exchange control, etc.).

The issue is more clearly exposed if the result to be split were an operating loss (e.g. as a consequence economic recession or other risk materialization) and company A should to pay company B to reach an arm’s length result in each country. In this case it is clear that the payment made by A is not the price of the exported tea. Thus, some relevant questions arise: What is the payment for? A service? IP? Will this charge paid by company A be deductible in its country of residence? How will it be treated by company A as regards to withholding taxes? Are there other tax, customs or exchange control issues that may be taken into account or questioned by the local authorities? Which will be the tea price for customs valuation purposes?
While it could be argued that these questions should be answered taking into account the domestic legislation (or the applicable tax treaty, if this be the case) greater clarity and harmonization between the different tax, customs and other regulatory aspects that evaluate the same transactions will be fundamental to a better and less uncertain approach to the transactional profit split method.

While the use of advanced pricing agreements might provide certainty to taxpayers and tax administrations over a period of time where the profit split method is applied, a more integrated approach considering all the viewpoints of the transactions would be desirable. The promotion of such a holistic approach by the OECD would be welcome.

Specific questions

We have provided below our feedback to each of the questions included in the discussion draft.

Profit splits of actual or anticipated profits

Regarding 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, our understanding is as follows:

As the draft of the revised guidance on profit splits stands, the actual profits will reflect the playing out of the risks assumed by the parties. We agree with the document that the splitting of actual profits would only be appropriate where the parties 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.

When both parties are actively involved in the ongoing business, performing functions and assuming risks that could give rise to losses that both parties have to solve, actual profits or losses have to be split. Instead, where both parties make unique valuable contributions, but only one of them is actively involved in the ongoing business after entering into the transaction, as it is the case in example 9 Scenario A of the OECD discussion draft, the actual profit approach would, in principle, not be suitable.

It has to be taken into account that there is a close relationship between the profit split method and the Guidance on Intangibles; since one of the characteristics of the transaction usually indicates the profit split method could be the most appropriate method to evaluate the price of transactions involving intangibles is the characteristic of the intangible as unique and being so, has no comparable data available.

Accordingly, Chapter VI of the revised Transfer Pricing Guidelines says that “Entitlement of any member of the MNE group to profit or loss relating to differences between actual and expected profits will depend on which entity or entities assume(s) the risks that caused these differences and whether the entity or entities are performing the important functions in relation to the development, enhancement, maintenance, protection or exploitation of the intangibles or contributing to the control over the economically significant risks and it is determined that arm’s length remuneration of these functions would include a profit sharing element”.

Tel./Fax (54-11) 4342-1796/7837 / 4345-0218 -E-mail: info@aaef.org.ar - Web: www.aaef.org.ar
In the case that one of the associated parties makes a contribution of a unique and valuable intangible fully developed at the moment the agreement was entered into, without being engaged in further contributions other than routine functions regarding the maintenance, registration and exploitation of the intangible, the profit split method should in principle be applied on anticipated profits, because the party does not assume an economically significant risk associated with the business opportunity and consequently would not be entitled to share the resulting profit and losses. Instead, the other party, who also makes a significant contribution, is the one who bares business opportunity risks and eventually will bear the loss.

A functional analysis must be done to appreciate which party assumes the opportunity business risks identified when the actual transaction has been delineated. The nature of the contributions, as well as the most significant characteristics of the business, would demonstrate which party assumes the significant risks associated with the business, which would mean to bear the losses caused by differences between the anticipated results and the actual ones.

Nevertheless, we consider that only in principle the split of anticipated profits would be applicable to situations where the ceding party does not perform any further DEMPE function relating the intangible asset. The assumption of the risks could also be determined by a contractual decision from the parties, provided that such decision would have been taken by independent parties under the same circumstances (that is, backed up by actual investment decisions). In effect, it is possible, at arm’s length that the party that contributes with a unique and valuable intangible decides to bear the risks - having financial capacity to do so - associated with a business opportunity, without having the control of the risk. This could be seen as a minority investment in a company or participating in a JV where the participation is not as the JV operator. There is arm’s length evidence where a third party decides to invest in a vehicle in which it has no control, but shares the bearing of the opportunity cost risk with the controlling party and is entitled to the fair share of the upside or the downside of the business. In the case at hand, the IP contribution (accurately valued based on the anticipated profits) could be considered the investment in a company or a contribution in a JV and, thus, the actual results of the joint business should also be shared between the parties based on the capital contributed by each to the total investment.

The grade of uncertainty regarding the outcome of the exploitation of the intangible could be a factor to ground the existence of contingent payments according to the actual results of the business, as the Guidance on Intangibles points out in paragraph 6.182 (in specific in the case of hard to value intangibles).

Finally, let us mention that the form of the retribution - a lump sum or a royalty - implies the assumption of different grades of risks for the party who makes the contribution of the intangible. In the case of a sale-based royalty for instance, the retribution will be partially in line with actual profits; nevertheless the percentage of the royalty has been set under anticipated basis. When the profit split method applies on actual profits, it implies the possibility of facing actual losses, which have to be borne, and not only the opportunity cost of obtaining a benefit, as it is the case of royalties that were agreed to be calculated on sales, when the sale performance was not the one the transferor would expect.

Regardless of whether anticipated or actual profits are used, the basis upon which the profits have to be split (relative contributions) must be determined ex-ante on the support of data known or foreseeable by the parties at the time the transactions were carried out.
Profit splitting factors

As the document described, the division of results under the profit split method is generally achieved using one or more profit splitting factors. The determination of the appropriate profit splitting factors should reflect the key contributions to value creation in relation to the transaction. In this sense, the functional analysis and the study of the context will be necessary in the process of determining the relevant factors to use in splitting results.

Depending on the facts and circumstances of the case, the factor can be a figure (based on evidence of a similar split achieved between independent parties in comparable transactions) or variable:

(a) based on assets or capital (operating assets, fixed assets (e.g. production assets, retail assets, IT assets), intangibles, capital employed);

(b) based on costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) often used where these capture the relative contributions of the parties to the profits being split;

(c) based on others (factors that may be appropriate to the circumstances of the case like incremental sales, or employee headcount (relating to the individuals involved in the key functions that generate value to the transaction), or time spent by a certain group of employees if there is a strong correlation between the time spent and the creation of value represented by the relevant profits).

The entrepreneurial result is what needs to be split, thus the splitting factor should be such that better reflects the entrepreneur’s contribution to the value creation. In this sense, assets or capital employed would in principle be the most relevant and direct variable to split the results under a profit split analysis.

However its usage is not exempt of certain comparability adjustments that must be performed to get a consistent result, such as the appropriate weighting of its maturity (i.e. period between the investment execution and the value creation) and its economic lifetime have to be considered (i.e. time during which the investment may create value). When assets or capital are the factors to be used the following issues need to be taken into account for the correct application of this methodology:

(1) Currency: to perform the distribution of results based on the assets utilized, it is necessary that those assets are expressed in a homogeneous currency and that they are essential to the transaction. Undoubtedly, currency exchange variations could provoke visible effects when expressing assets in a homogenous currency and therefore have impact on the allocation of results. When important currency exchange variations occur over time, it is advisable to calculate carefully currency exchange conversions.

(2) Accounting: ideally, accounting standards (related to valuation criteria) used by the parties involved in the transaction should be consistent. In case they are not, an analysis should be made to determine if different accounting standards are generating an undervaluation or overvaluation of the assets and ultimately having an impact on the asset-based allocation.

(3) Inflation: in countries with high inflation, not updating the value of the long term assets (i.e. property, plant and equipment) and capital could distort the profit splitting factor.
Period: age of the assets involved could have an impact on the asset-based distribution. If two similar assets that are vital to value creation are owned by two different companies, their valuation and age should be analyzed. A fully depreciated asset can have an impact on the asset based distribution that may differ from the impact that a new asset may have.

Intangibles: the application of a profit split method and the intangible property are interrelated. It is usually applied in certain transactions where value creation is based on intangible assets (i.e. a company possesses certain knowledge regarding wheat production, while another company owns certain technology in relation with drought resistance; and these companies associate to develop drought-resistant wheat). Additionally it is usual that, according to international accounting standards, self-developed intangible assets are not registered according to their market value, unless they have been acquired or specifically valuated. Accordingly, a significant effort is required when determining a proper value for an important intangible asset. Otherwise, the result of the transaction on the whole could be distributed inadequately, without considering the correct contribution made by each participant with relation to its intangible assets.

After having spoken about the assets or capital employed, now we will discuss other splitting factors that might be used as proxy to splitting entrepreneurial profit.

As regards the use of headcount of similarly skilled and competent employees, it may be a good profit splitting factor provided that the value creation derives mostly from the activities of such employees (and the entrepreneurial contribution to the value creation is to put in place an assembled workforce of highly skilled employees).

Nevertheless, it is worth noting that for such variable to be a good splitting factor, it is necessary that the employees in the different entities perform similar functions at the same level of the value chain creation (as opposed to entities that perform activities at different stages of the value creation that is successively linked to each other) and the mix of skills within each entity must be somehow homogenized (e.g. attributing to the different categories of employees a different weighting factor, so as to have for each entity an equivalent number of employees of a certain category).

On the other hand, the use of variable compensation as a splitting factor may derive inconsistent results if is not properly used. Since labor and capital compensation have different fundamentals, the use of labor as a proxy to attribute results for the capital will yield, under certain circumstances, inconsistent results.

Variable compensation could be a good proxy to compensate the entrepreneurial activity when operating results are positive and the value creation is derived from skilled staff that receives such variable compensation (the higher the variable compensation, the more the entrepreneurial entity that engages in such would receive). Nevertheless, this will not be true when due to the risks assumed by the entrepreneur, the operating results turn negative. Since labor laws generally prohibit wages to be negative, there will be an asymmetry between capital and labor. While competent staff that performed the best will receive positive variable compensation, those that did not perform that well will not receive less than zero. Thus, when splitting the results through a weighting of variable compensation the entities that contributed the most to reduce the losses (those whose staff received the higher variable compensation) will be attributed the greater portion of losses. A way to mitigate this bias could be to use the reciprocal (1/x) of the weighting factors, profit splitting factors when it is a loss split instead of a profit split.
In this case, since labor compensation will be used as a proxy to split entrepreneurial results, comparability adjustment should be carried out to homogenize the variable compensation (e.g. purchasing power, labor and social security costs, etc.) and to avoid transferring such differences specific to the labor market to the entrepreneurs’ results.

Finally we would like to thank the OECD again for this opportunity to comment on this matter; and we would be happy to expand on these points and contribute further information at later stages of this review, if required. Should you have any inquires or doubts, please do not hesitate to contact us at the e-mail addresses below.

Sincerely,

Guillermo O. Teijeiro. AAEF President.

Cecilia Goldemberg. Transfer Pricing Working Group. cecilia.goldemberg@gshr.com.ar

José María Segura. Transfer Pricing Working Group. segurajosemaria@yahoo.com.ar

Julieta Firpo. Transfer Pricing Working Group. julieta.firpo@gshr.com.ar

Ariel Efraim. Transfer Pricing Working Group. aefraim@bdoargentina.com

Martín Simian. Transfer Pricing Working Group. martin.simian@gmail.com
14 September 2017

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

Dear Sir

FEEDBACK ON OECD DISCUSSION DRAFT DOCUMENT: BEPS ACTION 10 REVISED
GUIDANCE ON PROFIT SPLITS

The Association of Banks in Singapore (“ABS”) welcome the opportunity to comment on the BEPS Action 10 Revised Guidance on Profit Splits discussion draft published on 22 June 2017.

Background

ABS plays an active role in promoting and representing the interests of the banking community in Singapore and has a membership of 159 local and foreign banks/institutions and representative offices. ABS also works closely with the authorities in supporting their role in developing and maintaining a sound financial system in Singapore.

Established in 1973, ABS has over the past 40 years, brought its members together, establishing common grounds through benchmarking and setting banking guidelines as well as working on projects of mutual benefits to face the challenges of the financial and banking community in Singapore.

Comments

It is important that the application of the transactional profit split method as set out in the Guidance on Profit Splits provides workable guidelines without being too prescriptive and yet with adequate details and examples to minimize unnecessary disputes between tax administrators and taxpayers on such application.

In this regard, we provide our comments that are relevant to financial institutions as follows, organised in line with the specific questions raised.

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.

Existing guidance in the OECD TP Guidelines (2017 OECD TP Guidelines, Chapter II, Section C.3.3.1, Para 2.134) correctly points out that in practice, in arm’s length circumstances independent enterprises may have relied upon projections in splitting profits and could not have known the actual profit experience.

Taxpayers face similar restrictions when utilizing the profit split method in setting TP policies. Notwithstanding this, the use of actual profits may be appropriate in certain circumstances provided an unfair application of hindsight is not applied (given constraints in what is reasonably foreseeable).

In determining whether actual or anticipated profits should be used, we have identified 2 key factors for consideration, namely the availability of actual profits and the cost and practicality of implementation.
A. Availability of actual profits - There are times when actual profits are not available at the time transfer price is set because the profits are not realized at that point and anticipated profits (e.g. mark-to-market valuation based on acceptable model/technique is used to compute the anticipated profits at that point) should be allowed.

B. Cost and practicality of implementation - Anticipated profits may also be used where the measurement of actual profits can be very tedious and not practical to implement especially for highly integrated operations. Bearing in mind that being accurate should not be done at the expense of higher cost of compliance and greater burden to taxpayers, anticipated profit computed on a reasonable/supportable basis should also be allowed.

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.

Financial institutions are required to hold regulatory capital which has a direct linkage to the risks that they assume. Financial institutions are also expected to generate an acceptable return on the capital employed. It should also be noted that capital could extend beyond the share capital/common equity of a banking enterprise to also include Additional Tier 1 (AT1) and Tier 2 (T2) capital.

One of the reasons for the stringent capital requirement imposed on financial institutions is the possibility of incurring a loss (e.g. loan losses or trading loss) and the ability to absorb such losses. Hence, capital plays a very important and direct role in the financial institutions’ ability to generate profit and for this reason, capital should be retained as a possible profit splitting factor.

In addition, particularly for financial institutions with regulated capital requirements, consideration should also be given to the potential role of capital in the application of a residual analysis.

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 of similarly skilled and competent employees should be included as a potential profit splitting factor as there could be situations where it would be impractical or impossible to obtain employee compensation of all the employees.

In certain situations, the compensation of some employees remain highly confidential and cannot be released by the HR function. Furthermore, when making comparisons of employee compensation across countries, differences in country compensation and purchasing power need to be taken into account. Determining the appropriate mechanism for purchasing power parity adjustment is subjective and therefore the undue application of such an adjustment may not always be appropriate (depending on the availability of objective data).

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?

Adjustments for purchasing power parity can be made in circumstances where various parts of the enterprise based in different locations are highly integrated with significant
related party transactions. A high degree of cross border service charges for routine functions would expose the location to the price levels of other locations. Without an appropriate adjustment for the profits, it could result in a location generating super or sub normal profits in the long term as the costs and profits are at different price levels.

However, the determination of a purchasing power parity rate is itself a subjective process. Furthermore, trying to determine the extent of cross border related party transactions that would result in an impact that necessitates a purchasing power parity adjustment for profit splitting factors, would increase the degree of subjectivity introduced into the profit split calculation that might not necessarily guarantee a more accurate outcome.

The appropriate application of purchasing power parity adjustments should therefore be situational, depending on the specific facts and circumstances, as well as the availability of non-subjective measures for parity adjustment.

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

No additional factors are proposed at present.

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.

From a financial institution perspective, the following examples are proposed as being appropriate for the application of the profit split method:

Example 1 – Corporate finance / transactions type activities

Company A and Company B are located in Country A and Country B respectively, and are part of a MNE group that provides financial services to unrelated parties. Both companies are regulated by their respective country regulators and are licensed to provide the financial services relevant to the transaction.

Company A and Company B both employ appropriately skilled and licensed staff to provide corporate finance and advisory services to clients. Such activities are wide ranging and include such categories as equity and debt capital markets activities, and buy-side / sell-side advisory. Depending on the fact pattern, there may be involvement of teams employed by both Company A and Company B in relation to specific transactions.

Given the integrated nature of the activities which will be performed by Company A and Company B in relation to such transactions, a contribution analysis can be applied to ascertain their relative value contributed. The transactional profit split method is therefore found to be the most appropriate method for determining the appropriate transfer pricing between Company A and Company B for such a transaction.

Taking into consideration the types of income and fees which may be earned by the MNE group for such activities, certain elements may facilitate the application of a residual analysis. This situation arises where either the fees can be directly attributed to the activities of one of the companies, or where such fees are inherently arm's length in nature (can be linked to actual client payments or agreements with third parties).

Example 2 – Interactions between trading / sales desks

Company A and Company B are located in Country A and Country B respectively, and are part of a MNE group that provides financial services to unrelated parties. Both companies are regulated by their respective country regulators and are licensed to provide the financial services relevant to the transaction.
For the transaction in question, Company A employs appropriately skilled and licensed staff to structure, credit/risk manage, and execute transactions (“Trading”) on the relevant exchange / secondary market. Furthermore, Company A also has the relevant systems and maintains the appropriate level of supporting and operational staff to support the Trading activity. Company B employs appropriately skilled and licensed staff to manage relationships with clients, and sell and originate deals to clients (“Sales”). Company B does not act in a Trading role in relation to this transaction.

Given the interconnectedness of the Sales and Trading activities to the overall value chain, it is difficult to entirely address the contribution of each without an assessment of the whole. Comparables for such Sales activities are available, but consideration needs to be given for adjustments given the unique variations which may exist on a case-by-case basis. Under these circumstances, the transactional profit split method is found to be the most appropriate method for determining the profits of Company A and Company B as their operations are highly integrated and interdependent.

In determining the profit base upon which such a split should be premised, it must be acknowledged that the actual profit may not be available at the point such a trade is executed. Therefore, it may be appropriate to apply a measure of anticipated profit, taking into account relevant tax and financial accounting standards.

**Example 3 – Interaction between booking/origination**

Company A and Company B are located in Country A and Country B respectively, and are part of a MNE group that provides financial services to unrelated parties. Both companies are regulated by their respective country regulators and are licensed to provide the financial services relevant to the transaction.

As banks are subject to lending and other regulatory limits within the jurisdictions they operate, it is possible that banks may not be able to book the loans in their books if they exceed the permissible limits allowed or transact in currencies prohibited by their respective regulators.

Company A has the relationship managers to manage relationships with clients, and originate deals to clients as well as assess credit-worthiness of clients and manage on-going risk assessment. Company B funds the loans to the clients originated by Company A, assumes significant risks (e.g. default risk, market risk, liquidity risk) and administers the loans.

Given the interconnectedness of the originating, risk management and funding activities to the overall value chain, it is difficult to address the contribution of each without an assessment of the whole. Comparables for origination and loan administration activities are available but not for the rest of the activities which are highly integrated and interdependent.

Under these circumstances, the transactional profit split method is found to be the most appropriate method as the operations of Company A and Company B are highly integrated and interdependent.

We trust that the above comments are useful and will be taken into account in the finalization of the Guidance on Profit Splits. Thank you.

Yours sincerely,

Mrs Ong-Ang Ai Boon
Director
Tax Treaties, Transfer Pricing and Financial Transactions Division  
Organisation for Economic Cooperation and Development  
2 rue André-Pascal  
75775, Paris, Cedex 16  
France

By email to: TransferPricing@oecd.org

15 September 2017

OECD Discussion Draft under BEPS Action 10: Revised Guidance on Profit Splits

We welcome the opportunity to comment on this discussion draft and are pleased to provide our comments below.

We acknowledge the importance of this topic and the requirement for guidance that provides a degree of certainty for taxpayers and tax administrations, however, we have a general concern that the guidance does not emphasize the key concept that profit splits should be used only in very limited circumstances and where the considered transaction is one that would be subject to a similar methodology between unrelated parties. We believe that this lack of emphasis could lead to tax administrations seeking to apply a profit split method more often than is necessary and where other traditional transfer pricing methods are more appropriate. We therefore suggest some reiteration throughout the guidance that its purpose is simply to provide clarification as to the application of the profit split method and not to promote its application.

We feel that the guidance does not cover to a sufficient extent the significant challenges associated with the practical application of a profit split method. A number of paragraphs are dedicated to explaining the strengths of a profit split method in detail, whereas the weaknesses (covered only by paragraph 10) are considerably understated in comparison. The guidance should provide the same level of detail to both the strengths and the weaknesses of the method to avoid unsuitable use of a profit split method by a tax administration. For example, a further weakness that could be included, in the pharmaceutical context, is with regard to differences in the timing of expenditure incurred - R&D costs which are relevant for one party could have been incurred several years in the past whereas expenditure for the other party may be current. Accordingly, in addition to bringing historic costs to current values, consideration must be given to enabling those historic costs to be given a greater weighting to reflect the fact that the risk of failure at the early stages is much greater than at the later stage.

We strongly disagree with the apparent limitation of the arm's length principle in paragraph 11 and suggest the removal of the wording which states that “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.” In our view, a profit split method should
not be applied in situations where a one-sided method can provide a reliable result and therefore, the 'most appropriate method' approach, under the arm's length principle, should be maintained.

We agree with the comments at paragraph 14 in that where one party performs only routine functions, does not assume economically significant risks and does not make unique and valuable contributions then a transactional profit split method would not be appropriate. The draft briefly refers to contract manufacturing or contract service organisations as relevant examples. This could be further expanded to include an example from the pharmaceutical sector of a contract research organization that is engaged to perform R&D activities for a pharmaceutical MNE group.

It is noted that the guidance provides that the existence of "...unique and valuable contributions by each party..." is a clear indicator of the appropriateness of a profit split method. However, this should not be confused with the making of unique and valuable contributions at different stages of the value chain. For example, in the pharmaceutical industry, intangibles created at the research and development and strategic marketing stages of a product life cycle are separate and created several years apart. In such a scenario where the different parties contributed a different intangible at different stages, there is not necessarily the same integration of risks to indicate that a profit split is appropriate.

The guidance should also be clear that, where a taxpayer does not use a profit split method, then it is highly likely that it will be considerably difficult to create, after the event, the level of detailed analysis that would be required to support the outcome of a profit split method. Tax administrations should be advised that, in such circumstances, an accurate estimation of profit is very unlikely. This is of particular relevance to the pharmaceutical industry given the long time horizons for development and commercialisation of a pharmaceutical product; R&D costs that are crucial to the value of a party's contributions to a product may have been incurred more than 10 years before that product becomes profitable, and at a more significant value than current R&D spend on that product. The lack of availability of historic cost data therefore could result in an inaccurate, overstated profit that has never been commercially realised.

Furthermore, consideration needs to be given as to how to share the R&D costs relating to failures and how to determine the probabilities of success on a larger pool of R&D spend. This also needs to reflect the fact that not all products are launched in all countries or at the same time. It is estimated on a macro level that only 7% of drugs entering pre-clinical development are expected to achieve approval and only 20% of new medicines earn enough revenue during their patented product life to cover the average development cost. Accordingly, historical data must be risk-adjusted to reflect industry factors and where applicable also company specific factors. It is clear that it would be administratively burdensome, if at all possible, and also very costly from a compliance perspective for MNE groups to gather the required detailed information for a large number of years, particularly so in the pharmaceutical sector when over 90% of the data would never otherwise be used due to the high rate of failure of compounds in development. Furthermore, to process such complex and detailed data might not be possible without major investments in system support.

We consider that the use of the profit split method will likely result in an additional risk of double taxation (or even worse) as competing jurisdictions use their own interpretations of the guidance to maximise their respective tax revenues. Consequently, this creates a high level of uncertainty for taxpayers. There may be difficulties in obtaining corresponding adjustments due to differing statutes of limitation and differing domestic rules relating to closed tax years. Whilst it is noted the Final BEPS Report for Action 14 describes a minimum standard on dispute resolution which is intended to help alleviate such problems, this does not require mandatory mutual agreement procedure arbitration and so corresponding relief would not be guaranteed. Application for bilateral and
multilateral APAs will become necessary, which would result in a significantly increased administrative burden for both taxpayers and tax administrations.

In addition to the more general comments made above, we have made specific comments on the examples below:

It would be helpful to add some further illustrative examples including when a profit split method should not be regarded as the most appropriate method for transactions – currently only 2 out of the 10 examples provide this.

Furthermore, it would be useful if some numerical examples could be included to include explanations on, for example, how profits should be split, apportionment of costs, weighting of historic costs, bringing historic costs to current values etc. In our view, without clear practical guidance in this area there is an obvious risk that tax administrations could seek to justify a variety of "homemade" transfer pricing approaches, based on their own interpretations of the guidance.

Example 1 describes the scenario of a MNE group in the pharmaceutical sector whereby Company A carries out, amongst other things, early stage R&D which contributes to it owning a patent. Company A then licenses the patent rights to Company S who then carries out the later development to bring the product to market where it is globally successful. The guidance concludes that a profit split method is likely to be the most appropriate for determining profits of Company A and Company S but the rationale behind this conclusion is not clear and, in our view, is incorrect. If the scenario was instead a license of patent rights between two third parties, the Licensor would receive a potential stream of payments – upfront, development milestones, regulatory milestones, sales milestones or royalties – from the Licensee, based on the future success of the product to reflect the risk profile of a typical pharmaceutical product. In our experience, the two third parties would not agree a profit split approach under such an arrangement and so this conclusion should not be reached in an intra-group situation. Paragraph 15 highlights the relevance of considering industry practices and states that "...if independent parties engaged in comparable transactions are found to make use of other pricing methods, this should also be taken into account in determining the most appropriate pricing method." We think that the examples should be consistent with the guidance, and therefore recommend this example is removed as there is a risk that tax administrations could erroneously consider it to be a ‘typical’ scenario for the pharmaceutical sector and seek to reference it when applying a profit split method as a default across the sector as a whole.

We would suggest the following example is included instead as this is more reflective of a typical pharmaceutical scenario:

Company A and Company S are members of an MNE group in the pharmaceutical sector. Company A performs the R&D functions over a period of 10+ years leading to the granting of a patent, is responsible for the design, development, manufacturing, strategic marketing and global distribution of the products. Company B undertakes local marketing and distribution of the products.

Furthermore, Company A determines the strategic direction of the group; target therapy areas, R&D resource and clinical trial design. Company A undertakes pharmaceutical development to scale up for global market launch, and uses its knowledge and expertise to design and implement the global marketing strategy.

Company B implements the global marketing strategy (designed by Company A) in the local market under the direction and instruction of Company A, and distributes products to the local market. Company B's contribution is relatively routine in nature and Company B does not possess any valuable intangible assets.
The functional analysis concludes that the economically significant risks in relation to the transaction relate to the R&D, manufacturing, marketing and distribution of the products. It is determined that Company A assumes all these risks and Company B assumes risks relating to local marketing and distribution only. Given the risks assumed by Company B are not economically significant the transactional profit split method will not be the most appropriate method as it is likely that the appropriate return to company B can be determined using a one-sided method e.g. TNMM with local benchmarks.

We trust the above provides useful input into the discussion draft. Please do not hesitate to contact me if you would like any clarification of the comments made.

Yours faithfully

Alistair Collins
VP Corporate Finance
Via e-mail: TransferPricing@oecd.org

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

15 September 2017

Dear Sirs

DISCUSSION DRAFT ON THE REVISED GUIDANCE ON PROFIT SPLITS

BDO welcomes the opportunity to comment on the OECD’s Public Discussion Draft on the Revised Guidance on Profit Splits issued on 22 June 2017 (‘the Discussion Draft’).

We support the OECD’s efforts to develop rules to achieve effective guidance on the application of profit split methods. We believe this will be helpful to address situations where other methods do not appropriately reflect the highly integrated operations conducted by multinational enterprises. We appreciate the consideration the OECD has given from the previous round of consultation on this matter.

We recognise that the use of the profit split method can increase the reliability of transfer pricing outcomes and result in transfer pricing which more closely aligns to commercial reality. It is also important to weigh the practicalities and administrative costs for businesses in implementing transactional profit split methods. We present below our comments and responses to questions posed in the Discussion Draft. To prevent repetition we have set these out thematically.

1. Profit split of anticipated or actual profits

Paragraph 6 et seq of C.2.1 of the Discussion Draft addresses the fact that the main strength of the transactional PSM is that it can offer a solution for cases where both parties to a transaction make ‘unique and valuable’ contributions (giving the example of ‘valuable’ intangible) to the transaction. There may, however, be circumstances where the application of the PSM may equally be appropriate where contributions are made by parties that are not necessarily ‘unique and valuable’ per se (and certainly where there are no particular ‘valuable’ intangibles that are being contributed) but the combination of contributions made (whether services, particular attributes etc) by the parties concerned are such that the business outcomes of that combination are greater than the ‘sum of the parts’ and of themselves generate new attributes/intangibles. The guidance should explicitly recognise this.
We appreciate that paragraph 46 of the Discussion Draft highlights that in general only information known or reasonably foreseeable by the associated enterprises at the time a transaction was entered into should be taken into account.

We still hold the view expressed in our comments of 5 September 2016 on the Revised Guidance on Profit Splits issued on 4 July 2016 (cf. pg. 17 (18) of the Comments Received on Public Discussion Draft BEPS Action 8-10 Revised Guidance on Profit Splits Part I of 8 September 2016) that in practice as far as ongoing relationships are concerned the profit split based on anticipated profits and the profit split based on actual profits appear more akin to two stages of a single method. In such situations of ongoing contributions by both parties and sharing in the assumption of the economically significant risks one would assume that unrelated parties as a rule include a price adjustment clause in the underlying agreement.

Any profit split which relies on anticipated profits will be vulnerable to the robustness of the forecasting and budgeting process of the particular enterprise. Significant variances of actuals versus budget need to be assessed. It is likely in a third party arrangement some contractual provision or contingency will exist to deal with significant differences between budget and actuals. Blind application of an anticipated profits approach could give rise to an unrealistic economic outcome.

To reflect arm’s length circumstances, Tax Authorities should be encouraged to review the appropriateness and reasonableness of the underlying assumptions and the determination process of the pricing of the transaction at the time it was entered into using the valuation techniques described in Chapter VI of the OECD Guidelines (a hypothetical arm’s length price). This would involve accepting and then considering the premise of how the pricing has been set, and not simply applying expectations by default (for example by expecting actual rather than anticipated profit to be used). Hence, from our point of view it would be favourable to add some wording in paragraph 45 of the Discussion Draft to guide Tax Authorities in this regard.

2. Profit splitting factors

Profit splitting factors are elaborated on in paragraphs 54 ff. of the Discussion Draft.

a) Loss years and use of multiple factors

The discussion draft makes clear that similar factors should be applied to both profits and losses. Particular consideration should be given to the appropriateness of an allocation factor to loss making years. This can assist in determining the appropriateness of an allocation factor and the degree to which that factor is a good indicator of profit.

The use of staff cost as a single allocation factor could give rise to anomalous results in loss years. For instance if staff receive any performance based remuneration allocating more losses to the location with the highest staff costs may not reflect the contributions of each related party.

To help eliminate or reduce the risk of anomalous allocations consideration should be given to the use of multiple allocation factors. For instance staff costs could be used combined with sales volume/transaction count.
b) Capital and capital employed
The objective of the application of any transfer pricing method is to ensure that profits of the associated enterprises are appropriately aligned with the value of their contributions. If the main contribution in a transaction is the provision of capital, the relevant capital attributable to the transaction (taking into account the facts and circumstances pertinent to that capital) might be an appropriate profit split factor. The use of capital-based profit splitting factors, such as capital employed, may be recommended when the parties undertake capital-intensive financial activities (e.g., leasing companies, banks, etc.).

c) Headcount of similarly skilled and competent employees
Headcount may be considered to be an appropriate profit splitting factor when employees are involved in the value creation activities and their contributions create the competitive advantage for the enterprise, e.g. where company A and company B both develop the same intangible (or different elements of the same intangible) for future commercialisation (and the relative value of the contributions of the employees involved can be reasonably evaluated and delineated). Care will be needed around the functional analysis to determine comparable levels of expertise and contributions to value creation, which may require some subjective judgement (e.g., routine contributions vs. unique and valuable contributions). Similarly, as set out in paragraph 56 of the Discussion Draft, costs may also be a helpful profit splitting factor but, again, it is important in our view to emphasise that staff costs will not always accurately reflect a suitable comparative measure of contribution to the particular transaction which may be subject to profit split and that this requires appropriate evaluation of where value is created by such staff, e.g. salaries of senior management team where the management team is split across two entities and the operations are highly integrated.

d) Adjustments for purchasing power parity
Adjustments for purchasing power parity may be appropriate, particularly where cost is used as a determining factor for a profit split. However it can be an involved process to determine relative market pricing levels with specificity. As such, while we support the inclusion of purchasing power parity as an option, its application should be restricted to cases of clear relevance to the facts and circumstances of the transaction.

e) Others
In many cases an asset or a cost based profit split factor seems to bring reasonable results. However, there are cases in which the key contribution does not align the profit share with the value of a contribution. In such cases a weighted function and risk analysis or a weighted contribution analysis could still be considered. If the relative importance of key management roles is a key factor of adding value to a business, RACI-style considerations may be useful. However, this analysis may contain a high degree of subjectivity and therefore it should be used where assets or costs based profit splitting factors cannot be used.
3. Additional examples

The OECD may want to consider to add an additional example for profit splits that is similar to Example 5 of the Discussion Draft where one group entity (Company A in country A) developed a software product, e.g. in the life insurance sector, for use in country A and allowed another group entity (Company B in country B) to distribute and modify it for the use in country B against a royalty. Company B keeps on modifying the software for use in another business segment, e.g. medical insurance, and distributes it in country B. Company A continues developing the underlying base technology and Company B utilises these developments in the modified software it distributes.

In this example Company A is not sharing in the assumption of the economically significant risks from the sale of the product in country B and, thus, following the logic expressed in paragraph 45 of the Discussion Draft, this example may from our point of view also serve as an example for a profit split based on anticipated profits.

Concluding remarks

We support the OECD’s efforts to provide clarity on the application of the transactional profit split method.

The Discussion Draft provides helpful principles in support of the use and application of the transactional profit split. We appreciate the examples provided for illustration purposes in the revised draft. We have set out some suggestions above how these may be revised to add greater specificity.

From a taxpayer’s point of view, it is important that both documentation requirements and the selection and application of the transfer pricing methodology employed are appropriate as regards the amount of work involved and its cost to the business.

We would like to thank the OECD again for this opportunity to comment and would be happy to expand on our responses and contribute to further stages of this discussion draft if required.

Please note that the responses presented above reflect the opinions of the authors and not necessarily the opinions of BDO as a whole. For clarification of any aspect of our responses presented above please contact:

Zara Ritchie  
Partner, BDO Australia  
Head of Global Transfer Pricing Services  
zara.ritchie@bdo.com.au  
+61 3 9605 8019

Richard Wellmann  
Senior Manager, BDO Germany  
richard.wellmann@bdo.de  
+49 69 95941 263

Dr. Dirk Elbert  
Partner, BDO Germany  
dirk.elbert@bdo.de  
+49 69 95941 263

Duncan Nott  
Director, BDO UK  
duncan.nott@bdo.co.uk  
+44 20 7893 3389

Anton Hume  
Partner, BDO UK  
anton.hume@bdo.co.uk  
+44 20 7893 3920

Ben Henton  
Director, BDO UK  
ben.henton@bdo.co.uk  
+44 20 7034 5820
Comments on the Public Discussion Draft on
REVISED GUIDANCE ON PROFIT SPLITS

These comments have been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Jeffery Kadet, with contributions and comments from Tommaso Faccio, Sol Picciotto and Cristián Garate.

We appreciate the opportunity to provide these comments, and are happy for them to be published. We would also be willing to speak at the public consultation in November.

September 2017

GENERAL REMARKS

This discussion draft (DD) offers a rewrite of Section C in Part III of Chapter II of the Transfer Pricing Guidelines. Such a rewrite is overdue, as there has not been a comprehensive re-examination of the profit-split method (PSM) since it was included in the Guidelines in 1995.

This DD is written in a much clearer way than the existing section and we welcome the effort that has been made. However, we regret that the opportunity has not been taken to develop and extend the PSM to make it easier to use. In our view this would be the most effective way forward to achieving the central mandate of the BEPS project, to ensure that multinationals are taxed ‘where economic activities occur and value is created’. In these comments we provide a specific approach that would allow easy use for tax authorities and taxpayers alike. The principal reason for this is that solely objective factors (e.g. personnel, assets, etc.) are used to apportion profits. This approach would ignore internal group-controlled and tax-motivated arrangements such as intercompany contractual terms. It would also dispense with the need for subjective value judgments, greatly reducing the potential for conflict and uncertainty.
It is evident from this DD that there remain deep divergences both among OECD member states as well as the much wider group now participating in the BEPS process through the Inclusive Framework, on how this can be done. Hence, we are grateful for this opportunity to restate and amplify some of our earlier suggestions, as well as adding some new ones, which we hope will contribute to the wider debate that is clearly still necessary.

SPECIFIC COMMENTS

1. Inappropriate Focus on Risk Rather Than on What Creates Value

The mandate for the BEPS project was to align profit with value creation. Focusing on an MNE and its operations, the factors that create value are assets, personnel, and activities. Business and commercial benefits and risks are of course inherent to the entire business process. However, any assignment of risks to an MNE’s group members, even when focusing on the people who manage and control that risk or the entities that have the financial capability to undertake risk, will always be terribly subjective. Especially the financial capability to undertake risk, that is something that is fully controllable through internal (and often tax motivated) decisions and intercompany transactions. Even focusing on the people who manage and control risk can sometimes provide nonsensical results. For example, personnel in one location who make decisions concerning advertising spend in multiple jurisdictions should not create a highly weighted “risk” factor that warrants the recognition of significant profit within that location.

The power and benefit of the PSM as a fair approach to better align profits with value creation is the ability to apply profit shifting factors that are objective and not subject to MNE manipulation.

Despite this ability to focus on the objective, the Discussion Draft includes over 80 uses of the word “risk”. We understand that some of the focus on “risk” is to identify where a situation might call for application of the PSM. However, we recommend that this over-weighted focus and attention on “risk” be reassessed so that more attention can be paid to objective factors that reflect integrated operations for which the PSM will be appropriate. Paying more attention to such objective factors that are not subject to MNE manipulation will strengthen the PSM.

2. Time for Practical Approach for Common Business Models

Section C.3, paragraph 31 on Guidance for Application appropriately notes:

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

Paragraph 51 includes:

…It is therefore not desirable to establish a prescriptive list of criteria or allocation keys. …

We of course agree that applying the facts and circumstances of each taxpayer situation will provide the “best” and most “correct” answer. It must be accepted, however, that the application of any transfer pricing method, including even the comparable uncontrolled price method, is simply an estimate. Each application of any transfer pricing method will involve significant subjective judgments that will materially affect the outcome. These subjectively determined outcomes will often be a range of possible pricing.

Despite the individual and factual nature of functional and other transfer pricing analyses, the inherently subjective application and the ranges of estimated outcomes means that this is, at best, an inexact science. Labeling it an “art” is probably more accurate. When the amount of
time and effort that taxpayers and under-resourced tax authorities must expend to deal with
transfer pricing is considered along with the estimated range of outcomes, it is high time to
accept a practical balance between theoretical correctness and practicality for certain
commonly used business models. Unless practical approaches are developed and
implemented for such models, there will be little or no meaningful reduction in BEPS
motivated structuring attributable to tax authority efforts.

We are not suggesting that the profit split method with concrete allocation keys and
weightings should be used for all situations, or even necessarily a majority of situations.
Rather, we believe that a significant number of MNEs operate through a limited number of
sufficiently similar business models. For these models, the Working Group, along with other
interested groups (e.g. the Committee of Experts, the OECD Forum on Tax Administration,
etc.), could after some study arrive at concrete allocation keys and weightings. Guidance
would also be provided for each model on the use of operating profits or gross profits and
other issues of application such as application of the contribution analysis or residual
analysis. Such keys, weightings, and other guidance would create easy-to-determine transfer
pricing results that are both reasonable estimates and fair to taxpayers and tax authorities
alike. They will achieve a reliable approximation of the division of profits that would have
been agreed between independent parties.

Several factors demonstrate in a compelling fashion that it is now time to provide taxpayers
and tax authorities with a convenient and low-resource consuming approach under the PSM
to determine transfer pricing or assess the acceptableness of transfer pricing used. One is the
serious disadvantage of relevant tax authorities in knowledge of an MNE, its actual
operations, and its industry. Another is the reality of the pervasiveness amongst MNEs of
BEPS structures including aggressive transfer pricing. MNEs have full freedom, and they
exercise that freedom liberally, to create from a blank page whatever structure of multiple
entities and intercompany agreements will best minimize their tax obligations by separating
the creation of value from the recording of revenues and profits. A further factor is the stark
mismatch of the resources available to tax authorities versus those available to taxpayers.
There is no level playing field.

If the Working Party wishes to make a real difference, then it must consider approaches that
will make the application of the PSM a practical reality.

The BEPS Monitoring Group has consistently suggested the creation of concrete allocation
keys and weightings that would be applied to common business models. It is time to take up
this approach by identifying those common business models and deciding upon the keys and
weightings. While the Working Party may choose to apply the “residual analysis” (Section
C.3.1.2) to some common business models, we recommend that the “contribution analysis”
(Section C.3.1.1) be applied to keep the process as simple and straightforward as possible.
Once allocation keys and weightings have been created, the TPG should provide that such
keys and weightings would apply except in those limited cases where a taxpayer is able to
establish to the satisfaction of the relevant tax authority that modifications are warranted to
the keys and/or weightings.

For the convenience of the reader, we have included as Appendix B an article that describes
this practical approach and includes details with specific examples. This article, “Expansion
of the Profit-Split Method: The Wave of the Future”, dated 30 March 2015, was published in
Tax Notes International (77 TI 1183). It is also available at:

3. Use of the Profit Split Method in Determining Profits of a Permanent Establishment
In some instances, where a non-resident enterprise maintains a permanent establishment (PE) in a host country, whether through its own personnel or through a dependent agent PE, the most appropriate approach to determining the profit attributable to that PE will be through the PSM. See our separate comments also of September 2017 on the 22 June 2017 discussion draft on profits attributable to PEs. It explains economically why in certain situations the profit split method will often be the most appropriate transfer pricing method for determining the profits of a PE.

Paragraph 14 provides, in part:

…Where the accurate delineation of the transaction determines that one party to the transaction performs only simple functions, does not assume economically significant risks in relation to the transaction and does not otherwise make any contribution which is unique and valuable (e.g. contract manufacturing or contract service activities in relevant circumstances), a transactional profit split method typically would not be appropriate since a share of profits (which may be impacted by the playing out of the economically significant risks) would be unlikely to represent an arm’s length outcome for such contributions or risk assumption. …

We of course agree this this is clear and appropriate guidance. Say, however, that the activities of a related party (ServiceCo) that conducts contract service activities causes a permanent establishment of the other party (SalesCo or WebAdvertisingCo) to exist in the host country under the newly expanded Article 5 permanent establishment rules. While this guidance that the PSM will not likely be appropriate for determining the profits of ServiceCo, the PSM may well be the most appropriate basis for determining the profits of the permanent establishment under Article 7.

To provide details of why this may well be the case, we have included as Appendix A comments we made in an earlier submission made on 12 June 2015.

While we would prefer to see additional guidance in the text and perhaps the addition of an appropriate example, we suggest at a minimum that a footnote be added at the end of the above quoted sentence from paragraph 14. The footnote could read as follows:

Although the profit split method would be unlikely to represent an arm’s length outcome for the contract manufacturer or contract service provider, where the activities of that provider cause the other party to maintain a permanent establishment under Article 5, then the profit split method may provide the most appropriate method to apply as a basis for determining the profits of the permanent establishment.

4. Comparables vs PSM

Paragraph 14 of the current DD states:

An appropriate method using uncontrolled transactions that are comparable, but not identical to the controlled transactions is likely to be more reliable than an inappropriate use of the transactional profit split method. [Emphasis added.]

The Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses published by the Platform for Collaboration on Tax in June 2017 identifies the lack of appropriate data on comparables as one of the of key challenges in conducting comparability analyses by tax administrations.

Developing countries in particular face problems of a lack of data, the often low quality of the limited data that is available, and the need for imprecise and subjective comparability
adjustments. The Toolkit reports that for more than 164 countries in 2013 there was not sufficient comparable data. This is a key flaw in the use of any method that utilizes comparables as the basis to allocate profits to an associated enterprise. The problem is not just a lack of data; rather it is because true comparables generally do not exist. This is due to the real competitive advantages enjoyed by MNEs resulting from their economies of scale and their operational integration and the synergies that result therefrom.

There is simply no evidence available to support an argument that using uncontrolled transactions that are comparable, but not identical to the controlled transactions, is likely to be more reliable than a use of the transactional profit split method. We recommend that the above paragraph be removed.

Furthermore, where there is a lack of information on close comparables, we recommend that the PSM also be used to corroborate the results of the comparables analysis. When applying both methods results in significantly different outcomes, we recommend that the difference should be reconciled.

5. Applicability of Profit Split Method to Modern Business Models

The introductory comments to the discussion draft includes:

… The discussion of the transactional profit split method in this discussion draft should not be taken to imply any change to this wider framework [of the Transfer Pricing Guidelines as amended by the October 2015 Final Report and subsequent developments].

We of course agree that defining the appropriate situations where the PSM should apply and providing guidance for applying the method must be made within the “wider framework” of the TPG. Without questioning this wider framework at all, though, it must be said that the environment of MNEs and how they operate has significantly changed over the past several decades.

Reality today is that there are many situations where none of the other methods can be practically applied. Or, where other methods are applied, the transfer pricing results are not only very subjectively determined, but they typically include wide ranges of outcomes that simply encourage additional taxpayer/tax authority disputes. Some applications of transfer pricing structures have been used by MNEs to buttress their profit shifting structures.

Paragraph 7 reads:

The transactional profit split method can also provide a solution for highly integrated operations in cases for which a one-sided method would not be appropriate. See section C.2.2.2, below.

We agree that Example 6, which concerns a contract manufacturer that is operating with no unique or valuable contribution of its own at the direction of its related party, may well be a situation where a one-sided transfer pricing method may be appropriate. However, many modern business model situations, especially where the core functions are marketing and customer support, local warehousing and delivery, etc. are such that a one-sided transfer pricing method is inappropriate. Placing operations in locations close to customers and conducting those operations within the MNE’s integrated and proprietary business model are critical to the group’s worldwide and local success. The group has invested in a worldwide business that crucially requires certain local and regional activities to make the model work. Where this is the case, a one-sided transfer pricing method is simply not appropriate. The discussion in paragraphs 25 and 26 concerning shared assumption of economically significant
risks and separate assumption of closely related risks strongly support this. See further
discussion in Appendix A.

We applaud this clear recognition expressed in Paragraph 7 that some MNEs can and do
operate in such an integrated manner. As explained in the below section “Comments on
Examples – Examples 3 and 4”, we recommend that at least one example be added to this
guidance that will make clear that “highly integrated operations” may include BEPS
motivated structures as applied to modern business models such as supply chain structures.

6. Sympathy for Purported Computational Difficulties

Paragraph 10 provides, in part:

... However, associated enterprises and tax administrations alike may have difficulty
accessing information from foreign affiliates. In addition, it may be difficult to
measure the relevant revenue and costs for all the associated enterprises participating
in the controlled transactions, which could require stating books and records on a
common basis and making adjustments in accounting practices and currencies. …

Without suggesting at all that this is not an issue that must be realistically dealt with, this is
not an excuse that should ever dissuade a tax authority or taxpayer from choosing to apply the
PSM. Guidance should make this point clear.

While admittedly there are different accounting and tax rules and systems in various
countries, most MNEs have management and other accounting systems in place that will
provide the operating information that will allow reasonable calculations of combined
operating results and the objective factors on which an allocation will be made. Further, with
such a high percentage of MNEs creating complex structures specifically to further BEPS
objectives, there is little reason to be sympathetic to claims of computational difficulties.

7. Availability of Reliable Information (Section C.2.3)

Paragraph 28 provides, in part:

… 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. …

While we agree that this will sometimes be the case, the synergy and nature of many modern
business models involve core functions critical to the success of a group’s business model
being performed in specific local or regional locations and using the group’s integrated and
proprietary business processes. Where this is the case, certain functions may on the surface
appear to be ones for which reliable comparable uncontrolled transactions are available. Such
functions, though, clearly meet the criteria as set out in section C.2.2.2 regarding highly
integrated business operations.

With this being the case, we suggest that the following additional line be added immediately
after the above quoted sentence in paragraph 28:

On the other hand, it will still be possibly the most appropriate method when factors
set out in section C.2.2.2 are in evidence.

8. Profit Splitting Factors (Section C.5.1, Paragraph 57)

We recommend the inclusion of incremental savings alongside incremental sales as another
profit splitting factor that may be appropriate depending on the particular circumstances.

9. Comments on Examples
Example 1 – This pharmaceutical example is excellent. Given, though, the aggressive nature of many groups in this sector and the need for guidance to both tax authorities and taxpayers alike, we suggest adding the following paragraph at the end of this example. This additional paragraph covers ground similar to what was very effectively covered in Example 4 through its changing of certain facts provided in Example 3.

While this example assumes that Company S through its own resources does perform important functions that are unique and valuable in the creation of the group’s profits, tax authorities and taxpayers must be alert to factual situations where Company A has never relinquished its control over the process of bringing the new product through further development and regulatory approvals. In such cases, the functional analysis may indicate that Company S has not performed functions that were unique in the creation of those profits. Such a finding would affect the determination of the most appropriate pricing method.

Example 3 – There are cases where marketing and distribution activities create unique and valuable intangibles, e.g. customer lists, etc. We therefore suggest that the following sentence be added at the end of paragraph 80:

Company B also has developed and maintained a unique and valuable extensive customer list.

Examples 3 and 4 – These examples involve one group member conducting the design, development, and manufacturing of a product with another group member conducting the marketing and distribution. We applaud these examples.

While this format of group operations is common and deserves the attention given it, there is another format that should be directly dealt with in this PSM guidance.

Many MNEs transfer product and service-related IP to one or more related parties outside their home country. Such transferred IP may cover worldwide exploitation or it may relate only to sales and services provided to customers outside the MNE’s home country or geographic region. Such effective transfers occur in legal form through sales, licensing, and cost contribution agreements. Following the IP transfers, the group member transferees either manufacture on their own, or more commonly source their products through unrelated contract manufacturers, and then sell the manufactured products and/or provide services in their defined territory.

In such situations regarding products, on the surface, there are no intercompany sales of products to which transfer pricing will apply. However, a functional analysis would find that personnel of the IP transferor are conducting one coordinated product sourcing function on behalf of both itself and the IP transferee. There may be an intercompany service or similar agreement that reflects the performance by the IP transferor of these functions. This product sourcing function, which is critical to the operations of each of these group members, includes activities such as managing all relationships with contract manufacturers, negotiating all agreements with them, component suppliers and other vendors, working directly with contract manufacturers, suppliers, and vendors on all engineering and production details, deciding all raw material and component vendors, negotiating pricing, conducting quality control functions, deciding which contract manufacturers will produce which products, determining the quantities and timing of production to meet the group’s worldwide needs, etc. In many cases, the group member for which a manufactured product is destined will not be known until it is placed in a box by the contract manufacturer for shipment to the IP transferor, the IP transferee, or the customer of either of these two group members.
The above focuses on production of products. As for product sales, transferor personnel may be involved with the transferee’s more major customers as well as actually maintaining the online platforms through which the transferee records online sales of products into its geographic territory. For these latter sales, typically the transferee will conduct little or no sales activities of its own. Often its principal function in support of these online sales will involve making product deliveries from local or regional warehouses.

The IP transferor’s involvement in product sourcing and some sales represents far more than merely providing policy direction and guidance. This is adding critical value to the business of the transferee for functions that it has no ability to perform on its own. The point is that although there may be no intercompany product sales, many MNEs are conducting highly integrated and interdependent businesses, but are recording transactions in separate group members as if they were totally separate businesses with each operating its own supply chain. It would be very helpful for there to be an additional example that deals with this supply chain model actually used by so many MNEs.

We have prepared the following Example for you to consider for inclusion along with the other Annex 1 examples.

Example X

Company A and Company B are members of an MNE group that designs, manufactures (through group members and unrelated contract manufacturers), and sells certain products. Company A, the parent company resident in Country A, owns all intellectual property concerning the manufacture of products. To allow its subsidiary, Company B, which is located in a low-tax jurisdiction, to independently conduct the group’s business for sales outside Country A, Companies A and B have entered into a license agreement covering all IP necessary so as to allow Company B as licensee to either manufacture the products or have them manufactured by contract manufacturers.

The MNE manages and conducts this business from its headquarters in Country A. Although group members other than Companies A and B perform some of the manufacturing in their own production facilities, third-party contract manufacturers both within and outside Country A produce the bulk of the group’s products. In addition to R&D and product design, which occur within Country A, Company A personnel manage on behalf of both Companies A and B all relationships with the contract manufacturers, negotiate all agreements with them, work directly with them on all engineering and production details, decide all raw material and component vendors, negotiate pricing, conduct quality control functions, decide which contract manufacturers will produce which products, and determine the quantities and timing of production to meet the group’s worldwide needs.

In addition to the above noted product sourcing functions, Company A personnel oversee and take an active role in Company B sales to major customers and resellers in Company B’s territory. Company A also created and maintains on behalf of both Companies A and B the MNE’s online platforms through which each of Companies A and B make sales and provide services directly to consumers within their respective territories.

The functional analysis concludes that Companies A and B conduct highly integrated business operations in relation to the design, development, manufacturing, marketing and distribution of products. Under these circumstances, the transactional profit split
method is the most appropriate method for determining the profits of each company from the sale of products.

In the absence of comparable uncontrolled transactions or other direct evidence of how independent parties would have split the profits in comparable circumstances, the allocation of profits can be based on the relative contributions of Company A and Company B. In particular, a headcount-based splitting factor may be appropriate, provided that the functional analysis concludes that there is a strong correlation between the personnel of Company A and Company B and the creation of value in the context of their highly integrated business operations.

Examples 5 and 7 – Both Examples 5 and 7 involve situations where the related group members each possess active operations and personnel that allow them to conduct different and unique functions that create combined value.

Too many MNEs have similar legal structures, but all or substantially all of the active operations and personnel are within only one of the two or more related group members. We suggest that an additional example be included for such situations.

We have prepared the following Example for you to consider for inclusion along with the other Annex 1 examples.

Example Y

Company A and Company B are members of an MNE group that maintains an online platform through which the two companies conduct income-producing services into their respective territories. They each charge customers for cloud application services and earn commissions from the sale or rental of third-party-owned applications, music, etc.

Company A, the parent company resident in Country A, legally owns all intellectual property (IP) concerning the online platform and the services that are provided through it. However, this IP was created under a cost contribution agreement (CCA) that provides economic ownership to each of Companies A and B allowing them to exploit the platform and provide the applicable services within their respective territories. Under this CCA, the extensive work to create the online platform, including its design, software architecture, and coding, was performed by Company A personnel in Country A, though group personnel in various of the MNE’s foreign offices contributed by helping translate the online platform’s pages and user instructions into the local language of each target market, many of which are in Company B’s territory.

Ongoing management, operation, and maintenance of the online platform and the service provided through it are performed primarily by Company A in Country A. This includes decisions concerning what services to offer, at what prices in each jurisdiction, etc. Company B pays Company A a service fee for this active operation of the online platform and performance of services through it.

The functional analysis concludes that Companies A and B conduct highly integrated business operations in relation to the performance of services through the online platform. Under these circumstances, the transactional profit split method is the most appropriate method for determining the profits of each company from the provision of services.

In the absence of comparable uncontrolled transactions or other direct evidence of how independent parties would have split the profits in comparable circumstances,
the allocation of profits can be based on the relative contributions of Company A and
Company B. In particular, a headcount-based splitting factor may be appropriate,
provided that the functional analysis concludes that there is a strong correlation
between the personnel of Company A and Company B and the creation of value in the
context of their highly integrated business operations.

10. Examples to Illustrate Guidance on the Transactional Profit Split Method for
Procurement Activities

We have prepared the following Example for you to consider for inclusion along with the
other Annex 1 examples.

Example Z

Company A, resident in country A, and Company B, resident in country B, are
members of a MNE group which operates in the pharmaceutical industry. Both
companies are responsible for the distribution of pharmaceutical products in their
respective and non-overlapping territories. A and B also undertake procurement
activities within their respective territories.

The two companies share a number of common suppliers across different countries
and have decided to create a strategic partnership to develop global relationships
with their suppliers.

In order to do so, they have set up a dedicated team made up of employees of both
companies. By working together, these employees are able to share supply chain and
procurement expertise, pricing information and develop, lead and manage both
existing and new global relationships. This strategic partnership has allowed the two
companies to significantly increase combined purchase volume offered to individual
suppliers and this additional bargaining power has resulted in significant savings
(through rebates and volume incentive savings) in the prices paid to A and B’s
suppliers, above and beyond what the individual companies could have secured in
absence of this strategic partnership.

Under these circumstances, the transactional profit split method is likely to be the
most appropriate method for determining the profits of Company A and Company B
resulting from the above transactions.

In the absence of comparable uncontrolled transactions or other direct evidence of
how independent parties would have split the profits in comparable circumstances,
the allocation of profits can be based on the relative contributions of Company A and
Company B. In particular, a headcount-based splitting factor is likely to be
appropriate in this case, as both parties to the transactions performed important
functions that were unique and valuable in the creation of those profits. As the volume
of purchasing related to each company’s territory is also a significant factor, this
volume will likely be a second splitting factor.

RESPONSES TO SPECIFIC QUESTIONS POSED ON PAGES 2 AND 3 OF DISCUSSION DRAFT

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:
We believe that many, if not a significant majority of MNEs, have adopted modern centrally managed business models that centralize many management and functional operations and place functions and activities in localities only when they are core functions integral to the production, sale, and delivery of the MNE’s products or services. Recognizing this plus the serious need for simplicity, we recommend that the use of actual profits be designated as the default manner of calculation. Despite this designated default, for simplicity, certainty, and to encourage taxpayer use of the profit split method where appropriate, we suggest that guidance provide that tax authorities should accept either approach as long as it is used consistently and in good faith by the applicable taxpayers.

Elsewhere in this comment letter we have recommended the use of concrete allocation keys and weightings for common business models. If the Working Group sees fit to accept this recommendation and to develop such keys and weightings for common business models, additional detailed guidance could include whether actual or anticipated profits should be used for a particular common business model.

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:
All references to capital or capital employed should be eliminated.

Profit splitting factors (allocation keys) must be real operational factors that are measurable and that reflect the actual assets, personnel, and activities of the various group members. This is how to ensure that profits of associated enterprises are aligned with the value of their contributions. The placement and location of capital within an MNE is fully controllable through internal (and often tax-motivated) decisions, and therefore should not be included 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:
The goal is to ensure that profits of associated enterprises are aligned with the value of their contributions. The value of a contribution is not affected by fluctuating exchange rates and the relative levels of wages and salaries across borders. Accordingly, we believe that the headcount of similarly skilled and competent personnel will provide better profit splitting factors in contrast to the use of compensation. However, in evaluating whether personnel are similarly skilled, it may be relevant to have regard to compensation, making appropriate adjustments to take account of differences in relative wage rates between countries (see next answer).

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:
In the interest of simplicity (and consistent with the immediately preceding response), we recommend that concrete factors be used whenever possible (e.g. headcount, units of assets, etc.). Where it is necessary to use currency units, then some appropriate convention should be
applied to convert all currencies into a common base for use within the profit splitting factor. Appropriate conventions, which must be used on a consistent basis, could include average exchange rates, year-end exchange rates, etc. Where reference is made to compensation of employees, we consider that it is appropriate to make adjustments to purchasing power parity rather than apply a standard currency exchange rate.

Elsewhere in this comment letter we have recommended the use of concrete allocation keys and weightings for common business models. If the Working Group sees fit to accept this recommendation and to develop such keys and weightings for common business models, additional detailed guidance would include one or more currency conversion conventions that would have to be used on a consistent basis.

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:
See Examples X and Y and accompanying discussion that have been provided above in the section headed “Comments on Examples”.

56
E. Profit attribution to PEs and interaction with action points on transfer pricing

We of course recognize that work on attribution of profit issues related to Action 7 cannot realistically be undertaken before the work on Action 7 and Actions 8-10 has been completed. As such, we agree that this area should be the subject of follow-up work to be carried out after September 2015 with a view to providing the necessary guidance before the end of 2016.

While we understand that this area will be focused on in the months ahead, we feel compelled to cover one important issue so that it can be considered and emphasized when work on this important area begins after September 2015.

The following is from paragraph 19 of the Discussion Draft and was repeated several other times (paragraphs 28 and 54), but in all cases without any comment within the Discussion Draft either agreeing or disagreeing with the point made by the complaint.

A complaint that was also found in many comments and that was made during the consultation meeting was that these options (as well as many of the other options included in the discussion draft) would create a multitude of PEs to which no or little profits could be attributed.

This ‘complaint’ of the many MNE representatives and the legal and accounting firms that act as their paid professional advisors strongly implies that nothing should be done to broaden the definition of permanent establishment since most if not all new permanent establishments created under broadened rules would have little if any income associated with them. They are saying, of course, that if the local commissionnaire, agent, or other party whose actions create the permanent establishment has been paid an arm’s length amount, then there will be little or no additional income to be reported by the principal that is making the sales or selling services.

It has been clear from the start of the BEPS process that commissionnaire and similar arrangements have been an important part of the worst BEPS excesses; such an important part that the language of Action 7 itself is specifically concerned with ‘the use of commissionnaire arrangements’. Considering this, we believe that this representation by MNEs and their paid advisors is misinformed at best and dishonest, misleading, and disingenuous at worst.

Considering these MNE and advisor representations, we discuss briefly below why total taxable income from an expanded definition of PE should always be higher than under non-PE treatment for situations where a PE is avoided because important functions occur within a commissionnaire, agent, or other service provider.

Say that an MNE, resident and headquartered in country A, has separated its centrally managed operations amongst its group members so that the group member (X) making product sales to customers in country B has no local activities or employees of its own in country B. To support its sales to country B customers, X contracts with Y, a group member resident in country B, for various support operations. These various support functions could include, for example, marketing activities, sales efforts, local warehousing and delivery, etc. Further, Y could be legally a commissionnaire, an agent, or only a service provider. Under the contractual relations between X and Y, Y is at limited risk so that the commissions or
service fees it receives are relatively low reflecting its low level of assumed risk. Assume for purposes of this discussion that the commissions or service fees are at arm’s length.

Assume that under the current Article 5 definition of PE that X has no PE in country B, but will have a PE under a future expanded Article 5 definition. For both simplicity and to clearly illustrate a key point, assume that X’s PE is considered to include solely the activities that Y is conducting for X.

Y will of course be taxable in country B on its own profits, which as noted above are based on its arm’s length commissions and/or service fees received.

Before the expansion of the Article 5 PE definition, X as an overseas seller has no PE and will be free of any country B tax. After the Article 5 expansion, X will have a PE and will be taxable in country B, but on what?

Needless to say, specifically how profits attributable to the PE are determined is beyond the scope of this comment letter. However, there’s one important point to make.

Y’s level of profits from its activities reflect its contractually lowered assumption of risk. Assume that in this particular case Y will get paid at least its expenses incurred plus a limited profit element no matter whether its services result in any sales for X or whether it inventories, warehouses, or delivers any of X’s products, etc. On the other hand, X’s profits from those same activities conducted by Y reflect X’s full commercial business risk. If X sells insufficient product to recoup its expenses including its local expenses in country B (i.e., the commissions and services fees paid to Y), then X will have a loss. If X sells plenty of product, then X will be the sole beneficiary with Y receiving no additional commission or service fees.

Clearly, X is in business to make profits. It believes that paying for Y’s activities will allow it to make sales and a profit on sales to customers in country B. The point of course is that the value of Y’s local activities to X, an overseas seller, is much higher to X since X is taking the business risk of paying Y for these local support operations irrespective of how many local sales are made. The portion of X’s profits (assuming of course that X has made some sufficient level of profits) that will be attributable to its PE cannot be the same as the limited risk commissions and service fees earned by Y under its artificial limited-risk position.

In addition to the above, of course, there will also be many situations, especially for MNEs operating in the digital economy, where X is selling or providing products or services to country Y customers where that customer base itself is a relevant asset of the X PE in country B. That will further increase the profits attributable to X’s PE far above any commissions and service fees paid to Y.

In short, we believe consideration should be given to making clear in future guidance why an expansion of the PE definition in Article 5 is fully expected to result in increased levels of taxable profit within the country of the PE, taking into account both the taxable income of any local commissionnaires, agents or service providers and the taxable income of the PE.
Appendix B
Expansion of the Profit Shift Method: The Wave of the Future

Jeffery M. Kadet
Tax Notes International, 77TI1183, 30 March 2015

December 2014 saw the OECD issuing a number of BEPS (Base Erosion and Profit Shifting) discussion drafts, one of which was titled: *BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains* (“DD10”). Issued on 16 December, DD10 is a response to both BEPS concerns about “value chain” planning articulated in Action 10 of the 2013 *BEPS Action Plan* and transfer pricing issues raised in *Addressing the Tax Challenges of the Digital Economy*, issued on 16 September 2014 in connection with Action 1 of the BEPS *Action Plan*. As a discussion draft, DD10 of course is not a final document and only invites responses about how current transfer pricing guidance might be amended. The guiding principle of DD10 is how the profit split method can achieve the *G20 mandate*, which states: “Profits should be taxed where economic activities deriving the profits are performed and where value is created.”

This article first provides background on why expanded use of the profit split method is needed. It next provides some description of the method. Finally, it suggests a simplified approach to applying the method. As is covered below, resource-constrained tax authorities in most countries are normally unable to administer or intelligently analyze and contest transfer pricing results presented by multinational groups. The overriding need at the present juncture is for rules which are easily administered and that provide results for taxpayers and countries that all regard as fair.

**BACKGROUND**

Despite all the continuing rhetoric about how arm’s length pricing and the separate entity principle are sacrosanct, there are compelling reasons why the OECD BEPS project has focused on the possible expanded use of the profit split method, a method which clearly flies in the face of these sacrosanct icons. In short (and definitely with pun intended), a principal reason is the extreme shortcomings of the separate entity principle and arm’s length pricing of transactions as applied to the big picture effort to match transfer pricing outcomes with value creation. Recognizing this, DD10 in paragraph 3 comments, in a very understated manner:

The integrated nature of many MNE groups and the ways in which they interact with each other means that finding comparables (or comparables for which reasonably reliable adjustments can be made) can give rise to practical difficulties. In some such cases, transactional profit split methods may provide an appropriate solution.

To provide more background, a combination of factors has strongly motivated the highly successful tax structures that have so significantly lowered the effective tax rates of multinational corporations (“MNCs”) and eroded the tax bases of so many countries. The existence of these factors means that some of the transfers pricing methods are a part of the problem; they are not a part of the solution. These factors include:

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1 This MS Word version of the article as published in Tax Notes International (TNI) does not include stylistic changes made by the TNI editors.
The Separate Entity Principle—Internationally, pretty much all countries accept each legal entity as being a separate legal person for tax purposes, independent of its owner(s) and related entities, including those who control it and direct its activities. It doesn’t matter whether the country of formation is a major country, an island tax haven, or someplace in between.

Fragmentation—Similar to an artist who starts with a blank canvas, an MNC’s in-house tax personnel and its outside advisors start with a blank sheet of paper. On that sheet of paper, they can create whatever legal entities they choose to create and they can define exactly what functions and activities each entity will conduct, what assets each will own, and what risks each will bear. In so doing, they minimize profits in higher tax countries and maximize profits in low or zero-tax countries. The Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures) (“DD8-10”), issued 19 December 2014, recognizes this by saying in paragraph 21:

A particular feature relevant in a functional analysis is that an MNE group has the capability to fragment even highly integrated functions across several group companies to achieve efficiencies and specialization, secure in the knowledge that the fragmented activities are under common control for the long term and are coordinated by group management functions. …

DD8-10 goes on to say in paragraph 85:

Attributes of non-arm’s length arrangements can be facilitated by the ability of MNE groups to create multiple separate group companies, and to determine which companies own which assets, carry out which activities, assume which risks under contracts, and engage in transactions with one another accordingly, in the knowledge that the consequences of the allocation of assets, function, and risks to separate legal entities is overridden by control.

With the grave respect given to the separate entity principle by tax authorities and courts worldwide, all this careful construction of an MNC’s organization chart is treated as real and is the basis for taxation in each relevant country.

Respect of Related Party Contracts—As a corollary to fragmentation, tax authorities and courts have for the most part fully respected related-party contracts, despite their having been carefully drafted to a large extent to achieve profit shifting goals.

The Arms’ Length Standard (“ALS”)—The ALS, which has been for the past few decades the guiding principle in transfer pricing, has required that the pricing between related parties reflect the pricing that would occur between unrelated parties considering the functions, assets, and risks relevant to each group member. By its nature, and despite all the detailed discussion in the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“Guidelines”), transfer pricing analyses under the ASL approach normally only provide highly subjective ranges of acceptable pricing. So, in addition to using fragmentation to shift profits out of higher taxed countries, MNCs will also seek to set pricing within the subjectively-determined ranges that further skew profits into low or zero-tax countries.

Inability to Effectively Audit MNC Transfer Pricing—The Guidelines require a serious analysis of matters that include (i) the various legal effects of forms of intangible property concerned, (ii) the various commercial and legal effects of any contractual terms concerning those intangibles, and (iii) the functions performed,
assets owned and risk assumed by the various parties. Each MNC that has implemented BEPS structuring has a relative army of in-house legal, tax, and other specialty personnel whose jobs it is to understand and protect the MNC’s interests. Most MNCs also engage outside counsel, tax advisors, economic analysts, and other specialists as well. On the other hand, the tax authorities of most countries in this world, if not all countries, have neither the sophisticated specialists nor the budgetary resources to truly conduct the work necessary to critically review the integrated and complex structures of most MNCs. This is particularly true for the many developing countries in this world. It may be noted that recent reporting has indicated that even the United States tax authorities have hired outside counsel to help them with an on-going transfer pricing review of Microsoft at a cost in the millions of dollars.

- **What the Capital Markets Value**—Capital markets reward successful reductions in an MNC’s effective tax rate through higher share prices.
- **Personal Motivation and Greed**—MNC managements are highly motivated to minimize effective tax rates due to equity-based compensation based wholly or partly on share price.

**THE PROFIT SPLIT METHOD**

Expanded use of the profit split method would counteract and seriously discourage the profit shifting that has been so prevalent and successful, and which is so dependent on the separate entity principle. What is the profit split method and why would it discourage BEPS behaviour?

Paragraph 2.108 of the Guidelines gives a concise statement of what the profit split method is. It states:

The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate…) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions. The transactional profit split method first identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged (the “combined profits”). … It then splits those combined profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm’s length. …

Additional guidance in the existing Guidelines (paragraphs 2.132ff) makes clear that the criteria or allocation keys on which the combined profits are split should be “…independent of transfer pricing policy formulation…” Hence, these criteria and allocation keys “…should be based on objective data (e.g. sales to independent parties), not on data relating to the remuneration of controlled transactions (e.g. sales to associated enterprises)…”

Paragraph 2.135 makes this objective basis clear by stating:

In practice, allocation keys based on assets/capital (operating assets, fixed assets, intangible assets, capital employed) or costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) are often used. Other allocation keys based for instance on incremental sales, headcounts (number of individuals involved in the key functions that generate value to the transaction), time spent by a certain group of employees if there is a strong correlation between the time spent and the creation of the combined profits, number of servers, data storage, floor area of retail points, etc. may be appropriate depending on the facts and circumstances of the transactions.
Further discussion in the Guidelines provides various approaches to splitting the combined profits amongst the relevant group members. While these approaches need not be detailed here, the point to make is that the approaches set out and discussed required a facts and circumstances case-by-case analysis before they can be implemented.

**A SIMPLIFIED APPROACH**

The Guidelines require a facts and circumstances case-by-case analysis for determining the most appropriate transfer pricing method for any particular case. Once it is determined that the profit split method is the most appropriate method for a particular case, then again, a facts and circumstances case-by-case analysis is required to determine how the combined profits are to be split amongst the relevant group members.

The reader may recall the bullet point in the Background section above headed: “Inability to Effectively Audit MNC Transfer Pricing”. Any time that transfer pricing rules require a facts and circumstances case-by-case analysis for a complicated MNC structure, the chances are very high that the relevant tax authorities will have neither the in-house expertise nor the budgetary resources to effectively analyze anything. As stated at the start of this article, there is an overriding need for transfer pricing rules that are easily administered and that provide results for taxpayers and countries that all regard as fair.

We believe the following approach answers the needs for simplicity, fairness and ease of administration. Further, given the investment of time of in-house personnel and the exorbitant costs of outside legal, tax, and economic consultants, it should as well be attractive to any MNC that chooses to focus more on its business and less on aggressive BEPS motivated tax structures.

The **first step** of this simplified approach is that the profit split approach will be deemed to be the most appropriate transfer pricing method for various categories of MNC businesses. Such categories would include:

- Any MNC operating a value chain involving multiple group entities conducting operations in multiple countries, and
- Any MNC involved in the digital economy that maintains supporting group members in various countries.

To provide concrete guidance, we suggest that the Guidelines include both a listing of these categories as they exist today and the principles on which such categories are determined so that as MNCs evolve new forms of business conduct and organization, these new forms can be added to this listing.

This presumption that the profit split method is the most appropriate method to apply would be rebuttable to the extent that an MNC establishes to the satisfaction of all relevant tax authorities the clearly superior applicability of one of the other methods.

The **second step** of this simplified approach is the allocation of combined profits amongst the relevant group members.

Specifically, we suggest that the Guidelines include clear guidance stating concrete objective allocation keys and relative weightings for all business models now commonly being used. Anticipating the likely emergence of new business models, the Guidelines should also articulate the principles on which concrete objective allocation keys and weightings should be determined. There would be no facts and circumstances case-by-case analysis.

Such a simple and clear approach would be easy to administer, and greatly reduce conflicts both between tax authorities and companies, and among tax authorities. They would make an
enormous step towards achieving the aim set by the G20 that: “Profits should be taxed where economic activities deriving the profits are performed and where value is created.”

An obvious question is whether such a simplified allocation approach would achieve reasonable results that governments and taxpayers can be comfortable with. We strongly believe the answer to this is “yes”.

It is clear that any allocation of profits of a complicated corporate structure that results from the current approach based on a detailed facts and circumstances case-by-case analysis of functions, assets and risks will, by its inherently subjective nature, only result in a very wide range of possible profit allocations. The use of simple-to-apply concrete objective allocation keys that are appropriate for the particular business model used will result in profit allocations that will virtually always fall within this wide range.

With tax authorities no longer hobbled by a need for detailed analyses, which they seldom have the resources or expertise to achieve, the adoption of such a simplified approach will greatly enhance their ability to actually administer and collect taxes. It will also reduce conflicts both between tax authorities and taxpayers and among tax authorities. In addition, the application of such rules should result in a reduction in complex BEPS motivated structures since all combined profits will be spread amongst the group members that actually conduct activities with little or none left within low-taxed group members that do not conduct economic activity and thereby contribute little if any to value creation. In sum, a simplified and standardized approach for each common business model will provide significant benefits as well as give results that are fair to MNCs and all relevant governments.

To provide an idea of how this simplified approach would work, the box beginning on page __ includes examples of allocation keys and weightings for two business models.
EXAMPLES OF ALLOCATION KEYS AND WEIGHTINGS FOR TWO COMMON BUSINESS MODELS

Example 1

This example is taken from DD10’s Scenario 2.

“The RCo Group provides a number of internet services (e.g. search engines, email services, advertising, etc.) to customers worldwide. On one side of the business model, advertising services provided through an online platform are charged to clients for a fee that is generally based on the number of users who click on each advertisement. On the other side, online services are offered free of charge to users, whose use of the services provides the RCo Group with a substantial amount of data, including location-based data, data based on online behaviour, and data based on users’ personal information. Over the course of years of data collection, refinement, processing, and analysis, the RCo Group has developed a sophisticated technology that enables it to offer to its clients the ability to target specific advertisements to certain users. The more extensive the online services, and the greater the extent of the associated data, the more valuable and attractive the other side of the business model becomes for clients wishing to advertise.

“The technology used in providing the internet advertising services, along with the various algorithms used to collect and process data in order to target potential customers, were originally developed and funded by Company R, the parent company of the RCo Group.

“For larger markets and in order to deal with key clients for advertising services, the group has established a number of local subsidiaries. These local subsidiaries perform two functions: they promote the use of online services provided free of charge to users, translate them into the local language, tailor them to the local market and culture, ensure that the services provided respect local regulatory requirements, and provide technical consulting to users. In addition, they generate demand for and adapt advertising services. In doing so, they also regularly interact with staff members in Company R in charge of developing the technology and make suggestions, notably on the algorithms and technologies used and their adaptation to local market features, and on new features that would be attractive to users in their market.”

Simplified Allocation Keys

For the combined profits of this common business model, two equally weighted allocation keys are defined as follows:

- Users

Using users as an allocation key reflects the importance of each market and the value of Aco’s users to the global business of Aco and Aco’s fee-paying third-party customers seeking advertising services. The country is determined by the location of the user and not the legal terms of any contracts, licenses, or other documents with either users or the third-parties that pay Aco for advertising, aggregate user data, etc.

- Operating Expenses

This allocation key recognizes all operational inputs. As such, it covers all research and development, website maintenance, sales, marketing, distribution, management, support functions, etc.

This key would include categories of expenses such as:

Salaries and bonuses of all operations personnel (allocated by location of personnel)
All other direct and allocated operating expenses (allocated by location of personnel or facility to which the expenses relate)

Commissions and service fees paid to other parties for all operational functions (allocated by location where the other party provides the services) (These payments economically include all personnel costs, office and manufacturing costs, etc. of the legal entity performing the relevant operational functions for the taxpayer. Payments to any related parties whose profits are included in the combined profits for the profit split would of course be excluded.)

**Example 2**

This example is taken from DD10’s Scenario 3.

“Company P, located in country P, is a manufacturer of high technology industrial equipment. Company S, a subsidiary of Company P, markets and distributes the equipment to unrelated customers in country S. Both companies are members of Group X. Company P conducts extensive R&D activities to develop and improve the technological features of its equipment. It funds and has legal ownership of all the technology intangibles it develops. Company P also owns the global trademark, and provides broad guidance to its subsidiaries around the world on its overall marketing strategy. There are several global competitors making equipment which is similar (in terms of functionality, performance, and reputation) to that made by Group X. These global competitors also operate in Country S, which is a large market for such equipment.

“Company S is responsible for sales of the equipment and undertakes marketing activities. Due to the nature of its business, this entails developing very close relationships with customers, including providing on-site services (often in remote locations), carrying an extensive stock of spare parts, and a highly proactive maintenance programme to detect likely problems before they arise. Company S also provides extensive advice to customers on equipment choice, makes modifications for particular local conditions, and for maximising performance efficiency and effectiveness. These activities provide a significant competitive advantage as customers place high value on the reliability and performance of the equipment. In this case, Company S is recognised as not merely a “routine” distributor, but its activities constitute a key source of competitive advantage for the Group.”

**Simplified Allocation Keys**

For the combined profits of this common business model, three allocation keys with the indicated weighting are defined as follows:

- **Sales (weighted at 25%)**

  The inclusion of sales as one of the allocation keys reflects the importance of each market and its customers to the global business of Companies P and S. The country of sale should be determined by the location of the customer and not the legal terms of the sales contract. (See further comment below concerning this sales allocation key.)

- **Marketing and Distribution Expenses (weighted at 25%)**

  Total marketing and distribution expenses make an excellent allocation key that reflects the amount of resources that a taxpayer invests in each market. This key would include categories of expenses such as:

  Salaries and bonuses of marketing and distribution personnel (allocated by location of personnel)

  Advertising expenses (allocated by market that advertising targets)
All other direct and allocated expenses of marketing and distribution, not including transportation costs of inventory (allocated by location of personnel or facility to which the expenses relate)

Commissions and service fees paid to other parties for marketing, distribution, and after-sales services and support (allocated by location where the other party provides the services) (A taxpayer will often pay other legal entities, whether related or not, for sales activities, other sales support, and/or after-sales service and support activities. These payments economically include all personnel costs, office and warehouse costs, etc. of the legal entity performing the marketing and/or distribution functions for the taxpayer. Payments to any related parties whose profits are included in the combined profits for the profit split would of course be excluded.)

- Expenses Other than Marketing and Distribution Expenses (weighted at 50%)

This allocation key recognizes all inputs other than those for marketing and distribution. As such, it covers all manufacturing activities, research and development, management and support functions, etc.

This key would include categories of expenses such as:

Salaries and bonuses of all personnel other than those involved in marketing and distribution functions (allocated by location of personnel)

All other direct and allocated expenses other than those related to marketing and distribution functions, not including transportation costs of inventory (allocated by location of personnel or facility to which the expenses relate)

Commissions and service fees paid to other parties for all operational functions other than marketing, distribution, and after-sales services and support (allocated by location where the other party provides the services) (For example, this category includes situations where a taxpayer pay another legal entity, whether related or not, for contract manufacturing services. These payments economically include all personnel costs, office and manufacturing costs, etc. of the legal entity performing the relevant operational functions for the taxpayer. Payments to any related parties whose profits are included in the combined profits for the profit split would of course be excluded.)

There is no allocation key suggested for either property or inventory. Regarding property (including rented and leased property), the value and extent of facilities will most typically be reflected by the labor retained by each group member. This reliance on labor thus avoids all the difficult property valuation issues that inevitably arise if property is included as a direct allocation key. It also avoids the many varying methods, lives, and inconsistent treatments if depreciation (book or tax) were used. Regarding inventory, the sales allocation key measures the importance of the source market and suggests that inventory and inventory transportation costs could be duplicative, to some extent.

Note that neither risks nor intangibles (e.g. patents, manufacturing processes, trade names, knowledge of market channels, etc.) are directly included. Consistent with the guidance in the Guidelines regarding objective allocation keys and given the integrated nature of the associated companies’ businesses and the fact that both parties are contributing their own unique and valuable intangibles, it is both appropriate and simpler to ignore these risks and intangibles as separate allocation keys. Both are, however, indirectly included through the other factors. For example, to the extent that risks and intangibles are related to manufacturing that is solely conducted in the home country or elsewhere outside the source country, then the higher-weighted allocation key (50%) for all expenses other than those for
marketing and distribution will reflect them. Such expenses include on-going R&D, the bulk of which will be in country P. As for marketing risks and marketing intangibles, the marketing and distribution expenses factor will similarly reflect them. For example, if relatively higher paid marketing executives in country P make sales and credit decisions regarding buyers, then relatively more profit will be allocated to Company P and relatively less to Company S, thereby reflecting the risk that is being managed from Company P. On the other hand, if sales personnel in Company S are performing important functions such that they are paid bonuses based on their productivity, then the value they add will be reflected in their bonuses with relatively more profit allocated to Company S.

Finally, an alternative approach would be to eliminate the “sales” allocation key and then equally weight the remaining two keys. This would leave the “sales” key to be used only in cases where there has been a meaningful creation of value due to participation of local users and consumers. If the “sales” key were eliminated, then consideration should be given to including a key for the value of inventory allocated by location where maintained.
William Morris  
Chair, BIAC Tax Committee  
13/15, Chaussée de la Muette, 75016 Paris  
France

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

Submitted by email: TransferPricing@oecd.org

September 15, 2017

REVISED GUIDANCE ON PROFIT SPLITS

Dear Acting Chair and Members of Working Party No. 6,

Thank you for the opportunity to comment on the Discussion Draft: BEPS Action 10 – Revised Guidance on Profit Splits (the “Discussion Draft”) issued 22 June 2017. We thank the OECD for the time and effort put into this draft.

However, while BIAC believes that the Discussion Draft does improve on certain aspects of the prior guidance, we also believe that the majority of the guidance still needs further development. In particular, it does not, unfortunately, reinforce the critical and generally accepted notion that profit splits should only be used in limited circumstances where the actual transaction under consideration is one that would be subject to a similar methodology when negotiating with unrelated parties. So, while portions of the guidance are helpful, we believe that a lack of detailed guidance may result in the transactional profit split method (“TPSM”) being applied more often – and inconsistently – by countries that are still developing their respective transfer pricing administrative guidance and examination framework. It is crucial that the guidance strongly and explicitly emphasise that the TPSM is only of limited application – and is not the default method.

BIAC acknowledges the considerable attention given to this important topic but we urge the OECD to further develop this guidance, providing greater detail and more detailed examples, so that this guidance can become a tool that bolsters tax certainty and taxpayer-tax authority relationships. In particular, the term “unique and valuable” is left vague in the guidance, with the result that the term could be used to support TPSM in a much broader range of transactions than would be appropriate. The thresholds in the examples further exacerbate this risk.

With regard to the above, the process of developing guidance that is practical is helped by inclusive consultations and discussions. If it would be useful in building consensus and understanding in WP6 (and interested participating countries), BIAC would be happy to provide additional input (e.g. in-person meetings/workshops) to explain the steps involved in agreeing pricing between unrelated
parties in the scenarios that are considered within the scope of the profit split guidance, and the difficulties that they may face in pricing similar intra-group transactions.

Finally, we encourage WP6 to consider the impact of any proposed changes to the profit splits guidance caused by the upcoming conclusions of the OECD’s follow up work on BEPS Action 1 (the tax challenges of the digital economy). At the very least, we would recommend that any profit splits guidance should remain in draft until the outcome of Action 1 workstream.

Again, we thank you for the opportunity to comment on this Discussion Draft, and look forward to working with you further on this important topic.

Sincerely,

Will Morris
Chair BIAC Tax Committee
General Comments

1. BIAC believes that the arm’s length principle (“ALP”), properly applied by both taxpayers and governments, still offers the best prospect of classifying transactions according to “real-world” economics, and equitably and consensually dividing income between countries based on economic activity. If this is not clearly articulated, and practical supporting guidance is not provided, then we are concerned that we will see an acceleration in a worrying trend (already apparent in the transfer pricing audit practices of numerous countries), where a broad interpretation of “BEPS principles” is used to justify new unilateral theories and automatic application of non-arm’s length approaches in routine situations.

2. BIAC urges the OECD to reiterate in the Discussion Draft that the goal of this guidance is not to alter the way in which the most appropriate transfer pricing method (only one) is selected or to promote the application of the TPSM but it is simply to provide additional clarity to the application of the TPSM. BIAC believes additional language in this regard is necessary to ensure that tax administrations do not rely on the TPSM as an additional or corroborative method where the comparable uncontrolled price (“CUP”) method or other traditional transfer pricing methods are the most appropriate method in assessing the arm’s length nature of transactions. The underdeveloped concept of “unique and valuable” and the low threshold of requiring only closely related risks to be shared cause us the most concern in this regard.

3. BIAC welcomes the language in para 2 of the Discussion Draft that “reference to ‘profits’ in this section should generally be taken as applying equally to losses.” However, it is critical that the inconsistent selection of transfer pricing methods is strictly refrained from so we believe that it is necessary to reinforce this point throughout the Discussion Draft. An example of such practice is, with regard to MNEs' controlled transactions, applying the TPSM to a case with combined profits for the purpose of levying taxes, while applying the Transactional Net Margin Method (“TNMM”) to a case with combined losses with the impact of artificially creating profits.

Most appropriate method

4. BIAC welcomes the language in para 4 of the Discussion Draft which states that “a transactional profit split should not be automatically selected on the basis that one or more of the listed indicators applies.” However, the overall message in para 4 fails to emphasize the limited circumstances in which a TPSM would be appropriate and instead implies that the TPSM could be applied with the same frequency and to the same extent as other transfer pricing methodologies. BIAC recommends that this language include reference to the limited circumstances in which application of the TPSM would be appropriate and draw a distinction between profit splitting “factors”, such as integration and risk sharing, versus profit splitting “indicators”, which should only be the contribution of unique and valuable intangible by both parties. There terms should not be used interchangeably.

5. The 4 July 2016 Discussion Draft included a clearer statement on the inappropriate use of the TPSM in the final sentence of paragraph 16:

“The application of a transactional profit split of actual profits when not supported by the features derived from the functional analysis, for example in cases where other methods are difficult to apply because reliable comparables are scarce, is unlikely to
produce an arm’s length outcome since the appropriate use of a profit split is determined by the existence of a specific commercial relationship between the parties.”

This sentence should be reinstated in the Discussion Draft as clear guidance to tax administrations that the absence of comparable data is not a valid reason for the use of the TPSM and that other pricing methodologies will be appropriate in most circumstances, whether or not directly comparable data on similar transactions is available.

6. Paras 6 through 9 of the Discussion Draft focus on the strengths of the TPSM. Whilst we agree that there are strengths and weaknesses, the way in which these are described gives the implication that they can be used to determine whether the TPSM is the most appropriate method. We consider this to be an inappropriate conclusion because the most appropriate method should be decided based upon the facts and circumstances of the transaction in question, not on the ease or difficulty of applying the method. This is particularly concerning because the weaknesses of the TPSM included in para 10 are considerably understated compared to the substantial detail regarding the strengths of the TPSM in paras 6 through 9.

7. More detail should be given regarding weaknesses and additional guidance provided on how these may be addressed during application. By focusing more on the strengths of the TPSM, a significant risk arises that tax administrations with limited experience in applying traditional transfer pricing methodologies will default to the TPSM in instances where it is not appropriate because they do not appreciate the significant limitations associated with the TPSM in real-life application that may make it less appropriate.

8. We also believe that it should be explicitly reiterated throughout that the strengths are only strengths to the extent that they reinforce or complement the method as the most appropriate method. For example, para 6 could be updated as follows (with changes underlined):

6. The main strength of the transactional profit split method is that it can offer a solution on appropriate pricing methodology for cases where both parties to a transaction make unique and valuable contributions (e.g. contribute unique and valuable intangibles) to the transaction. In such a case—This may be most likely to be the most appropriate pricing method in such cases where independent parties might effectively share the profits of the transaction in proportion to their respective contributions, making a two-sided method more appropriate...

9. The Discussion Draft makes the point in para 11 that the infrequency of the use of the TPSM among independent enterprises should not be a factor in applying the TPSM since “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.” BIAC strongly disagrees with any language that implies a disregard for the ALP and believes that the ‘most appropriate method’ approach, under the ALP should be preserved, and that the profit split should not be automatically applied in situations where one-sided methods can provide a reliable result. This apparent limitation on the application of the ALP should be removed.

10. BIAC welcomes the language in para 14 which states that 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." However, BIAC would strongly encourage the OECD to simplify this language to be consistent with the more concise language in para 28 which states that "a lack of comparables alone is insufficient to warrant the use of a transactional profit split." The additional qualifications and caveats in the language in para 14 implies that there will be instances where the lack of comparables alone would justify the application of the TPSM.

11. The Discussion Draft notes in para 25 (and implies in paras 13 and 14) that the TPSM may be the most appropriate method "where, according to the accurately delineated transaction, each party to the controlled transaction shares the assumption of one or more of the economically significant risks in relation to the transaction." BIAC suggests that "sharing of a control function with regard to economically significant risks" may better define situations where profit splitting is the most appropriate method. Constituent entities of a MNE group share business outcomes to some degree, but sharing business outcomes does not always mean sharing economically significant risks. Our concern is that tax authorities will first look at business outcomes and then determine that there is sharing of economically significant risks, without looking at how that risk is managed.

12. We strongly believe that while risk sharing is a necessary precondition to the use of the TPSM, sharing of risks alone is not enough to justify its application. This should be made explicit. The existence of risk does not mean that third party comparables are not available (in fact, there are risks to both parties in many transactions which are either managed or accepted) and in most cases risks can be priced more accurately by looking to these comparables. The only exception is where the risks relate to unique and valuable contributions (of non-routine intangibles), because only under these scenarios are third party comparables likely to not exist and it is appropriate therefore that this should rather be used as the main indicator of when the TPSM is likely to be the most appropriate method. Paras 13 and 25 - 27 in particular should be amended to reflect this point.

13. Further, we see a distinction between "shared" risks and "closely related" risks. We consider the latter to be an inappropriate basis for a TPSM to be applied. We also question whether this is in line with Chapter 1 of the OECD Transfer Pricing Guidelines ("TPG") (which respects appropriately delineated transactions) and would welcome further guidance on their interaction.

14. Similarly, para 24 of the Discussion Draft refers to control and assumption of risk and makes a reference to paragraph 1.105 of the TPG, but to be consistent with the 6 step process recommended in Chapter 1 of the TPG, this cross reference should be expanded to paragraphs 1.72 through to 1.106, to ensure that this is not taken out of context.

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1 In many cases, risk can actually be addressed as a comparability factor through appropriate adjustments to one-sided methods (and if it would not materially impact the pricing of the transaction then would generally not be considered further).
Unique and valuable

15. Para 13 notes that “[t]he 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.” The phrases “unique and valuable contributions” and “unique and valuable intangibles” are used throughout the Discussion Draft with considerable importance so BIAC would urge the OECD to provide greater clarification as to the meaning of these phrases beyond the limited definition included in para 6.17 of the TPG to avoid inconsistent interpretation that may result from the references and descriptions used for this phrase within the Discussion Draft.

16. For instance, para 16 defines contributions that are “unique and valuable” as those cases where the contributions are not comparable to contributions made by uncontrolled parties in comparable circumstances and their use in business operations represents a key source of actual or potential economic benefits. However, the contributions detailed in the examples seem to imply a lower threshold, which is not appropriate. More detail in para 16, and a broader range of more detailed examples would be very useful in assisting taxpayers determining whether something is “unique and valuable”.

17. Example 9 (for example) gives the impression that a TPSM could be commonly used in relation to groups operating in the fashion or luxury goods sectors, as well as for groups owning very valuable trademarks. In fact, when groups owning valuable trademarks are in their development phase and/or enter new markets, they will often use local independent business partners (such as retailers, franchisees, wholesalers, agents). This means that, in general, independent comparables are likely to exist and will often represent a more reliable reference to set transfer prices in case a local subsidiary plays a similar role (with appropriate comparability adjustments, if needed). In a more mature and successful phase, such groups will tend to expand their control to the retail chain, operating more often with subsidiaries. However, in such phases the control of the retail chain will typically imply centralised business models, leaving very limited autonomy to local subsidiaries, notably in order to ensure that travelling customers will meet similar shopping experiences across the world.

18. Additionally, it is important not to confuse “making of unique and valuable contributions by both parties to a transaction” with making of unique and valuable contributions by both the parties at different stages of the value chain. For example, intangibles at the manufacturing and marketing stages of a supply chain are distinct and, in a scenario where different parties contributed an intangible at each stage, there is not necessarily the same integration of risks that would indicate that the TPSM could be appropriate.

19. Clarification of this important phrase and expansion of the facts and circumstances surrounding the supporting examples will be necessary to ensure this guidance is applied consistently by tax administrations. The method is difficult enough to apply on an ex post basis, and to accurately create the requisite books and records several years after the transaction has completed will be impossible in many instances. It is therefore imperative that a clear definition is included that makes it less subjective when the method is appropriate. In many respects, this is more important than the certainty over the detailed calculations. Sufficiently detailed examples would also assist in this regard. We have included an example in Appendix B that we believe includes the requisite detail and reasoning to determine why the profit split is the most appropriate
method, and for what elements of the transaction. Similarly detailed examples should be drawn to demonstrate the different features that would lead to a conclusion that profit split is not the most appropriate method.

**Application**

20. BIAC believes that the guidance should be updated to make explicit that the TPSM only applies to those residual profits over and above compensation for routine functions. Additional detail in this area would be very useful, but the guidance must also incorporate an appropriate amount of flexibility; a formula for profit splitting which is too prescriptive is unlikely to be economically justifiable in a broad range of circumstances to which it could apply. In its current form, the guidance in this area creates a great deal of uncertainty for taxpayers and tax authorities, as it is neither detailed enough to be easily applied nor flexible enough to be appropriately interpreted.

21. The Discussion Draft uses “operating profit” as a concept throughout, but this term is not defined in the 2017 TPG glossary. It would be helpful to include a definition, either in this draft or in the glossary of the TPG.

22. Para 1 of the Draft specifies that the method should first identify the “relevant profits”. Para 35 notes only that these are “the total profits from the controlled transactions under examination”. It should be specified more clearly that only profits arising from the transaction(s) between the related parties to which the TPSM is applied can be included, and not any other controlled transactions between the parties, or elements of the controlled transactions under investigation for which the TPSM is not the most appropriate method. While the language in paras 39 and 40 captures this message generally, we would welcome additional detail and a reinforcement of this important point throughout the Discussion Draft.

23. BIAC continues to believe that a great deal more detail is required regarding period to period adjustments. It is simply not realistic for unrelated parties to agree to prices (profits being split or otherwise) that do not change over the lifetime of a business relationship and/or piece of intellectual property. It is equally unrealistic for unrelated parties to agree for retrospective or frequent changes in their remuneration/returns. Thresholds and set points in time would generally be included to trigger such renegotiations, in order to give certainty over a period of time and to protect both parties to the transaction. This same logic could be used to ensure that taxpayers and tax authorities are appropriately protected. In order to allow taxpayers to follow the arm’s length principle, guidance on how to deal with situations where profits are accrued on an ongoing basis is essential.

**Splitting the profits**

24. BIAC believes the Discussion Draft is quite helpful in highlighting the extreme instances where the transactional profit split of actual profits would be appropriate. However, the guidance also provides fairly limited circumstances where profits splits based on anticipated profits would be appropriate. While the overall application of the TPSM should be considerably limited, within that application it should be clear to tax authorities under which circumstances the TPSM should be applied to anticipated profits versus actual profits and flexibility should awarded for the application of the TPSM to one or the other. To this point, BIAC would recommend including additional examples and/or further guidance which support the application of profit splits based
on anticipated profits as well as actual profits in the limited circumstances where the TPSM is considered to be the most appropriate method and also where *ex post* adjustments to the *ex ante* pricing are made based on actual results.

25. BIAC continues to believe that there is not enough clarity regarding how the anticipated profit split differs from a conventional CUP royalty analysis. Similar third party scenarios could even include adjustment clauses based on performance or milestone payments which result in a much closer outcome over time to a TPSM based on actual profits. We would welcome confirmation about the factors which should be taken into account in making the determination of which method to apply, and how this may change over time.

**Administration burden**

26. It would be appropriate for the guidance to emphasise that, where the taxpayer does not use a TPSM, there are likely to be very considerable difficulties in creating, after the event, the level of detailed analysis that would be required to support or quantify the outcome of a TPSM. Tax administrations should be advised that the circumstances in which a tax administration could estimate with a reasonable degree of accuracy the outcome of a TPSM, or require that a taxpayer should undertake the very significant work required to perform a reasonably accurate TPSM, are likely to be very limited.

27. Paragraph 46 contains some confirmation that the method must be applied on the basis of information known or reasonably foreseeable at the time the transactions were entered into and that the method of calculation should be based on written contracts documenting the intentions of the parties, and should not generally be varied over the lifetime of the agreement. The implications of this guidance for any tax administration proposal to assert the TPSM after the event should be highlighted.

**Examples**

28. Although we understand that there is not a model answer to transfer pricing problems, as each situation is unique and solutions must be based on the facts, we were hoping that there would be some directional quantified examples included in the Discussion Draft. We ask that some numerical examples are included in the final report. Such examples should include an explanation on how the gross and actual profits should be split, taking into account, for example, how Selling, General and Administrative expenses should be apportioned in the calculation.

29. It is not clear why in some examples (e.g. 1, 2 and 5) the TPSM is considered the most appropriate method as it appears that other pricing methodologies could be used so the Discussion Draft must explain the analysis used to reach such a conclusion.

30. It would be helpful for the examples to include a discussion of whether a split of anticipated or actual profits should be used (examples 1, 2, 3 5 and 7).

31. Examples 4 and 6 both conclude that TPSM is not the most appropriate method, but the conclusions are differently worded “..the profit split method may not be the most appropriate method...” compared with “..the profit split method is unlikely to be the most appropriate method”. It is not clear from the examples why the strength of the conclusion is different. BIAC
strongly recommends the consistent use of a clear statement that the profit split method is not the most appropriate method in these instances.

32. In example 10, it is not clear why, based on the information provided in the example, that an asset-based profit splitting factor is appropriate and the proviso “that the functional analysis concludes that there is a strong correlation between the assets of Company A and Company B and the creation of value.” would be better shown as a fact in an earlier paragraph, so that the conclusion is based on the presented facts, not an assumption.

33. We have stated throughout this response that we believe that more comprehensive examples are required. We believe specifically that more guidance is required regarding the definition of “unique and valuable”. If a definition cannot be found that can be applied easily and with certainty, it is critical that the examples give enough detail to determine how the test is to be applied in determining the most appropriate method. We have included an example in Appendix B that we believe includes the requisite detail and reasoning to determine why the profit split is the most appropriate method, and for what elements of the transaction. Similarly detailed examples should be drawn to demonstrate the different features that would lead to a conclusion that profit split is not the most appropriate method.

34. We also believe that numerical examples would be helpful to assist in understanding how the method should be applied once it has been decided that it is the most appropriate method. In order to assist the OECD, we have developed some numerical examples in Appendix A that demonstrate the potential impact of applying an interpretation of the Discussion Draft under various conditions. We hope that the comparison of these outcomes with each other (and other non-TPSM pricing methods) is instructive and can be used to build consensus within WP6 on the appropriateness of the outcomes (either through endorsement or clarification in the final guidance).

Responses to Specific Questions

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.

BIAC interprets “profit split of actual profits” as implying the use of an actual profit measure which has deducted more than just marginal transaction costs. We believe that form of actual profit split approach will only be appropriate in narrowly defined circumstances within the already limited application of the TPSM as the most appropriate method in independent and related party transactions. 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 within the limited application of the TPSM. BIAC believes that approach would mirror the approach which would be expected to be taken in comparable arms-length circumstances.
Similar to the analysis provided in Example 9 of the Discussion Draft, BIAC believes that in the limited circumstances where the TPSM is the most appropriate method, profit splits based on anticipated profits are likely more 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.

The guidance already notes at para 43 that the basis of a TPSM should be the accurately delineated transaction, based on written contracts (para 46). Whether the TPSM should be based on anticipated or actual profits will therefore depend on the nature of the relationship between the parties and the investment or contribution that each makes. Where unique and valuable contributions are made and one party could not realise profit without the other, anticipated profits may be appropriate (as suggested in para 45). It does not, however, follow that where the business operations are highly integrated or each party makes unique and valuable contributions, that actual profits should be used. Para 44 posits a scenario where business risks are shared and concludes that actual profits should be used in computing the split of profit. This may be appropriate where the relationship between the parties is close to a joint venture or partnership, but it should not be concluded that in all cases where there is some sharing of risk that actual profits should be used.

2. A number of profit splitting factors are addressed in the discussion draft.

Generally, the profit splitting factors should be identified as those which are most appropriate to the accurately delineated transaction. However, we would welcome examples of what these may be and suggest the following points could be used to refine and guide the application of examples.

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 for use with regard not only to financial services but also other capital-intensive industries, given the role of capital and that capital is in itself a risk. Some of the factors to take into account prior to selecting capital / capital employed are:

- Whether the entities involved perform valuable functions with respect to the transaction;
- Importance of capital contributions / investment to the transaction, with reference to comparable third party transactions; and
- Whether capital / capital employed can be used reliably as a profit splitting factor without adjustments, or where adjustments are necessary, whether the adjustments can be performed reliably to yield reasonable results.

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 could be a suitable factor, in limited circumstances, but would need to be used with care. It would not be appropriate to use headcount as a proxy for the relative value of research and development or the development of marketing intangibles or market share, for
example. In the limited circumstances in which headcount could be used as a profit splitting factor, consideration should be given to applying weighting factors to headcount, and these weightings will often not be the same as payroll/employment costs.

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 and should not be used for determining profit splitting factors. Calculating PPP is complex and unreliable given the challenges with data reliability. Additionally, the use of PPP as a profit split factor would also necessitate the use of PPP for all costs and revenues associated with the transaction, a major change in global accounting and tax standards. Lastly, we note that the references to “purchasing power” in the TPG 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?

The Guidance should include profit splitting factors that drive the economics of the business / transaction. For example, the use of multifactor keys which are weighted to the economic reality of the transaction could produce results that are more in line with the arm’s length principle.
Appendix A – Numerical Examples and associated concerns

Background, assumptions, and methodology

Despite the concerns noted in the body of this letter (paras 19 and 38, in particular) regarding Example 9 of the Discussion Draft, it has the unique feature of comparing a scenario of split of anticipated profits with a scenario of split of actual profits. For this reason it has been chosen as reference to develop a numerical example to illustrate some concerns, uncertainties, and implications of the TPSM as described in the Discussion Draft.

Profit split models tend to be very complicated. We have tried to simplify the example as much as possible in order to make it understandable, whilst preserving the key elements. The tables below illustrate five cases which help identifying issues and concerns.

- **Base case**: represents the reference simplified P&L and profit split model (in case of anticipated profits split, this should be intended as showing data related to an “appropriate period”; details about how to bring values to the same time-reference are omitted for simplification purposes). The Base case results, based on anticipated profits, imply a transfer price from Company A to Company B of 120 (lump sum) or 12% of anticipated revenue (royalty).
- **Case 1**: illustrates a lump sum payment approach as mentioned in Scenario 1 of Example 9 in the Discussion Draft. In this case the lump sum amount remains fixed at 120.
- **Case 2**: illustrates a sales-based royalty approach as mentioned in Scenario 1 of Example 9 in the Discussion Draft. In this case the transfer price is represented by a 12% royalty calculated on actual sales.
- **Case 3**: illustrates the case of actual profits split. In this case the transfer price can be either a lump sum or a royalty, adjusted ex-post on the basis of actual results in order to ensure a 50/50 split of actual profits.
- **Case 4**: is similar to Case 2 and illustrates the fact that, in this example, if the proportions of costs and expenses remain stable, using a sales-based royalty brings the method based on anticipated profits and the method based on actual profits to coincide.

Each case is presented in two alternative models:

- “Positive model”, illustrating each case in a situation where actual sales were higher than anticipated.
- “Negative model”, illustrating each case in a situation where actual sales were lower than anticipated.

Anticipated vs Actual Profit Split

Each line of the model is briefly described here below:

- **A. Revenue**: represents the (actual sales) customer revenue of Company B; the “positive model” assumes actual revenue to be 30% higher than anticipated; the “negative model” assumes actual revenue to be 30% lower than anticipated.
- **B. Other items**: represents all “routine” costs and expenses, including routine profits; the average amount is assumed to decrease/increase of 3 percentage points in the two models, due to the lower/higher average impact of fixed costs and expenses.
- C. Expenses of Company A: represents the “residual driving” expenses of Company A; the average amount is assumed to decrease/increase by 1 percentage point in the two models, due to the lower/higher average impact of fixed expenses. It should be noted that Company A’s contribution is assumed to be the sum of the initial value of the trademark and associated goodwill and know how (which doesn’t appear on the P&L), plus Company A’s recurring expenses to maintain/enhance/protect/etc. such intangibles.

- D. Expenses of Company B: represents the “residual driving” expenses of Company B; the average amount is assumed to decrease/increase by 2 percentage points in the two models, due to the lower/higher average impact of fixed expenses.

- E. Residual profit: A – B – C – D

- F. and G.: (for simplification purposes) it is assumed that the profit split calculations will drive a split of residual profits in a proportion of 50/50 between Company A and Company B. Lines F. and G. illustrate the actual results occurring in the various cases.

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</tr>
<tr>
<td>Other items %</td>
<td>68%</td>
<td>71%</td>
<td>71%</td>
<td>71%</td>
<td>68%</td>
</tr>
<tr>
<td>C. Expenses of Company A</td>
<td>70</td>
<td>56</td>
<td>56</td>
<td>56</td>
<td>49</td>
</tr>
<tr>
<td>Expenses of Company A %</td>
<td>7%</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
<td>7%</td>
</tr>
<tr>
<td>D. Expenses of Company B</td>
<td>150</td>
<td>119</td>
<td>119</td>
<td>119</td>
<td>105</td>
</tr>
<tr>
<td>Expenses of Company B %</td>
<td>15%</td>
<td>17%</td>
<td>17%</td>
<td>17%</td>
<td>15%</td>
</tr>
<tr>
<td>E. Residual profit</td>
<td>100</td>
<td>28</td>
<td>28</td>
<td>28</td>
<td>70</td>
</tr>
<tr>
<td>F. Residual profit Company A</td>
<td>50</td>
<td>64</td>
<td>28</td>
<td>14</td>
<td>35</td>
</tr>
<tr>
<td>G. Residual profit Company B</td>
<td>50</td>
<td>-36</td>
<td>0</td>
<td>14</td>
<td>35</td>
</tr>
<tr>
<td>Lump sum or Royalty</td>
<td>120</td>
<td>120</td>
<td>84</td>
<td>70</td>
<td>84</td>
</tr>
<tr>
<td>Royalty %</td>
<td>12.0%</td>
<td>12.0%</td>
<td>10.0%</td>
<td>12.0%</td>
<td>12.0%</td>
</tr>
</tbody>
</table>
Scenario 1 of the Discussion Draft

The Discussion Draft states that the payment for the transaction may take a variety of forms, including a lump sum payment to Company A or a sales-based royalty. Both appear to be perfectly arm’s length options, in appropriate circumstances. However, the wording of the Discussion Draft could be interpreted as considering the two options as equally applicable to a same situation. The analysis in this example highlights some concerns and drives some conclusions:

- Case 1 above illustrates the lump sum option. Company A will receive a fixed amount of 120 and this will not change. The examples above show that in case of better results for the group (positive model), Company A is expected to be penalized by additional variable costs driven by higher volumes, while its lump sum reward will not change. The opposite will occur in the negative model.

In the “positive model”, if Country A’s tax authorities interpret the OECD guidance as indifferently allowing the option of a sales-based royalty, they are likely to challenge Company A’s results by asserting that a sales-based royalty approach should have been applied, instead of a lump sum (bringing Company A to the much healthier results of Case 2). In the “negative model”, the opposite is likely to occur, i.e. Country B’s tax authorities could challenge Company B’s results with similar arguments.

- Case 2 and Case 4 highlight a different type of concern: as long as actual revenue differs from anticipated revenue, a sales-based royalty will drive Company A to get some share of the (higher or lower) actual profits. (Case 4 shows the extreme case where the stability of proportions of costs and expenses brings the method based on anticipated profits and the method based on actual profits to coincide).

The concern is opposite to the that of Case 1: In the “negative model”, if Country A’s tax authorities interpret the OECD guidance as indifferently allowing the option of a lump sum, they are likely to challenge Company A’s results by asserting that a lump sum approach should have been applied instead of a sales based royalty (bringing Company A to the much healthier results of case 1). In the “positive model”, the opposite is likely to occur, i.e. Country B’s tax authorities could challenge Company B’s results with similar arguments.

- One additional concern is represented by the fact that a literal interpretation of the concept of “anticipated profits” could lead Country A’s tax authorities to assert that that Company should get an amount of profit equal to 50 in any case, and therefore challenge the results of the “positive model” in Case 1 or challenge the results of the “negative model” in Case 2.

Scenario 2 of the Discussion Draft

Scenario 2 describes circumstances under which the transactional profit split method applies on actual profits. The main concern in relation to actual profits is related to the fact that the wording in the Discussion Draft seems to impose retrospective adjustments. This seems to exclude the possibility that adjustments to actual results will be built into the next period’s price setting. In our experience, a prospective approach is more likely to represent an arm’s length outcome (also considering the significant operational difficulties of retrospective adjustments).

In addition, also due to the self-adjusting nature of a sales-based royalty (i.e. the fact that it
automatically reflects an impact of actual profits), royalty agreements between independent parties are more likely to establish fixed royalty rates for a period of at least few years, rather than imposing year-end adjustments to actual results, and are consistent with the desired outcomes.

**TNMM Scenario**

The figures developed in our example can also be used to simulate another scenario, under which the taxpayer or one of the tax authorities could reach the conclusion that the best method should be one based on independent comparables’ results (with comparability adjustments, if needed), e.g. using the transactional net margin method (TNMM). This scenario is intended to demonstrate the considerable differences that will result without additional clarity as to the application of the TNMM versus the TPSM.

In this “TNMM” scenario, we compare the results of the “positive model” and “negative model” to a model under which Company B is rewarded using the TNMM method and the return on sales (ROS) is chosen as profit indicator.

In order to develop the TNMM scenario, we make two additional assumptions:

- In the profit split scenario, on top of its residual profit (or loss), Company B is also entitled to a routine profit of 10 in all cases; this amount is assumed to be included in line “B. Other items” in the above tables (for simplification purposes, this amount is kept fixed in all cases).
- In the TNMM scenario, Company B receives a 4% return on sales (ROS).

Using these assumptions, the profits of Company B will be the following:

**POSITIVE MODEL**

<table>
<thead>
<tr>
<th></th>
<th>Base</th>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
<th>Case 4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Profit split scenario</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Residual profit Company B</td>
<td>50</td>
<td>166</td>
<td>130</td>
<td>104</td>
<td>65</td>
</tr>
<tr>
<td>Routine profit Company B</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Total profit Company B</td>
<td>60</td>
<td>176</td>
<td>140</td>
<td>114</td>
<td>75</td>
</tr>
<tr>
<td><strong>TNMM scenario</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4% ROS Company B</td>
<td>40</td>
<td>52</td>
<td>52</td>
<td>52</td>
<td>52</td>
</tr>
</tbody>
</table>

**NEGATIVE MODEL**

<table>
<thead>
<tr>
<th></th>
<th>Base</th>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
<th>Case 4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Profit split scenario</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Residual profit Company B</td>
<td>50</td>
<td>-36</td>
<td>0</td>
<td>14</td>
<td>35</td>
</tr>
<tr>
<td>Routine profit Company B</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Total profit Company B</td>
<td>60</td>
<td>-26</td>
<td>10</td>
<td>24</td>
<td>45</td>
</tr>
<tr>
<td><strong>TNMM scenario</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4% ROS Company B</td>
<td>40</td>
<td>28</td>
<td>28</td>
<td>28</td>
<td>28</td>
</tr>
</tbody>
</table>
The positive model is apparently very favorable to Company B if the profit split method is chosen, in particular in the case of split of anticipated profits (Case 1 and Case 2\textsuperscript{2}). However, the wide gap vs. the TNMM approach is likely to generate disputes. In fact, County A’s tax authorities are more likely to react to a large disproportion of profit allocation, in particular in the case of split of anticipated profits which appears to be particularly unfit to reflect the reality of centralized business models as those common within the fashion industry.

More generally, in the “positive model” Country A’s tax authorities are likely to challenge all cases where the TNMM appears to be reasonably applicable. For example, in the scenario described by Examples 3 and 4 of the Discussion Draft, there may be situations where strong facts support the choice of profit split or TNMM, but there may also be many cases where the situation is much more uncertain and diverging interpretations have both a certain degree of justification.

The negative model shows that the profit split scenario may be particularly negative for Company B if profit split is adopted instead of TNMM, in particular in the case of split of anticipated profits (Case 1 and Case 2). We fear that the likelihood of occurrence of negative scenarios may be underestimated on the basis of an optimistic view that (for tax authorities) profit split generally means more taxable income. On the contrary, downturns and crisis periods may affect any group and sector, at some point. As shown in the example, in Case 1 of the negative scenario Company B faces significant losses.

\textsuperscript{2} Case 4 is also based on anticipated profits, but must be considered a theoretical, testing case, based on the unlikely assumption that all costs and expenses will be variable and remain in the same proportion to revenue.
Appendix B – Detailed Examples to assist in delineating the factors appropriate to determine profit split as the most appropriate method

As noted in the body of this letter (and in particular in paras 21 and 37), we believe that understanding of the definition of “unique and valuable” could be enhanced by providing more details around the facts and circumstances under which it is expected to apply. We believe that the following examples include the requisite detail and reasoning to determine why the profit split is the most appropriate method, and for what elements of the transaction. Similarly detailed examples should be drawn to demonstrate the different features that would lead to a conclusion that profit split is not the most appropriate method.

Example 1

Company A is the parent company of an MNE group which has owned and invested in a trademark for many years, and has always controlled the DEMPE functions related to that trademark. Company A has entered into a contract with Company S, a subsidiary company, according to which it licenses the use of the trademark to manufacture and sell products bearing the trademark in the territory of country S. The contract stipulates a royalty to be paid by Company S to Company A, which is based on a CUP benchmark.

Company S exploits the licensed right to the trademark in the territory by manufacturing and selling the product in the territory. Company S conducts all local marketing activities with regard to selling products bearing the trademark, and incurs substantial advertising and promotion costs to generate and increase sales of products bearing the trademark in the territory. None of the activities performed by Company S are related to Company A licensing the trademark to companies in other territories.

Under these circumstances, CUP is the most appropriate method to determine the level of royalties to be paid by Company S to Company A. Functional analysis of the transaction indicates that in this transaction Company A makes no other contribution to the profits of Company S other than the provision of the trademark, and therefore a split of the profit made by Company S would be inappropriate. The transactional profit split method is therefore not the most appropriate method.

Example 2

Company A is the parent company of an MNE group which carries out significant and continuous R&D innovation and improvement programs through various R&D centres set up in subsidiaries across countries. It therefore owns substantial technical know-how with regard to the technologies that goes into products/brands it owns. It always controlled the DEMPE functions related to development/generation of such technical know-how and recovers royalties from MNE group company for use of such technical know-how.

Company A has entered into a contract with Company S, a subsidiary company, to provide contract R&D service on the specific areas assigned by Company A. Company S performs its research activities within the overall guidance and framework laid down by Company A. Further, the allocation of resources, budget, timelines, etc. in respect of the research activities are approved by Company A. Company S does not bear any responsibility or liability on account of failure of the research which it
performs and is merely entitled to a fixed return on its cost irrespective of the outcome of the research. The contract stipulates a Cost plus mark up to be paid by Company A to Company S.

Company S does not own any intangibles in the form of patents or technical know-how. The results of the research carried out by Company S are assigned to Company A or any other operating company within the MNE Group as nominated by Company A for further development and other application in any of the products.

Under these circumstances, cost plus method (‘CPM’) which evaluates the arm's length nature of a controlled transaction by reference to the gross profit mark-up basis similarity FAR assumed by the controlled and uncontrolled parties can be an appropriate method however, in reality CPM cannot be used as difference between direct and indirect cost attributable to providing services cannot be determined therefore the CPM starts to approach a net margin rather than gross margin, thus falling within the definition of the Transactional Net Margin Method (‘TNMM’).

One strength of the TNMM is that net profit indicators (e.g. return on assets, operating income to sales, and possibly other measures of net profit) are less affected by transactional differences than is the case with price, as used in the CUP Method. Net profit indicators also may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins. Differences in the functions performed between enterprises are often reflected in variations in operating expenses. Consequently, enterprises may have a wide range of gross profit margins but still earn broadly similar levels of net operating profit indicators. Accordingly TNMM is considered as the most appropriate method for determining the arm’s length operating results for the provision of contract R&D services of Company S. In any event application of transactional profit split method whereby the royalty recovered by Company A is split between Country A and Country S would not be appropriate given the FAR analysis wherein all risks are assumed by Company A.

**Example 3**

Company X sets strategies and monitors performance in the supply chain and brand marketing processes for the MNE group. It is also responsible for key decision in supply chain as well as brand marketing including brand strategies, planning, development, communication, and product innovation. Further, it holds the licence to use trademarks to manufacture and sell products bearing the trademarks in various territories.

Company X has entered into a distribution contract with Company B, a related company, under which Company B is a distributor of Company X’s products to customers. Company B (I am not sure of the antecedent here – I think it is B, but you should clarify) is responsible for developing customer relationships, executing marketing plans and managing product promotions with customers to maximise sales in its territory. Company X provides a royalty-free license to Company B for the use of the trademarks to sell its products in the territory.

Company B only activates marketing plans developed and/or provided by Company X and incurs third party advertising and promotion costs in activating those plans. Company X bears the marketing costs relating to creation of marketing assets such as advertisement production. The marketing team involved in brand development, planning and communication are employed by Company X.
The marketing costs incurred by Company B can be high and fluctuate because they relate to third party media buying costs e.g. purchasing space or time slots in various media channels. Company X’s costs are relatively stable because a significant proportion relates to personnel costs of the marketing teams. Notwithstanding the level of marketing spend, valuable intangibles are created from the brand development and product innovation activities in Company X. Hence, marketing spend should not be used as the sole indicator of the existence of valuable marketing intangibles.

In these circumstances, the TNMM method is the most appropriate method to determine the pricing of products from Company X to Company B under the distribution contract. The functions performed by Company B are less complex than those performed by Company X, and Company B does not own or create any valuable intangibles in its overall distribution operations. Hence, transactional profit split method is not an appropriate method to apply.
I appreciate the opportunity of providing comments to the revised guidance on profit splits 2017.

The document is theoretically very clear. By applying the revised guideline, tax payers and tax administrations will find it easier to distinguish those cases in which the Profit Split Method (hereinafter PSM) is the most appropriate method for a specific transaction.

If the purpose of the document is to further facilitate its application, then a possible point of improvement could be a more step by step guide after the theoretical description. The PSM is clearly the most complicated method to apply in practice. This step by step guide described as case study could be included in the 10 examples pgs. 18 to 23.

For some SME’s the process for splitting the profits (or loss) in a transfer pricing context can represent a significant administrative and expensive burden (considering the need of different Benchmark studies and probably consultancy fees). The establishment of internal thresholds (linked to overall profit, volume etc.) could help SME’s to determine in what cases the transaction is relevant enough to perform a profit split analysis. A recommendation to use best practices and evaluate the administrative burden with the weight of the transaction from a profit shifting perspective could help SME’s prioritize its needs. This recommendation should also apply to tax administrations for their assessment of risk.

Due to the new weight that value creation and value chain analysis has in the context of BEPS. The document could address more deeply how the profit split analysis should have as a corner stone, a value creation analysis. This value creation analysis should start with the success factors of the company. These success factors are going to help defining the value drivers of each legal entity (or step in the supply chain). As a result of this process the analysis can evolve into the definition of roles for each legal entity and a better delineation of the transaction from an overall perspective for the application of the PSM.

There are several challenges that the document does not cover. The first one, the fact that taxpayers will set prices always ex ante, but the tax audit will take place years after the price setting year. The transaction at the moment of the tax audit, might not even be in a mature stage to be evaluated from an ex post perspective. This is often the case in long term technological or medical developments. If the transaction would take place between third parties, they would never make an adjustment to previous year’s results, but probably adjust the agreement for the future depending...
on a previous stage result. Therefore, a recommendation for the tax authorities to evaluate always from the taxpayer perspective at the moment of the price setting is very important. Considering also what related parties have planned for future years.

The second one, the fact that in a lot of cases lack of information will limit the level of analysis. What practical tools can the taxpayer and the tax administration use in those cases? And how deep should this process be documented if at the end the information is not available.

The third point is, the intrinsic evolution in market conditions, development, customers demands, factors that make a forecast a sensitive analysis. Transactions in the practice depend on several aspects that are rarely under the control of taxpayers. The markets evolve the customers demand change, regulations also affect transactions, all these facts and circumstances cannot be always evaluated with numbers. Uncertainty can relatively be evaluated with an amount. Therefore, it is also difficult to put a number for a specific risk. Taxpayers and tax administrations should apply flexibility and common sense while evaluating transactions for future uncertain years. Working with budgets used for companies valuation performed by third parties could be very helpful even if they are performed for other compliance purposes.

Comments on specific questions

Factors that 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 mentioned before, prices are set among third parties before the profit or loss is realized. The use of actual profits or loss would create more uncertainty and practical problems. Let take an example:

Two manufacturing companies will enter a project for the same end customer. Both companies will perform unique and valuable contributions in terms of R&D and market development. One of the companies will provide raw material and technical assistance to the other one at t1. The customer will purchase the products after testing and using some free samples in t2. The price of all transaction between the related parties between t0 and t1 have to be settle at the moment of the transaction. Due to customs, VAT and accounting issues the related parties are not able to wait until the end customer decides to if the product is appropriate, if it works for him etc.

From our perspective, there are only two moments in time where the profit split should be used, and that is

1) at the moment in which the transaction takes place and the analysis is based on anticipated profits or loss.
2) at the moment in which the transaction has evolved further, and the analysis is reviewed for possible adjustments into the future, this analysis will be performed also with anticipated profit or loss the difference with point one is the level of experience and information that is going to be available.
If we want the ALP to survive we have to apply the sentence “as if they were third parties” in all cases. Not only when it benefits the tax administration. The reality is that we do not see adjustment for the past between third parties. That is part of the risk and it is also reality.

References to Capital or Capital employed.- From my perspective the reference to capital employed should be kept. A capital employed analysis implies the analysis of funds being used during the operating cycle the analysis provides a sense of future capital flexibility. The reference will not harm, because the taxpayer will have to decide what is the most appropriate information for analyzing the transaction the reference can add a lot of value.

Headcount of skilled and competent employees and in what circumstances would it be relevant.- I am glad to see this question and be able to comment. From a value creation perspective, the only asset within a company that is capable of creating value through creativity innovation and customer relationships is human capital. Even the most elaborated machines, software’s, know how, automatic processes are all created by employees, people. Therefore, I not only think that headcount of skilled and competent employees should be used as a profit splitting factor, I believe is the most important value driver and therefore the most relevant profit splitting factor that a company can use.

Adjustments for purchasing power parity and in what circumstances. - The purchasing power parity (hereinafter PPP) is a very complex macroeconomic concept. People in business, sales, R&D etc. take decisions far from such a complex analysis. If the concept were to stay in the guidelines it should be simplified through a description in simple and commonly used words. From my perspective, the PPP is already represented in the delineation of the transaction through the economic circumstance. There is no need to add complexity.

Other profit splitting factors should be included. - No additional comments.

Other examples.- Financial transactions, Franchises.

For any clarification regarding the context of the present document please do not hesitate to contact me.

Brigitte Baumgartner

brigitte@tp-baumgartner.com

www.tp-baumgartner.com
BUSINESSEUROPE position on the Public Discussion Draft on BEPS Action 10: Revised Guidance on Profit Splits

Through its members, BUSINESSEUROPE represents 20 million European small, medium and large companies. BUSINESSEUROPE’s members are 41 leading industrial and employers’ federations from 35 European countries, working together since 1958 to achieve growth and competitiveness in Europe.

BUSINESSEUROPE is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft entitled “BEPS Action10: Revised Guidance on Profit Splits” (hereinafter referred to as the Draft).

BUSINESSEUROPE notes the OECD recognition that guidance on the transactional profit split method (TPSM) requires clarification and strengthening following the BEPS Actions 8-10 Final Report in 2015, and appreciates the efforts of WP 6 and the Inclusive Framework to produce relevant and useful updates to Section C of Chapter II of the 2010 Transfer Pricing Guidelines (TPG). However, to be effective as guidance for both taxpayers and tax administrations, particularly tax administrations who are members of the Inclusive Framework and have limited past direct exposure to the TPG, the guidance needs to be a consensus document that more clearly distinguishes the circumstances in which the TPSM is not an appropriate pricing method and that the TPSM should not be a default method in the absence of readily available comparable uncontrolled prices or transactions.

Recognising that there may be practical difficulties in achieving consensus on detailed guidance relating to the TPSM in a relatively short time frame, and that very high level consensus guidance may be of limited practical assistance in complex inter-company business scenarios, the OECD should perhaps consider whether this particularly contentious issue should be dealt with through a two-stream approach, with consensus on detailed practical guidance among OECD members and other countries who support the previous OECD position on the use of profit splits as documented in the 2010 TPG, and a higher level consensus, based on this draft, that all Inclusive Framework members could support.

The previous draft guidance, issued on July 4, 2016 included a clearer statement on the inappropriate use of the TPSM in the final sentence of paragraph 16:
"The application of a transactional profit split of actual profits when not supported by the features derived from the functional analysis, for example in cases where other methods are difficult to apply because reliable comparables are scarce, is unlikely to produce an arm’s length outcome since the appropriate use of a profit split is determined by the existence of a specific commercial relationship between the parties."

BUSINESSEUROPE would recommend that this sentence is reinstated in the current draft as clear guidance to tax administrations that the absence of comparable data is not a valid reason for the use of the TPSM and that other pricing methodologies will be appropriate in most circumstances, whether or not directly comparable data on similar transactions is available.

It would be appropriate for the guidance to emphasise that, where the taxpayer does not use a TPSM, there are likely to be very considerable difficulties in creating, after the event, the level of detailed analysis that would be required to support or quantify the outcome of a TPSM. Tax administrations should be advised that the circumstances in which a tax administration could estimate the outcome of a TPSM, or require that a taxpayer should undertake the very significant work required to perform a reasonably accurate TPSM, are likely to be very limited. Paragraph 46 contains some confirmation that the method must be applied on the basis of information known or reasonably foreseeable at the time the transactions were entered into and that the method of calculation should be based on written contracts documenting the intentions of the parties, and should not be varied over the lifetime of the agreement: the implications of this guidance for any tax administration proposal to use TPSM after the event should be highlighted.

The Draft uses "operating profit" as a concept throughout, but this term is not defined in the 2017 TPG glossary. It would be helpful to include a definition, either in this draft or in the glossary of the TPG.

Throughout the draft the phrase "unique and valuable contributions" or "unique and valuable intangibles" and similar words are used, but "unique and valuable" is not defined. The draft should include a definition that is useful to taxpayers and tax administrations and which helps identify the threshold for a contribution or intangible to be considered "unique" and "valuable" in particular circumstances.

Paragraph 7 identifies one of the strengths of the TPSM as a solution for highly integrated operations, with a reference to section C2.2.2. It would be relevant to include the wording in paragraph 19: "Although most MNE groups are integrated to some extent a particularly high degree of integration...is an indicator".

The draft, at paragraph 10, refers to the difficulty of obtaining relevant information as a weakness of the TPSM: this paragraph underestimates and understates the significant practical difficulties that many taxpayers would experience in gathering sufficient accurate information to carry out a reasonably accurate TPSM analysis.
Paragraph 32 of the discussion draft identifies two main factors TPSM should incorporate. The second factor refers to the ability of TPSM of “Be capable of being measured in a reliable manner”. Although paragraphs 60-62 include some scenarios to support the measurement of the TPSM, the term “reliable manner” is not defined further and perhaps a clear definition of this in the guidance would assist MNEs in determining in what circumstances profit splits could be considered truly measurable. This is particularly relevant when other internal data rather than asset-based and cost-based profit splitting factors are used (e.g. weight of people).

Paragraphs 35-36 refer to contribution analysis, but with very little guidance being provided on the concepts and processes used in this analysis. BUSINESS EUROPE would recommend that more detailed guidance is provided, or that the draft includes a clearer caveat that contribution analysis is complex and requires detailed knowledge of the business processes of both parties.

Paragraph 24 of the Draft refers to control and assumption of risk and makes a reference to paragraph 1.105 of the TPG. To be consistent with the 6 steps process recommended in Chapter 1 of the TPG, this cross reference should be expanded to paragraphs 1.72 through to 1.106, not to a single paragraph that could be taken out of context. It is important that the guidance on the control of risk in a TPSM takes full account of the detailed guidance in Chapter 1 on the analysis and pricing of economically significant risks.

The Draft, at paragraphs 60-61, refers to the use of especially drawn-up transactional balance sheets. It should be recognised and explained in the guidance that there are likely to be very significant practical and financial system difficulties to be overcome in drawing up such balance sheets, even on a contemporary basis, and creating a transactional balance sheet for an audit sometime after the event would be particularly challenging.

Specific questions

1. The guidance already notes at paragraph 43 that the basis of a TPSM should be the accurately delineated transaction, based on written contracts (paragraph 46). Whether the TPSM should be based on anticipated or actual profits will therefore depend on the nature of the relationship between the parties and the investment or contribution that each makes, and the guidance should not encourage tax administrations or tax payers to rely on one or other in all circumstances. Certainly, as paragraph 45 suggests, where unique and valuable contributions are made and one party could not realise profit without the other, anticipated profits should be used. It does not, however, follow that where the business operations are highly integrated or each party makes unique and valuable contributions, that actual profits should be used in all cases. Paragraph 44 posits a scenario where business risks are shared and concludes that actual profits should be used in computing the split of profit: this may be appropriate where the relationship between the parties is close to a joint venture or partnership, but it should not be
concluded that in all cases where there is some sharing of risk that actual profits should be used.

2. Profit splitting factors: as a general comment, the accurate delineation of the transaction should facilitate the identification of profit splitting factors that are appropriate to the particular economic relationship between the parties, and creating a limited list of factors that appear to be endorsed by the OECD could restrict the use of economically appropriate factors or combinations of factors.

   a. Capital and capital employed should be retained, not only because of relevance for financial transactions, but also for capital intensive industries and because the current value of assets reflected in a capital account that are contributed to a trading relationship can be an effective proxy for the arm's length value of the underlying assets.

   b. Headcount: this could be a suitable factor, if used with care. It has the merit of being simple, practical and consistent with third party arrangements e.g. in the services sector. However, consideration should be given to applying weighting factors to headcount, and these weightings will often not be the same as payroll/employment costs.

   c. Purchasing power parity: this would be very difficult to estimate and in practice is likely to be of limited use. 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 consequentially impacts the comparability of the population. In such a scenario, the application of purchasing power parity might be relevant.

   d. Other factors: as noted above, the guidance should not be prescriptive but should support the use of factors that are appropriate for the accurately delineated transaction.

Examples

It is not clear why in some examples (e.g. 1, 2 and 5) the TPSM is considered the most appropriate method as it appears that other pricing methodologies could be used.

It would be helpful for the examples to include a discussion of whether a split of anticipated or actual profits should be used (examples 1, 2, 3, 5 and 7). This would demonstrate that the circumstances where a split of actual profits should be used are in practice limited and the use of anticipated profits would be more common.
Examples 4 and 6 both conclude that TPSM is not the most appropriate method, but the conclusions are differently worded "...the profit split method may not be the most appropriate method..." compared with "...the profit split method is unlikely to be the most appropriate method". It is not clear from the examples why the strength of the conclusion is different.

In example 10, it is not clear why, based on the information provided in the example, that an asset-based profit splitting factor is appropriate and the proviso "that the functional analysis concludes that there is a strong correlation between the assets of Company A and Company B and the creation of value..." would be better shown as a fact in an earlier paragraph, so that the conclusion is based on the presented facts, not an assumption.

Yours sincerely,

James Watson
Director Economics Department
REPLY TO THE OECD’S REQUEST FOR COMMENTS ON THE
“PUBLIC DISCUSSION DRAFT ON BEPS ACTION 10
REVISED GUIDANCE ON PROFIT SPLITS”
FROM CMS

CMS is a European Economic Interest Grouping that coordinates an organisation of independent law firms:

CMS Adonnino Ascoli & Cavasola Scamoni, Associazione Professionale (Italy);
CMS Albiñana & Suárez de Lezo S. L. P. (Spain);
CMS Bureau Francis Lefebvre S.E.L.A.F.A. (France);
CMS Cameron McKenna Nabarro Olswang LLP (United Kingdom);
CMS Carey & Allende (Chile);
CMS DeBacker SCRL / CVBA (Belgium);
CMS Derks Star Busmann N. V. (Netherlands);
CMS GRAU Abogados (Peru);
CMS von Erlach Poncet SA (Switzerland);
CMS Hasche Sigle, Partnerschaft von Rechtsanwälten und Steuerberatern (Germany);
CMS Pasquier Ciulla & Marquet (Monaco);
CMS Reich-Rohrwig Hainz Rechtsanwälte GmbH (Austria);
CMS Rodriguez Azuero Contexto Legal Abogados (Colombia) and
CMS Rui Pena & Arnaut (Portugal).

Contacts for follow-up. This contribution was prepared by the CMS Transfer Pricing Group and, in particular, by the following experts:

Name: Arnaud Le Boulanger: Partner, Chief Economist
       Mohamed Haj Taieb: Counsel

Organisation: CMS Bureau Francis Lefebvre
              2, rue Ancelle
              92522 Neuilly-sur-Seine Cedex

Country: France

E-mail address: arnaud.leboulanger@cms-bfl.com
               mohamed.hajtaieb@cms-bfl.com

Telephone: +33 (0)1 47 38 44 06
Fax: +33 (0)1 47 38 56 68

Do you authorize the OECD to publish your contribution on the OECD website? Yes
The Discussion Draft echoes the argument “that a transactional profit split method is rarely used among independent enterprises, and thus its application in controlled transactions should be similarly rare”, and counters it by stating that “transfer pricing methods are not necessarily intended to replicate arm’s length behavior, but rather to serve as a means of establishing and/or verifying arm’s length outcomes for controlled transactions.” (Paragraph 11 of the Discussion Draft).

While the above statement may be valid in general as regards most of the transfer pricing methods, we believe that, when specifically applied to the transactional profit split method, it may lead to dangerous and invalid conclusions. Indeed, there is an intrinsic difference between the transactional profit split method and all other methods discussed by the OECD, in the very fact that profit is split among the parties. Therefore, assuming that, in a specific situation and given a specific functional analysis, independent parties would not have used the transactional profit split method (as would often be the case as the OECD noted in the first part of Paragraph 11 of the Discussion Draft), this fact implies that said independent parties would not have agreed to share profits, i.e. that each party would not bear any risk in the level, or fluctuation, of the other party’s own profit, but would instead bear risks strictly limited to the level, and fluctuation, of its own profit. Now, it that same situation and with exactly the same functional analysis, but applying to a controlled transaction, using the transactional profit split method to establish or verify arm’s length outcomes for that controlled transaction, inevitably bears the effect to force both parties to bear risks related to the level, or fluctuation, of the other party’s profit. In other words, using the transactional profit split method to establish or verify arm’s length outcomes for that controlled transaction, distorts the functional analysis itself as independent parties would have concluded on it. As a consequence, we recommend that the OECD recognizes that fact, and accordingly concludes that, in situations where independent parties would not use the transactional profit method, it should generally not be used to establish or verify arm’s length outcomes for controlled transactions, unless no other method can be used in a sufficiently reliable manner.

Regarding the appropriateness of the transactional profit split method in general, we greatly welcome the arguments presented in paragraphs 14 and 28 of the Discussion Draft. Indeed, we strongly agree that in situations where one of the parties to the transaction has a routine functional profile (simple functions, no economically significant risks, no unique and/or valuable intangibles), then it is indeed unlikely that the transactional profit split method would constitute an appropriate transfer pricing method. We also agree that a lack of information on comparable uncontrolled transactions should not be sufficient to justify, alone, the application of the transactional profit split method and that an appropriate method based on comparable (though not identical) uncontrolled transactions should lead to more reliable results than an inappropriately used transactional profit split method.

Besides, paragraph 15 of the Discussion Draft stresses out that industry practice between unrelated parties is relevant. We concur to this view. Indeed, we believe that where independent parties use other methods besides the transactional profit split method, this should always be taken into account. We suggest that the OECD should consider pushing this
reasoning to its logical conclusion, which is to say that in situations where independent parties
generated in comparable transactions would not take into account their respective profits when
setting their prices – and, indeed, would not even share any information concerning their
profits with the other party at all – then it should be considered that the transactional profit
split method is most likely not an appropriate transfer pricing method for said transaction.
Conversely, in situations or industries where there are indications that unrelated parties use
the transactional profit split method in a transactional context, we would suggest that the
transactional profit split method should be considered as probably being appropriate.

Under this approach, information on how unrelated parties actually implement profit split
would be most helpful. The Discussion Draft raises very interesting questions in this respect:
(i) should actual or anticipated profits be split, (ii) what measure of profit should be taken into
account, (iii) what are the profit splitting factors.

The approach of the Discussion Draft is to obtain comments on virtual behavior of potential
unrelated parties; our suggestion would be to seek evidence of actual behavior of unrelated
parties.

To be more precise:

- **Question 1:** when the transactional profit split method is applicable, we believe it is
dangerous, both for the taxpayers as well as for the tax administrations, to base a
transactional profit split solely on anticipated profits unless it is the only available
metric, i.e. when actual profits are either unavailable or irrelevant. Indeed:
  - From the taxpayer’s point of view, overreliance on anticipated profits as the
    basis to be split is synonymous with systematic fiscal insecurity because,
    despite the OECD’s constant reservations with regards to this matter, tax
    administrations quite often use hindsight and compare the taxpayer’s
    anticipated profits to the actual profits eventually made, which necessarily
    leads to issues on one or the other end of the cross-border transaction.
  - From the tax administrations’ point of view, overreliance on anticipated profits
    as the basis to be split is problematic because it is very difficult for a tax
    administration to assess whether or not these anticipated profits constituted the
    best and fairest guess of an arm’s length outcome at the time when the
    transaction was closed.

These comments notwithstanding, there remain situations where it may be correct to
resort to the transactional profit split method based on anticipated profits. This could
for example be the case when transferring a still in-process intangible asset for which
there is no track records of actual profits yet. Another example could be relying on a
DCF based on future profits to determine an amount to be split among parties on the
basis of their respective contributions.

- **Question 2:** we find that, as a general rule, shortlisting a set amount of splitting factors
to the exclusion of all others is a very delicate matter. Moreover, it is often more
appropriate to take into consideration multiple, combined factors rather than a single one. Bearing this in mind:

- Capital or capital employed: we believe it is likely that capital-based splitting factors will often be more appropriate when dealing with transactions which take place in an economic context which is capital-intensive, and/or is not labour-intensive.

- Headcount: conversely, we believe it is likely that headcount-based splitting factors will often be more appropriate when dealing with transactions which take place in an economic context which is labour-intensive, and/or is not capital-intensive. In any case, headcount-based factors should often be limited to the employees or employee categories which are relevant to the transaction at hand, i.e. that take a significant role in the contributions of the parties to the transaction.

- Purchasing power parity: it is difficult to offer a general answer, but we suggest it may be possible to draw a parallel with how location savings are treated depending on whether or not they can be practically taken into account as a comparability factor in a given situation. Indeed:
  - Where location savings exist and can actually be taken into account as a comparability factor, i.e. when it is possible to identify comparable transactions between unrelated parties which involve comparable location savings (for instance, a benchmark of independent companies comparable to a tested party and located in a country generating similar location savings to that of the tested party), it is not necessary to separately take purchasing power into account.
  - Where location savings exist but cannot be taken into account as a comparability factor (lack of available comparable transactions between independent parties displaying the same profile), the question becomes the following: is it appropriate to share these location savings between the controlled parties? If the answer to that question is yes, then it might be possible to limit a transactional profit split to the sharing of these location savings, basing this split on an economic analysis of the parties’ respective bargaining power (for example, by resorting to Game theory).
BEPS Action 10 – revised guidance on profit splits – Comment

1 Summary
The present paper provides a concise summary of the constituents of a profit split situation (section 2.1). The next section discusses ways to actually achieve such split. An example illustrates how licence agreements can be used to actually implement a residual profit split for a complex transaction (section 2.2). Considering the splitting of anticipated profits it is shown that such procedure may lead to a fixed price which may leave at least one partner with results inconsistent with the arm’s length principle. Furthermore, it is argued that anticipated profits and the associated business plan are indispensable to properly setting-up the transaction and to value the partners’ contribution. However, the four structures discussed suggest that the information is better used to achieve a proper splitting of the actual profits. A fixed price approach is considered to represent an exceptional case. In particular, setting-up a joint venture is proposed as a means to explicitly determining how risks should be shared. Such decision may also resolve some issues associated with identifying the appropriate profit splitting factor (section 3).

2 TPS intends to achieve an arm’s length division of profits

2.1 Constituents of the profit split situation
Controlled parties may contribute tangible property, intangibles and/or services to the transaction subject to the profit split. Once the transaction is properly delineated, the profits to be split – the relevant profits – are identified and split between the associated enterprises involved. This requires splitting factors that approximate the division of profits agreed at arm’s length (between uncontrolled parties). It is expected that uncontrolled parties try to achieve a division of profits which is in line with the value of their respective contributions.\(^1\)

In profit split situations, the one-sided methods are not suitable, i.e., do not approximate an arm’s length result for the following reasons:\(^2\):

- the controlled parties involved make unique and valuable contributions to the transaction considered;
- unique, valuable intangibles are involved;
- the operations are highly integrated;
- the parties share risks related to the transaction considered.

Obviously, an appropriate profit splitting factor measures each controlled parties’ share in the total valuable contributions the partners make. With respect to TPS and the general approach of the guidelines, contributions are deemed unique and valuable when the fol-

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1 See [1], p. 4
2 See [1], p. 6 - 8

Dr. Steffen R. Möckel
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lowing conditions are met:

- comparable uncontrolled contributions in comparable circumstances are not available / identifiable;
- they are a key source of the expected future benefits.

2.2 Achieving the profit split

According to the guidelines, the following constituents of a profit split should be agreed in advance and for the life-time of the arrangement:

- the functions the controlled parties intend to contribute;
- the significant risks the parties assume with respect to the transaction(s);
- the profit splitting factors;
- the rules according to which the profits related to the transaction are determined;
- the business plan our budget delineating the expected life-time profits on a monthly / annual basis.

In practice, there are several ways to actually achieve the intended profit split. Table 1 discusses some basic approaches to the issue.

<table>
<thead>
<tr>
<th>Approach</th>
<th>Description</th>
<th>Remark</th>
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| Global debit / credit note           | The affiliated partners generating the transaction related revenues issue periodic debit or credit notes to actually achieve a profit split in line with the related allocation of functions and risk | • Such debit / credit notes may not be acceptable unless agreed upon as part of an APA → income tax / withholding tax implications need to be considered / to be dealt with.  
• The simplified procedure may be inconsistent with the bundle of transactions to be considered (not a transactional profit split anymore) |
| Transfer prices for products and services | The transfer prices are defined prospectively (e.g. @budget) to ensure the profit split consistent with the underlying profit splitting factors. | • Requires transaction flows suitable to achieve the appropriate division of profits;  
• The resulting transfer prices must be meaningful (e.g. avoid negative product prices etc.) |
| Licence agreements                   | A set of licence agreements is implemented                               | • Licensees’ profits after licences payment are to commensurate with the functions performed and the risk assumed |

Table 1: Approach to achieve the appropriate profit split

Example 1 illustrates a complex joined project between two sub-groups each being a wholly owned subsidiary of M, the ultimate parent.

Given the intertwined decision process and the way the two partners contribute to the project, considering one of the partners just a management service provider would be inappropriate. As a consequence, irrespective of possible unique valuable contributions a profit split is deemed appropriate.

Successfully executing such a complex project, the transaction the profit of which is to be split, represents a collection of transactions such as product design/engineering, financing, and last but not least volume production after start of production. However, the various affiliates involved – in particular the various manufacturing sites – are not necessarily party
to the profit split. Both manufacturers as well as potential service companies involved in design and engineering perform functions for which an arm’s length price can be derived from appropriate comparable uncontrolled transactions (outside evidence / benchmarking study). In such situation, the residual profit split is the most appropriate transfer pricing method.

Supposing that the plants located in different affiliates around the globe directly deliver the product to the customer and generate the associated revenues the challenge is to set-up a licence scheme ensuring that residual profits – if any – accrue at either A or B, while allowing the manufacturing sites a functional profit commensurate with the functions performed and the risk assumed. This may require transfer pricing system that allows for variable royalty rates.

Two wholly owned subsidiaries A and B of M (ultimate parent) operate as 1st tier automotive suppliers. A and M are incorporated in country A, B is incorporated in country B. Both, A and B are parent companies of sub-groups consisting of plants and service companies incorporated in various countries around the globe. A won a contract to develop and supply a major component for a specific car line with an expected economic life of 10 years. Such projects are divided into two major phases the development / investment phase and the production period (see Exhibit 1).

To effectively master the project related challenges, both A and B join forces. In fact, B takes over the daily project management including the management of the customer in general and with respect to change requests in particular. As a consequence, mission critical entrepreneurial decisions with respect to

- product design and engineering are taken primarily by A’s management whereas
- B’s management primarily assumes responsibility for the supply chain / manufacturing approach.

A joint steering committee (A and B management) approves the decisions taken.

**Example 1:** Highly integrated decision processes suggest a transactional profit split approach

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**Exhibit 1:** Time horizon and cash flow related to a transaction

To effectively master the project related challenges, both A and B join forces. In fact, B takes over the daily project management including the management of the customer in general and with respect to change requests in particular. As a consequence, mission critical entrepreneurial decisions with respect to

- product design and engineering are taken primarily by A’s management whereas
- B’s management primarily assumes responsibility for the supply chain / manufacturing approach.

A joint steering committee (A and B management) approves the decisions taken.

**Example 1:** Highly integrated decision processes suggest a transactional profit split approach
Please note that the transfer prices as well as the royalty rates are to be determined pro-
spectively (@budget). This may well include a cross-licence arrangement between A and B
in order to ensure a division of the residual profits according to the profit splitting factor.
Each partners’ share in uncompensated initial investment in product design and manufac-
turing process development may serve as profit splitting factors.

3  Discussion of selected specific questions

3.1 Splitting anticipated profits may not lead to arm’s length results

The guidelines employ the notion of risk exposure or assumption of significant risk as a cri-
teron to determine whether actual or anticipated profits should be split.

As shown below, anticipated profits, business plans and or forecasts are necessary to set-
ting up transactions and to valuing the partners contribution. However, just using anticip-
ated profits to value a contribution likely leads to a fixed price. This fixed price may not be
in line with the transaction’s actual profit potential. As a consequence, the resulting division
of profits may be inconsistent with the true value of the contribution and the arm’s length
principle. In order to avoid such a favourable outcome, such solution should be chosen
only if

• the fixed payment derived from the initial budget is immaterial to the value of the re-
spective transaction;
• such constant fee is also agreed with 3rd parties under similar circumstances.

Please bear in mind, that in case of a better business than initially expected there will a
chance that the fixed income parent derives from the intangible may be deemed too low,
i.e., inconsistent with an arm’s length approach.

Structuring a deal, the parties effectively consider two factors, the value of the contribu-
tions and the way they choose to share the associated risk. Example 2 below is used to il-
lustrate the argument.

Example 2: Anticipated profits and structure of the transaction

There are numerous options to structure the transaction of which Table 2 intends to com-
pare the most common approaches to sharing both, opportunities and risk between (con-
trolled) partners.

The partners may choose a joint venture to exploit the opportunities and to mitigate the as-
sociated risk (options [1] and [2] Table 2). As stated above, the anticipated profits are suffi-
ciently high to justify the efforts.

To simplify the process, each partner pays 50% of the mandatory stated capital (option [1],
Table 2). Generally, the partners agreed to equally share the associated opportunities and

3 Slightly adjusted example 9, See [1], page 22

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risk. Under the assumption that whatever service each of the partners render to the joint venture is compensated at arm’s length there is no need to determine whether the interest in the joint venture is consistent with some profit splitting factor.

The joint venture and parent A conclude a license agreement. As parent A enters into similar transactions with uncontrolled parties a comparable uncontrolled transaction is available. On that basis the combination of initial lump-sum payment and royalty rate is determined. In case that no suitable outside evidence is available, the anticipated profits / the business plan has to be used to determine the intangible’s value. In such situation, the profit commensurate with the functions performed and the risks assumed.

Both, parent A and B may render services to the joint venture. The fees charged are derived taking into account appropriate outside evidence.

<table>
<thead>
<tr>
<th>Option</th>
<th>Details</th>
<th>Use of anticipated profits</th>
<th>Remarks</th>
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</table>
| Establish a joint venture     | [1] The two partners contribute 50% of the stated capital and incorporate a new entity in country B. | • Crucial for setting up the joint venture  
• May be required to arrive at a royalty rate if comparable royalty rates are not identifiable | • Net assets are shared;  
• The results should coincide with a residual profit split analysis;  
• The partners’ share in the stated capital is the profit splitting factor. |
| [2] The partners incorporate the company and endow the new affiliate with intangible assets (Company A) and tangible assets (Company B). | • Crucial for setting up the joint venture  
• Required to arrive at the value of the tangible / intangible assets the JV is endowed with | • Net assets are shared;  
• A royalty is not charged;  
• A residual profit split solution is achieved supposing that the partners render services at arm’s length conditions. |
| Enter into a license agreement | [3] Licensee pays the licence fee (an initial lump sum and/or a fixed percentage on sales). | • Crucial for entering into the agreement  
• May be required to arrive at a royalty rate if comparable royalty rates are not identifiable | • No net assets to share;  
• Licensee assumes the bulk of the entrepreneurial risk and receives the entire residual profit. |
| Fixed fee arrangement         | [4] A receives a fixed annual fee                                        | • Crucial for setting up the transaction  
• The business plan specifies expected profits, the profit splitting factors.  
• The fixed annual fee is determined based on the assumption that the transaction is implemented according to plan. | • Neither a license fee nor a service fee is charged.  
• A receives the annual compensation irrespective of the actual result. |

Table 2: Options to structure a transaction and anticipated profits

Option [2], Table 2 is similar to [1], however, the partners endow the joint venture with intangible assets (Parent A) and fixed assets (Company B) instead of paying the stated capital in cash. The anticipated profits / the business plan is the basis for valuing both, the intangible assets and the tangible assets made available. The partners use their share in total assets contributed as profit splitting factor.

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103
Obviously, a regular royalty rate is not required as the right to exploit the know-how constitute part of the entities equity. As with option [1] – supposing that arm’s length fee is charged for services rendered – the solution is consistent with a residual profit split of the actual profits.

Just entering into a licence agreement (option [3], Table 2) suggests that parent A choose to assign the entire business risk to affiliate B. Services B may require from A are rendered under an existing service agreement using arm’s length fees. The licences agreement provides for an initial lump-sum payment and an annual royalty rate (linked to sales). The terms are determined taking into account outside evidence from similar contracts A entered into with 3rd parties.

Derive fixed annual or monthly payments to parent A from the business plan and decouple the payments from the actual success of the transaction (option [4], Table 2). Suppose developing the new business is much more expensive and time consuming than expected. Therefore, B’s sales are significantly lower and the it takes more time to achieve the envisaged sales level. In such situation monthly or annual fixed payments derived from a way to optimistic business plan create for B an income lower than commensurate with the functions performed and the risk assumed.

Please note, that options [1] and [3] (Table 2) can be combined with a fixed monthly/annual licence payment. As a consequence, the resulting profit may not be commensurate with the functions performed and the risk assumed.

### 3.2 Profit splitting factors

As outlined above, it is expected that uncontrolled partners try to achieve a division of profits which is consistent with the value of their respective contributions. Since there are countless ways in which partners can contribute to a transaction it is hardly possible to come up with a comprehensive set of profit splitting factors. However – as the proposed guidelines point out the profit splitting factors should meet the following criteria:

- capable of being measured in a reliable manner
- consistently applied over the expected life-time of the arrangement.

This implies that the factor deemed appropriate is initially determined and applied to the results achieved over the transactions life-time.

Given the complexity and size of some of the transactions subject to a profit split it may be more appropriate to take an explicit decision how to share profits between the partners instead of relying on eventually artificially created profit splitting factors. As shown above, this can be achieved by establishing a joint venture.

In this situation the partners may choose to provide the stated capital in cash or in tangible and intangible assets. Obviously, the cash contribution is the simplest way to clarify the intended split of profits. This, however, requires that arm’s length transfer prices are determined for whatever service or product (tangible and intangible) the joint venture might receive from each of the partners. Such solution is particularly appropriate in case of transactions as complex as illustrated by Example 1.
4 References

5 Contact
Dr. Steffen R. Möckel
ccontrabass
www.contrabass.biz
Konkordiastraße 2
40219 Düsseldorf, Germany
e-mail.: dr.s.moeckel@contrabass.biz
Tel.: +49 15774111022
Copenhagen Economics welcomes the opportunity to comment on the OECD’s Discussion Draft on BEPS 10, Revised Guidance on Profit Splits, issued on 22 June 2017.

Copenhagen Economics supports the OECD’s efforts to develop rules to prevent base erosion and profit shifting by engaging in transactions that require the use of the profit split method.

Copenhagen Economics believes that additional clarifications on the proposed guidance and examples will help both the taxpayer and the tax administration in the application of the profit split method.

It is our opinion that clear and pragmatic guidance on the profit split method would represent a further step in the proper allocation of profits based on economic substance.

We present our comments and feedback to the discussion draft below.
1 Background

Action 10 of the BEPS Action Plan identifies that work needs to be undertaken to develop “rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains”.

Further, the report on “Addressing the Tax Challenges of the Digital Economy” developed in relation to BEPS Action 1 identified issues in the digital economy that need to be taken into account in the course of the work on transfer pricing. The report noted in particular that the work should devote attention to the consequences of greater integration in MNEs and should evaluate the need for increased reliance on value chain analyses and profit split methods. The report also noted that this work should address situations where comparables are not available and could consider improvements to the guidance on the use of profit splits and other profit methods along the lines already applied in connection with global trading and other integrated financial services businesses.

In accordance with this mandate, Working Party No. 6 on the Taxation of Multinational Enterprises has considered a number of scenarios where it may be more difficult to apply one-sided transfer pricing methods to determine transfer pricing outcomes that are in line with value creation, and where (as a result) the application of a transactional profit split method may be appropriate.

Given this purpose, the OECD released three discussion drafts on 16 December 2014, on 4 July 2016, and on 22 June 2017 with the final aim to clarify, improve and strengthen the guidance on when and how it is appropriate to apply a transactional profit split method.

The final outcome of this work is to replace Part III Section C of Chapter II of the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“TP Guidelines”).
2 The Discussion Draft

The newly released public Discussion Draft “Revised Guidance on Profit Splits” (the “Discussion Draft”) deals with the clarification and strengthening of the guidance on the transactional profit split method, as set out in the BEPS Actions 8-10, 2015 Final Report, and sets out the text of proposed revised guidance on the application of the transactional profit split method.

Moreover, the Discussion Draft poses a number of questions intended to elicit responses which will then be considered by Working Party No. 6 in its revisions to the relevant guidance in Chapter II of the Transfer Pricing Guidelines.

It is our opinion that although there are significant improvements and in-depth clarifications included in the Discussion Draft, thanks to the numerous comments provided on the previous discussion drafts, the guidance on the application of the profit split method can be enhanced further.

To further clarify and strengthen the use of the transactional profit split method, it is our opinion that the Working Party No. 6 should consider filling the gaps concerning: (i) revisions to the current guidance, (ii) further guidance on specific elements, and (iii) clarifications on technical issues, as discussed in the paragraphs below.
3 Revisions to the current guidance

3.1 Contradiction of the draft guidance on Hard-to-Value-Intangibles

Para 46 of the Discussion Draft\(^1\) appears to contradict the draft guidance on Hard-to-Value-Intangibles (HTVI) released by the OECD on 23 May 2017. This particularly refers to the use or non-use of hindsight. It is our opinion that is necessary to align the guidance, particularly by a revision of the OECD’s draft guidance on HTVI.

3.2 Actual vs. anticipated profits

Para 27 as well as 44 and 45 of the Discussion Draft appear to suggest that the profit split method should be based on actual profits in some instances, given how economically significant risks play out\(^3\). It is our opinion that this section of the Discussion Draft might be misinterpreted since third parties would undertake a transaction (i.e. determine and exchange the transaction price) based on their expectation of how the transacted functions, risks, or assets, may materialize and would not wait until actual profits arise. To do so, third parties can and would model the possible outcomes of economically significant risks ex-ante to determine their transaction price and would thereby factor these possible risk outcomes in ex-ante, so that no awaiting of actual profits is necessary.

In addition, it is our opinion that even when applying a transactional profit split of anticipated profits, the taxpayer takes in account the probability of the outcome of risk through the discount rate (e.g. WACC\(^4\) used for discounting future income/cash flows).

3.3 Comparable uncontrolled transactions vs. relative contributions

Para 52 and 53 of the Discussion Draft appear to suggest that the splitting of the profits based on “relative contributions” is secondary to the splitting of the profits based on comparable independent transactions\(^5\). In this, the Discussion Draft refers to joint-venture arrangements between independent parties under which profits are shared.

First, it is our opinion that this hierarchy of application should not be in place (i.e. split based on relative contributions should not be secondary to the split identified in third-party relationships). Second, the reference to joint-venture arrangements could be

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1. 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 Discussion Draft, para 46 (Emphasis added).


3. 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. See Discussion Draft, para 44 (Emphasis added).

4. Weighted average cost of capital.

5. Where there is no more direct evidence of how independent parties in comparable circumstances would have split the profit in comparable transactions, the allocation of profits may be based on the relative contributions of the parties, as measured by their functions, assets used and risks assumed. See Discussion Draft, para 53 (Emphasis added).
misleading as these arrangements are often affected by other unobservable interests than the transactional interests under review. By this, joint-venture arrangements rarely qualify as “independent” arrangements, irrespective of any capital contributions.

### 3.4 External data vs. internal data

Para 59 of the Discussion Draft appears to suggest a hierarchy in the use of data sources for the determination of the splitting factors, favouring external data over internal data. It is our opinion that the “most appropriate” data source based on the accurately delineated transaction should be used, rather than the application of an artificial hierarchy of data sources.

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6. Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the relevant profits, consideration should be given to internal data, which may provide a reliable means of establishing or testing the arm’s length nature of the division of profits. See Discussion Draft, para 59 (Emphasis added).
4 Further guidance on specific elements

4.1 Key source of actual or potential economic benefits

Para 16 of the Discussion Draft refers to a “key source of actual or potential economic benefits” as an element to identify unique and valuable contributions. The Discussion Draft, however, does not provide any indication of what taxpayer and tax administration should mean by “key source of actual or potential economic benefits”. Therefore, it is our opinion that further guidance is needed in order to determine what a “key source of actual or potential economic benefits” is.

4.2 Economically significant risks and relevant profit

Para 25 of the Discussion Draft introduces “economically significant risks” as one reason for the application of the transactional profit split. In addition, para 26 of the Discussion Draft loosely relates such risk to “such that a share of relevant profits would be warranted for each party”. It is our opinion that further guidance is needed on what an “economically significant risk” and a “relevant profit” are.

4.3 Weighting of splitting factors

Para 55 of the Discussion Draft refers to the use of different splitting factors in the application of the transactional profit split method. While we agree that the use of different splitting factors may be needed in the application of the transactional profit split, it is our opinion that further guidance is needed on how the different splitting factors should be weighed against each other.

In addition, whilst factors based on assets, capital or costs may accurately measure the relative contribution of each party to a transaction in instances where the parties perform activities within the same function, it is unlikely to provide a good representation of the relative contribution in instances where the parties perform different functions within the value chain, employ distinct assets, and or bear different risks.

In order to measure the relative value of each party’s contribution to a transaction, one should take into account all the functions performed, assets employed and risks borne.
by the related parties, as well as the corresponding benefit attributed to such functions, assets and risks.

Since it may not be feasible to accurately quantify how much each activity, asset and risk contributes to the generation of profit in a transaction, room should be made for splitting profits based on a reasonable estimation of (i) the proportion of functions performed, assets employed and risks borne by each party, and (ii) the relative importance of and value created by each function, asset and risk.
5 Technical clarifications

5.1 Legal ownership of unique and valuable intangibles

Para 17 of the Discussion Draft only states the concept of “legal ownership” of unique and valuable intangibles, while it additionally refers to economically significant risks. It is our opinion that the concept of economic ownership should be introduced more fully within the guidance on the profit split method as indicated by the OECD guidance on intangibles and it should be noted that not only the assumption of economically significant risks builds up or accounts for economic ownership.

Para 36 of the Discussion Draft appears to suggest that contributions should be assessed based on the “relative contributions” and “external market data”. In this regard, it seems that the specific mention of “internal data”, as outlined in para 51, is missing. Hence, it is our opinion that an alignment to Para 51, by including the notion of “internal data” in Para 36, is needed.

5.2 Use of segregated data

Para 42 of the Discussion Draft indicates that segregated data should be used in the application of the transactional profit split. It is our opinion that the revised guidance on the profit split method should also account for the fact that the application of the method may often lead to the split of the total profit of one or more parties, especially for highly integrated businesses as suggested by para 19-24.

5.3 Bearing of risks and financial capability

Para 24 of the Discussion Draft refers to the bearing of risk and the allocation of remuneration in this regard. It is our opinion that a further clarification about the link between the bearing of risks and the financial capability to bear such risks (as indicated in

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11 Where each party to the transaction legally owns unique and valuable intangibles that are relevant to the transaction, it will also be necessary to consider whether, under the accurate delineation of the transaction, they each assume the economically significant risks relating to those intangibles. See Discussion Draft, para 17 (Emphasis added).

12 See OECD TP Guidelines, July 2017, Chapter VI Special Considerations for Intangibles, Section B, para 6.32.

13 It can be difficult to determine the relative value of the contribution that each of the associated enterprises makes to the controlled transactions [...]. The determination might be made by comparing the nature and degree of each party’s contribution of differing types [...] and assigning a percentage based upon the relative comparison and external market data. See Discussion Draft, para 36 (Emphasis added).

14 Except in circumstances where the total activities of each of the parties are the subject of the profit split, the financial data will need to be segregated and allocations made in accordance with the accurately delineated transaction(s) so that the profits relating to the combined contributions made by the parties are identified. See Discussion Draft, para 42 (Emphasis added).

15 Where 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 Discussion Draft, para 24 (Emphasis added).
the 2016 Discussion Draft on Profit Split, para 9) is needed. In this regard, it seems relevant to clarify whether and how the financial capacity to assume the relevant risks should be considered as a key element in the application of the profit split method.

16 In accordance with the guidance in Section D of Chapter I, such an outcome would only be consistent with the accurate delineation of the actual transaction in cases where the economically significant risks associated with the outcomes of the business activities are controlled, either separately or collectively, by the parties sharing in the actual profits, and each party has the financial capacity to assume its share of the risks. See Public Discussion Draft, Revised Guidance on Profit Splits, 04 July 2016, para 9 (Emphasis added).
For clarification of any aspect of our responses presented above please contact:

Hendrik Fügemann  Partner  hef@copenhageneconomics.com
Vincenzo Zurzolo  Senior Economist  viz@copenhageneconomics.com
Claire Foley Danielsson  Senior Economist  clf@copenhageneconomics.com
September 15, 2017

Mr. Jefferson VanderWolk
OECD Secretariat
Centre for Tax Policy and Administration
Tax Treaty, Transfer Pricing & Financial Transactions Division
Organization for Economic Cooperation and Development
2, rue André Pascal
75775 Paris
FRANCE

Re: Comments on Public Discussion Draft on Revised Guidance on Profit Splits (22 June – 15 September 2017)

Dear Mr. VanderWolk:

Deloitte Tax LLP (“Deloitte Tax”), a subsidiary of Deloitte LLP1 (“Deloitte”) appreciates the opportunity to submit comments regarding the Organization for Economic Cooperation and Development’s (OECD’s) Public Discussion Draft on BEPS Action 10 Revised Guidance on Profit Splits 22 June – 15 September 2017 (the “Discussion Draft”).

Deloitte Tax recognizes and appreciates the extent of the work performed since last year by the OECD on this topic. The Discussion Draft reflects thoughtful consideration by Working Party 6 of the comments provided by stakeholders to the Public Discussion Draft on transactional profit splits issued July 4, 2016, and the public consultation on that topic subsequently held in Paris.

Our comments on the Discussion Draft focus primarily on ensuring that guidance issued by the OECD on the selection and application of the transactional profit split as the most appropriate transfer pricing method is fully consistent with the extensive and rigorous risk control framework provided in Chapter I of the 2017 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. With that goal in mind, we offer in the first section of this comment letter a conceptual discussion of how an accurately delineated transaction informs the selection and application of the transactional profit split as the most appropriate method, followed in the second section by an application of those concepts to the examples provided in the Discussion Draft.

More specifically, Deloitte Tax believes that paragraph 24 of the Discussion Draft unintentionally suggests that when considering the transactional profit split, no guidance other than that

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1 Please see www.deloitte.com/us/about for a detailed description of our legal structure.
provided at paragraph 1.105 is relevant in accurately delineating the subject transaction. Such interpretation of paragraph 24 would undermine the integrity of the risk control framework of Chapter I.

Indeed, the failure of paragraph 24 to emphasize that paragraph 1.94 and Section D.1.2.1.5 of Chapter I are equally important as paragraph 1.105 in accurately delineating any transaction, including a transaction for which the transactional profit split may be an appropriate method, may result in a tax administration compelling a taxpayer to reallocate taxable income through a transactional profit split to parties that only contribute to the control of an economically significant risk, but do not assume that risk, contrary to paragraph 1.94 or paragraph 1.95 of Chapter I.

Such reallocation is inappropriate when the party assuming the economically significant risk as a result of paragraph 1.94 does not pursue a further allocation of that risk and associated return through step 5 of the six-step process required for the accurate delineation of the transaction provided at paragraph 1.60.

The last sentence of paragraph 1.94 specifically states that “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, and step 5 need not be considered.” [Emphasis added].

Since step 5 of the six-step process provided at paragraph 1.60 is the only way that a party not assuming a risk may be allocated all or some of that risk and its associated return (the upside and downside of the risk) in an accurately delineated transaction, and since paragraph 1.105 states that the entitlement to upside and downside of a risk usually results from being allocated a risk (Step 5: Allocation of risk), the only logical conclusion that can be drawn from an application of paragraphs 1.94 and 1.105 is that when more than one party contributes to the control over a risk, but one party assumes that risk within the meaning of paragraph 1.94 and does not affirmatively allocate risk under step 5, all other parties contributing to the control over that risk are entitled to an arm’s length compensation equal to a service fee for their control functions. Deloitte Tax believes that the only way to read paragraphs 1.60, 1.94, 1.95, and 1.105 consistently is to conclude that an allocation of risk must take place pursuant to step 5.

The service fee should be commensurate with the ex ante value of the control function provided, not with the value of the underlying risk assumed by the paragraph 1.94 party assuming the risk.

Deloitte Tax believes that without such clarification as to how paragraphs 1.94, 1.105, and Section D.1.2.1.5 work together in accurately delineating a transaction in the context of a transactional profit split, unnecessary controversy will ensue.

From a practical perspective, paragraph 24 could be entirely eliminated and replaced with an example illustrating the application of paragraphs 1.94 and 1.105 to accurately delineate a transaction when the party assuming the risk pursuant to paragraph 1.94 elects not to consider step 5 of Section D.1.2.1.5. Deloitte Tax recommends such an approach.

The proposed example should start with a contractual arrangement between parties allocating the economically significant risk subject to upside and downside to one of the parties, while the other party is provided a service fee for its contribution to the control function over the economically significant risk subject to upside and downside.

Should the OECD decide not to eliminate the guidance at paragraph 24 of the Discussion Draft, Deloitte Tax requests that paragraph 24 be clarified and that the same references to all relevant sections of Chapter I (paragraphs 1.94, 1.105, and Section D.1.2.1.5.) be incorporated on an equal footing in a revised paragraph 24 to ensure the appropriate application of the guidance on the
accurate delineation of the transaction to transactions considered for an application of the transactional profit split method.

You will also find in our comments our views in connection with the “Specific Questions for Commentators” at page 2 of the Discussion Draft.

We appreciate this opportunity to share our views on this issue and hope you find our comments valuable to the discussion.

We look forward to continued collaboration with the OECD on this and other transfer pricing initiatives. Please feel free to contact Philippe at +1 202 220 2601 should you have any questions about this submission.

Very truly yours,

DELOITTE TAX LLP

By: John Wells, Ph.D.
Managing Principal
Transfer Pricing

By: Philippe G. Penelle, Ph.D.
Managing Principal
WNT Transfer Pricing

By: Robert Stack
Managing Director
WNT International Tax
Glossary

TPG: Generic reference to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.


OECD: Organization for Economic Cooperation and Development.

BEPS: Base erosion and profit shifting.


Executive Summary

Our comments on the Discussion Draft focus primarily on ensuring that guidance issued by the OECD on the selection and application of the transactional profit split as the most appropriate transfer pricing method is fully consistent with the extensive and rigorous risk control framework provided in Chapter I of the 2017 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

More specifically, Deloitte Tax believes that the failure of paragraph 24 to emphasize that paragraph 1.94 and Section D.1.2.1.5 of Chapter I are equally important as paragraph 1.105 in accurately delineating any transaction, including a transaction for which the transactional profit split may be an appropriate method, may result in a tax administration compelling a taxpayer to reallocate taxable income through a transactional profit split to parties that only contribute to the control of an economically significant risk, but do not assume that risk, contrary to paragraph 1.94 or paragraph 1.95 of Chapter I.

Such reallocation is inappropriate when the party assuming the economically significant risk as a result of paragraph 1.94 does not pursue a further allocation of that risk and associated return through step 5 of the six-step process required for the accurate delineation of the transaction provided at paragraph 1.60.

The last sentence of paragraph 1.94 specifically states that “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, and step 5 need not be considered.” [Emphasis added].

Since step 5 of the six-step process provided at paragraph 1.60 is the only way that a party not contractually assuming a risk may be allocated all or some of that risk and its associated return (the upside and downside of the risk) in an accurately delineated transaction, and since paragraph 1.105 states that the entitlement to upside and downside of a risk usually results from being allocated a risk (Step 5: Allocation of risk), the only logical conclusion one can draw from an application of paragraphs 1.94 and 1.105 is that when more than one parties contribute to the control over a risk, but one party contractually assumes that risk within the meaning of paragraph 1.94 and does not affirmatively allocate risk under step 5, all other parties contributing to the control over that risk are entitled to an arm’s length compensation equal to a service fee for their control functions. Deloitte Tax believes the only way to read paragraphs 1.60, 1.94, 1.95, and 1.105 consistently is to conclude that an allocation of risk must take place pursuant to step 5.

The service fee should be commensurate with the ex ante value of the control function provided, not with the value of the underlying risk assumed by the paragraph 1.94 party.

Deloitte Tax believes that without such clarification as to how paragraphs 1.94, 1.105, and Section D.1.2.1.5 work together in accurately delineating a transaction in the context of a transactional profit split, controversy will ensue.

From a practical perspective, paragraph 24 could be entirely eliminated and replaced with an example illustrating the application of paragraphs 1.94 and 1.105 to accurately delineate a transaction when the party assuming the risk pursuant to paragraph 1.94 does not utilize step 5 of Section D.1.2.1.5 to allocate the risk to another party. Deloitte Tax recommends such an approach.

The proposed example should start with a contractual arrangement between parties allocating the economically significant risk subject to upside and downside to one of the parties, while the
other party is provided a service fee for its contribution to the control function over the economically significant risk subject to upside and downside.

Should the OECD decide not to eliminate the guidance at paragraph 24 of the Discussion Draft, Deloitte Tax requests that paragraph 24 be clarified and that the same references to all relevant sections of Chapter I (paragraphs 1.94, 1.105, and Section D.1.2.1.5.) be incorporated on equal footing in a revised paragraph 24 to ensure an appropriate application of the guidance on the accurate delineation of the transaction to transactions considered for an application of the transactional profit split method.
The Accurate Delineation of the Transaction and Guidance on Profit Splits

It is important that the guidance provided by the OECD in Chapter II of the TPG be fully consistent with the risk and control framework in Chapter I of the 2017 OECD TPG. Because the analysis of the most appropriate transfer pricing method critically hinges on an accurately delineated transaction, guidance issued in Chapter II must apply to a transaction for which (i) each economically significant risk has been identified, (ii) each party involved in the transaction has been identified, and (iii) the party assuming each economically significant risk (for transfer pricing purposes) has been identified through the six-step process outlined at paragraph 1.60.

In other words, an analysis of the most appropriate transfer pricing method under Chapter II cannot be performed without a clear and complete understanding of which party is assuming which risk either solely, jointly or through an allocation pursuant to step 5 of the accurate delineation of the transaction (see Section D.1.2.1.5).

Therefore, the guidance provided under Chapter II of the TPG should not contain elements that are relevant to the accurate delineation of the transaction without the risk of undermining the guidance provided in Chapter I. In addition, the guidance provided in Chapter II of the TPG should focus on illustrating how the accurate delineation of the transaction under Chapter I concepts informs the selection of the most appropriate method, including the transactional profit split method.

**Paragraph 24 of the Discussion Draft**

Where 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 paragraph 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 transactional profit split is the most appropriate method in the case. [Discussion Draft, paragraph 24].

Although Deloitte Tax does not disagree with the statement contained in the first sentence of paragraph 24 because it is limited to “...some cases...” it should be pointed out that such cases whereby a party that contributes to the control of an economically significant risk, but that risk is assumed by the other party to the transaction, is entitled to the potential upside and downside associated with that risk are extensively discussed in Chapter I of the TPG at paragraphs 1.94, and 1.105, and Section D.1.2.1.5 (Step 5: Allocation of risk).

At a minimum, Deloitte Tax requests that this guidance from Chapter I be incorporated at paragraph 24 by reference. Paragraph 1.105 is the only reference to the relevant guidance of Chapter I that is currently mentioned at paragraph 24 of the Discussion Draft, but it is not the only relevant one. As a practical matter, if paragraphs 1.60, 1.94, and 1.95 are to have any meaning, “some cases” are likely to be relatively rare.

Paragraph 1.94 is relevant because it addresses specifically cases in which more than one party to the transaction exercises control over a specific economically significant risk.

 Furthermore, in some cases, there may be more than one party to the transaction exercising control over a specific risk. When the associated enterprise assuming risk (as analysed under step 4(i)) controls that risk in accordance with the
requirements set out in paragraphs 1.65 – 1.66, all that remains under step 4(ii) 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, and step 5 need not be considered. [2017 OECD TPG, paragraph 1.94].

Paragraph 1.105, as noted at paragraph 24 of the Discussion Draft, is also relevant because it addresses specifically cases in which more than one party to the transaction exercises control over a specific economically significant risk.

A party should always be appropriately compensated for its control functions in relation to risk. Usually, the compensation will derive from the consequences of being allocated risk, and therefore that party will be entitled to receive the upside benefits and to incur the downside costs. In circumstances where a party contributes to the control of risk, but does not assume the risk, compensation which takes the form of a sharing in the potential upside and downside, commensurate with that contribution to control, may be appropriate. [2017 OECD TPG, paragraph 1.105].

Section D.1.2.1.5 (Step 5: Allocation of risk) is relevant because it discusses the allocation of risk which, as a result of the second sentence of paragraph 1.105, entitles a party that does not assume a risk as a result of the application of the first 4 steps in paragraph 1.60, but contributes to the control of that risk, only to receive the upside and downside associated with that risk if, pursuant to step 5 the party is allocated the risk. Any other interpretation of paragraphs 1.60, 1.94, 1.95, and 1.105 would not be logical or consistent.

The second sentence of paragraph 1.105 reads: “Usually, the compensation will derive from the consequence of being *allocated* risk, and therefore that party will be entitled to receive the upside benefits and to incur the downside costs.” [Emphasis added]

Having established the relevance of paragraphs 1.94 and 1.105 and of Section D.1.2.1.5 to cases addressed by paragraph 24 of the Discussion Draft, it is important to articulate how these elements of guidance work together to accurately delineate which party is entitled to the potential upside and downside of risk.

In cases in which more than one party contributes to the control of an economically significant risk, paragraph 1.94 provides that when the associated enterprise assuming that risk (as analyzed under step 4(i)) controls that risk in accordance with the requirements set out in paragraphs 1.65-1.66, assuming that associated enterprise has the financial capacity to assume the risk, 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, and step 5 need not be considered.

The last statement at paragraph 1.94 does not say that step 5 cannot be considered; it says that “...step 5 *need* not be considered.” [Emphasis added].

Because step 5 is the step that addresses the cases in which more than one party controlling a risk is allocated a risk and is therefore entitled to the potential upside and downside associated with the risk pursuant to the second sentence of paragraph 1.105, a taxpayer who satisfies the conditions at paragraph 1.94 and does not reallocate that risk pursuant to step 5 (as authorized in the last sentence of paragraph 1.94), will not only be the party deemed to assume the risk for transfer pricing purposes, it will furthermore be the only party to be allocated that risk.
Therefore, pursuant to the second sentence of paragraph 1.105, it will be the only party entitled to the upside and downside of the risk realization.

It is within the discretion of a multinational enterprise to arrange its affairs so that more than one party controlling an economically significant risk (and having financial capacity to assume it) assumes that risk for transfer pricing purposes. Paragraph 1.95 specifically addresses such a case:

> 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. [2017 OECD TPG, paragraph 1.95].

It is also within the discretion of a multinational enterprise to arrange its affairs so that only one party controlling an economically significant risk along with other parties (and having financial capacity to assume it) solely assumes that risk for transfer pricing purposes. This requires (i) a contractual allocation of risk consistent with the aforementioned arrangement, (ii) satisfying the conditions in step 4, and (iii) not allocating the risk pursuant to step 5.

In those cases, the arms’ length consideration for parties contributing to the control of an economically significant risk, but not assuming such risk, and not being allocated such risk under step 5, is a service fee that reflects the *ex ante* value of the control function, not the economic value of the underlying economically significant risk under analysis.

Deloitte Tax believes that paragraph 24 of the Discussion Draft obfuscates and potentially undermines the rigorous accurate delineation of the transaction six-step process outlined by the OECD at paragraphs 1.60, 1.94, 1.105, and Section D.1.2.1.5. By the time the guidance of paragraph 24 of the Discussion Draft becomes relevant, the subject transaction and associated economically significant risks must have already been accurately delineated following an analysis under the relevant guidance in Chapter I of the 2017 OECT TPG articulated above.

Therefore, paragraph 24 of the Discussion Draft, which goes to the accurate delineation of a transaction, but refers only to a single paragraph of relevant guidance in Chapter I, has the potential to undermine the guidance in Chapter I by suggesting that when considering a transactional profit split, only the guidance at paragraph 1.105 matters in the accurate delineation of the transaction. It could therefore be read as an exception to the general guidance of Chapter I, whereby only paragraph 1.105 matters in the accurate delineation of the transaction, and paragraphs 1.60, 1.94, 1.95, and Section D.1.2.1.5 do not.

The OECD did not intend to provide in its guidance on transactional profit split an exception to the general principles controlling the accurate delineation of the transaction. Paragraph 12 of the Discussion Draft provides that:

> The accurate delineation of the actual transaction will be important in determining whether a transactional profit split is potentially applicable. The 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). [Discussion Draft, paragraph 12].

Paragraph 12 clearly states that the accurate delineation of a transaction analysis is done “irrespective of which transfer pricing method is ultimately found to be the most appropriate,” and the references to paragraphs 1.33-1.35 incorporate by reference the entire six-step process that encapsulate paragraphs 1.60, 1.94, 1.95, 1.105, and Section D.1.2.1.5.

Therefore, Deloitte Tax urges the OECD to remove paragraph 24 altogether. Should WP6 decide to keep paragraph 24, Deloitte Tax urges the OECD to add references to paragraph 1.94 and Section D.1.2.1.5 to the existing relevant references to paragraph 1.105 in the Discussion Draft at paragraph 24, or to refer more generally to paragraphs 1.33-1.35 and the six-step process of the accurate delineation of a transaction.

Further to the conceptual comments developed above, please refer to our discussion of Example 1 at Annex I, illustrating why the sole reference to paragraph 1.105 as relevant to the accurate delineation of the transaction is not sufficient to conclude on the most appropriate transfer pricing method.

Shared Assumption of Economically Significant Risks, Separate Assumption of Closely Related Risk

Deloitte Tax recommended in its comments to the OECD on the 2016 Discussion Draft to remove from the draft, and from Chapter II of the TPG, guidance related to value chain analysis, and to incorporate such guidance, if distinct from the guidance on “functional analysis,” into Chapter I of the TPG.

Deloitte Tax appreciates that all guidance related to value chain analysis has been removed from the Discussion Draft, and reiterates that, to the extent the OECD believes that guidance -- supplemental and distinct from the guidance on functional analysis -- should be provided with regard to value chain analysis, such guidance should be provided in Chapter I. At the very least, Deloitte Tax recommends that a reference to value chain analysis be provided in Chapter I, including a statement to the effect that for transfer pricing purposes, a value chain analysis is synonymous to a functional analysis. Such clarification would eliminate any further confusion in the mind of taxpayers and tax administrations.

Deloitte Tax also recognizes that the OECD provided explicitly at paragraph 2 of the Discussion Draft that the guidance on transactional profits split applies not only to splitting profits, but also to losses. In our experience, tax administrations seek a guaranteed return (e.g., cost-plus return) in all years (including loss years), but also seek an additional share of the entrepreneurial profits (the upside of risk realization) in profitable years. Further, tax administrations are more prone to suggest the use of transactional profit splits for transactions and years that involve ex post profits. Because these approaches inappropriately ignore the possibility of loss splitting, Deloitte Tax respectfully requests that the title of the guidance at Section C of Chapter II of the TPG addressing transactional profits split be changed to “guidance on transactional profits and losses split method.”

The 2016 Discussion Draft provided some level of guidance addressing the extent of the control over economically significant risks between participants to a transaction expected to support the transactional profit split as the most appropriate method.

For example, in cases where a product is jointly developed by incorporating two distinct and separate technologies, one developed and controlled by participant A without control by participant B, and the other developed and controlled by participant B without control by
participant A, a strict application of the concepts of Chapter I may have suggested that the transactional profit split cannot be the most appropriate transfer pricing method because participant A does not exercise any control over the risks related to the development of one of the technologies, and participant B does not exercise any control over the risks related to the development of the other technology.

The 2016 Discussion Draft referred to “separate or collective control” without specifying how “separate” control over development risks of the two technologies in the example above was consistent with the guidance provided in Chapter I of the 2017 TPG, and could result in the transactional profit split being the most appropriate method.

In Deloitte Tax’s comments submitted to the OECD on September 15, 2016, we noted:

Paragraph 9 also provides guidance as to when a transactional profit split of actual profits is the most appropriate method, as a result of the application of the principles of the control framework of Chapter I. The last sentence of that paragraph reads: "In accordance with the guidance in Section D of Chapter I, such an outcome would only be consistent with the accurate delineation of the actual transaction in cases where the economically significant risks associated with the outcomes of the business activities are controlled, either separately or collectively, by the parties sharing in the actual profits, and each party has the financial capacity to assume its share of the risks." [Emphasis added]. Although this sentence is helpful in conforming the guidance on transactional profit splits on actual profits with the control requirement of Chapter I, Deloitte Tax requests that the statement “... either separately or collectively...” be clarified, specifically with respect to the separate control of the economically significant risks associated with the outcomes of the business activities. [Deloitte Comment Letter to the OECD, September 15, 2016].

The Discussion Draft addressed this comment by clarifying at Section C.2.2.3 paragraph 26 that:

A transactional profit split may also be found to be the most appropriate method where, according to the accurately delineated transaction, the various economically significant risks 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.... [Discussion Draft, paragraph 26].

In addition, paragraph 23 states that:

Where business operations are highly integrated, the extent to which the parties share the assumption of the same economically significant risks or separately assume closely related, economically significant risks will be relevant to the determination of the most appropriate method and, if a transactional profit split is considered the most appropriate method, how it should be applied. [Discussion Draft, paragraph 23].

Deloitte Tax appreciates this clarification and further suggests the following.

Since the determination of the level of integration of a multinational’s transactions, and the identification of the associated economically significant risks, and the identification of the contractual allocation of such economically significant risks, and the interrelation of such economically significant risks, and the accurate delineation of the underlying transactions giving rise to such economically significant risks, are all achieved by the application of guidance
provided in Chapter I, Deloitte Tax suggests that guidance explaining the concepts of “shared assumption of economically significant risks, separate assumption of closely related risks” be provided in Chapter I.

Since, as indicated earlier, the selection of the most appropriate transfer pricing method under Chapter II can only be achieved after a transaction has been accurately delineated under Chapter I, and the concepts of “shared assumption of economically significant risks, separate assumption of closely related risks” are relevant in informing the selection of the most appropriate method, the existence of such “shared assumption of economically significant risks, separate assumption of closely related risks” should be discovered as part of the functional analysis and of the accurate delineation of the transaction. Section C.2.2.3 of the guidance on the transactional profit split should then build on guidance provided in Chapter I to illustrate how these concepts inform the selection of the transactional profit split as the most appropriate transfer pricing method versus all other appropriate methods.

Failing to do so results in relevant additional guidance on the control framework of Chapter I being provided exclusively in the guidance on a single transfer pricing method—the transactional profit splits guidance-- suggesting that the concepts of “shared assumption of economically significant risks, separate assumption of closely related risks” are not relevant to the selection and application of other transfer pricing methods. Because the selection of the most appropriate transfer pricing method is a relative exercise of comparing the appropriateness of one transfer pricing method to all other appropriate methods, any and all guidance on control is relevant to the selection and application of all transfer pricing methods, not just the transactional profit split method.

Clearly separating guidance pertinent to the accurate delineation of transactions from guidance pertinent to the selection and application of the most appropriate transfer pricing method after the transaction has been accurately delineated will help taxpayers and tax administrations respect the integrity of the risk control framework of Chapter I.
Deloitte Tax appreciates the inclusion of examples in the guidance. We believe examples are particularly helpful in illustrating the principles contained in the transactional profit split method guidance. We also understand that the factual background of the examples must be limited to focus the reader on the one or two points the example is intended to illustrate. However, Deloitte Tax believes it is important that the examples contain the essential elements of the required analysis (even if in conclusory format) in order to clearly assist tax administrators and taxpayers to apply the principles contained in the transactional profit split analysis. Otherwise, tax administrators may focus only on the facts contained in the example, and not consider the overall principles for the selection and application of the transactional profit split method.

As discussed earlier, Deloitte Tax believes that the failure of paragraph 24 to emphasize that paragraph 1.94 and Section D.1.2.1.5 of Chapter I are equally important as paragraph 1.105 in accurately delineating any transaction, including a transaction for which the transactional profit split may be an appropriate method, may result in a tax administration compelling a taxpayer to reallocate taxable income through a transactional profit split to parties that only contribute to the control of an economically significant risk, but do not assume that risk, contrary to paragraph 1.94 or paragraph 1.95 of Chapter I. Several of our comments related to the examples provided by the OECD in the Discussion Draft further illustrate how paragraph 1.94 and Section D.1.2.1.5 of Chapter I are relevant to a clearer discussion of the fact patterns presented in these examples.

**Example 1**

Deloitte Tax believes that the fact pattern presented in Example 1 is insufficient to conclude that “Under these circumstances, the transactional profit split method is likely to be the most appropriate method for determining the profits of Company A and Company S from the sale of the patented product provided that the functional analysis indicates that Company A and Company S performed important functions that were unique and valuable in the creation of those profits.” [Discussion Draft, Example 1, paragraph 71].

First, the “performance of important functions,” including those that are “unique and valuable” is not the principle endorsed by the OECD to determine whether a transactional profit split is the most appropriate method. Paragraph 12 clearly states that “The accurate delineation of the actual transaction will be important in determining whether a transactional profit split is potentially applicable...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 the be the most appropriate. (See paragraphs 1.33-1.35).” [Discussion Draft, paragraph 12].

With regard to the accurate delineation of the transaction in Example 1, there are three facts that are critically important and are currently missing from the narrated facts presented, namely (i) what is the contractual arrangement between Company A and Company S? (Section D.1.1); (ii) does Company S have unique and valuable rights in resources, rights, or capabilities in existence at the time the license in entered into, that Company S will contribute to the transaction? (Section D.1.2); and (iii) does Company A or Company S exercise control (within the meaning of paragraph 1.65) over the economically significant risks associated with the assets and functions expected to be developed by Company S through the rights it acquires in the license?
Consider a fact pattern whereby (i) Company A appoints Company S to further develop the drug and seek regulatory approval as a service provider, (ii) Company S does not have any preexisting rights, resources, or capabilities it will contribute to the transaction, and (iii) Company A exercises control (within the meaning of paragraph 1.65) over the economically significant risks involved in the services provided by Company S, and has financial capacity to assume these risks.

Company A and Company S did not structure their transaction pursuant to paragraph 1.95. Assuming that Company A is deemed to assume the economically significant risks associated with the performance by Company S of its obligations under the license (paragraph 1.94), since Company A and Company S decided to structure their transaction as a service transaction, should they not reallocate risk pursuant to step 5 (Step 5: Allocation of risks), even if Company S exercises some level of control over the economically significant risks, Company S is not allocated any of the underlying economically significant risks associated with the performance of its obligations under the contract. Company S is entitled to a service fee commensurate with the ex ante value of the risk control function it provides. See Section I of this comment letter.

It should be noted that in the previous fact pattern, since Company S is not expected to contribute any preexisting rights, resources, or capabilities to the transaction, Company A would be in a position to extract through a royalty a significant amount of the value expected to be created through the performance by Company S of its obligations under the contract, especially if the market structure is such that a large number of companies similarly situated as Company S can be found in the open market.

More specifically, if the guidance of Chapter VI of the 2017 OECD TPG on the use of valuation methods is followed (Sections D.2.6.3 and D.2.6.4) to price the subject license, the expectations that Company S will develop certain rights, resources, or capabilities as a result of the transaction itself (that is, no preexisting rights, resources or capabilities), at arm’s length Company S will have to pay for acquiring the present value of such rights, resources, or capabilities.

Example 3

Example 3 appears to be intended to illustrate the notion of “shared assumption of economically significant risks, separate assumption of closely related risks,” and how the separate assumption of closely related risks can lead to a transactional profit split being the most appropriate transfer pricing method.

Although Company A does not control marketing risks and Company B does not control research and development risks and manufacturing risks, both parties to the transaction assume closely related risks that are economically significant for their business operations.

As was the case in Example 1, the facts presented in Example 3 are insufficient to reach the conclusion that the accurate delineation of the subject transaction would result in a transactional profit split method being deemed the most appropriate, and if it is, which kind of transactional profit split (actual or anticipated profits), and what level of profits should be subject to the split.

The accurate delineation of any transaction always starts with the identification of economically significant risks (Step 1: Identify economically significant risks with specificity), directly followed by the identification of the parties assuming each economically significant risk contractually (Step 2: Contractual assumption of risk). Example 3 outlines the economically significant risks involved in the subject transaction, but it is silent as to what the second step indicates in terms of the party or parties contractually intended to assume each of these risks.
In addition, it is unclear from the example what preexisting rights, resources, and capabilities Company B contributes to the transaction. It appears from the narrative that Company B contributes to the transaction an already developed sophisticated algorithm; however, it also appears from the narrative that a number of important unique and valuable business assets are expected to be developed by Company B as a result of the transaction itself: “Once the products are manufactured, they are sold to Company B, which will develop and execute cutting-edge global marketing activities relating to the new line of products....The marketing activities performed by Company B result in a valuable trademark and associated goodwill by which the new line of products is favourably differentiated from competitors' alternatives in the market.” [Discussion Draft, Example 3, paragraph 79][Emphasis added].

It is unclear whether the business assets Company B will develop are expected to leverage existing unique and valuable resources, rights, and capabilities of Company B. In particular, it is unclear from the narrative whether or not Company B owns a valuable trademark at the time the arrangement is entered into, or is expected to develop such valuable trademark as a result of the transaction itself. Finally, it is unclear whether the conclusion of the example hinges on the “cutting-edge” nature of the marketing activities expected to be performed by Company B, and if it does, to what extent. We therefore recommend removing the words “cutting edge,” because what really matters in the accurate delineation of the transaction is whether or not Company B owns unique and valuable rights, resources, or capabilities at the time the transaction is entered into.

The contractual arrangement and the identification of unique and valuable rights, resources, or capabilities contributed by each party to the transaction are prerequisites to the accurate delineation of the transaction pursuant to the six-step process outlined at paragraph 1.60. In Example 3, assuming that the only unique and valuable preexisting rights, resources, or capabilities contributed by Company B to the transaction is the proprietary sophisticated algorithm, it may well be the case that an internal or external CUT is available to price such contribution. Along with a contractual arrangement limiting the assumption of risks by Company B, and supported by the accurate delineation of the transaction, a transactional profit may not be the most appropriate method and therefore may not be “…likely to be the most appropriate method for determining the profits of Company A and Company B from the sales of products...” [Discussion Draft, Example 3, paragraph 82].

Example 4

Example 4 is the same as Example 3, with the exception that the marketing activities of Company B do not involve economically significant risks for the business operations. Similar to Example 3, Example 4 does not address the contractual arrangement between Company A and Company B and the intended level of sharing of market risks contemplated by the parties at the time of the arrangement.

Deloitte Tax agrees that compared to Example 3, Example 4 is less likely to result in a transactional profit split being the most appropriate method; however, there still is a “shared assumption of economically significant risks, separate assumption of closely related risks,” insofar as Example 3 deals in “shades of grey” regarding the significance of the marketing functions and assets, and the contributions of such functions and assets to the ultimate profitability of Company A. The first two sentences of paragraph 85 read: “Marketing and distribution risks assumed by Company B may impact on the ultimate profitability of Company A. However, the functional analysis determines that the risks assumed by Company B are not economically significant for the business operations.” [Discussion Draft, Example 4, paragraph
85]. It is not completely clear from the example how these two sentences are fully compatible with each other.

One possible remedy would be to replace the second sentence with this sentence: “However, the functional analysis determines that the functions performed and risks assumed by Company B are not unique and do not materially contribute to the overall risk of Companies A and B operations.”

Deloitte Tax believes that the example aims to describe a scenario whereby the marketing functions and assets developed by Company B do not materially contribute to the systemic risk involved in the business operations of Companies A and B. Therefore, the risks involved in the marketing functions and assets are largely diversifiable—the playing out of these risks affects the profitability of the business operations (first sentence), but would not be priced in the open market (second sentence).

**Example 5**

Example 5 does not clarify what are the contractual terms of the arrangement between WebCo and ScaleCo. Specifically, the phrase “At this stage, WebCo transfer the program to ScaleCo...” [Discussion Draft, Example 5, paragraph 87] is vague and does not adequately describe the extent of the rights to the program transferred from WebCo to ScaleCo, nor does it describe the intended allocation of risks between WebCo and ScaleCo with respect to the exploitation of the assets resulting from the transaction.

As we pointed out in the discussion of Example 1, WebCo and ScaleCo could structure their transaction so that ScaleCo’s only right is to further develop the web-crawling technology developed by WebCo, with all resulting intellectual property being owned by WebCo in exchange for a service fee from WebCo to ScaleCo. Such a structure requires WebCo to actively manage and control ScaleCo’s activities, and to assume the economically significant risks associated with the activities of ScaleCo. See paragraph 1.94.

Alternatively, WebCo and ScaleCo could enter into a transaction consistent with paragraph 1.95 whereby both parties are intended to assume the economically significant risks associated with the business opportunities the transaction is envisioned to leverage.

Therefore, consideration of paragraphs 1.60, 1.94, 1.95, 1.105, and Section D.1.2.1.5 (step 5) with regard to the contractual allocation of risk is a critical aspect of the accurate delineation of such a transaction as described in Example 5. By not referring to the contractual arrangement or the relevant paragraphs in Chapter I of the 2017 OECD TPG, Example 5 is at best incomplete and at worst misleading in reaching its rather conclusive statement at paragraph 88: “Under these circumstances, the transactional profit split method is likely to be the most appropriate method for determining the profits of WebCo and ScaleCo from the sale of the system to customers provided that the accurate delineation of the transaction indicates that WebCo’s and ScaleCo’s contributions are unique and valuable to the creation of those profits.” [Discussion Draft, Example 5, paragraph 88].

As in several previously discussed examples, it is unclear whether or not ScaleCo contributes any preexisting unique and valuable resources, rights, or capabilities to the transaction, or whether it is instead expected to develop those as a result of the transaction itself. This has significant repercussions on the selection of the most appropriate transfer pricing method and the ultimate pricing of this transaction because, at arms’ length, one party (WebCo) would not subsidize the creation of another party’s (ScaleCo) unique and valuable rights, resources, or capabilities by agreeing to split actual profits based on an expectation of contributions by ScaleCo that would
Example 6
Example 6 is the first example that directly addresses the intended allocation of risks between Company A and Company B by referring to the contractual arrangement. This example appears to be intended to illustrate a case whereby a service arrangement is respected for transfer pricing purposes. Deloitte Tax agrees with the conclusion of the example that “…the transactional profit split method is unlikely to be the most appropriate method” [Discussion Draft, Example 6, paragraph 92], provided comparables that have “…invested in machinery and tooling that is specifically adapted to the production of electronics devices…” can be found, or reliable adjustments may be made to comparables that have not made such investments.

Example 7
Example 7, as Example 3, appears to be intended to illustrate the notion of “shared assumption of economically significant risks, separate assumption of closely related risks,” and how the separate assumption of closely related risks can lead to a transactional profit split being the most appropriate transfer pricing method. Example 7 is particularly relevant because it addresses a situation where decisions on key economically significant risks are made by a committee involving personnel belonging to different legal entities of the same multinational group. Such a decision-making structure is commonly encountered in multinational enterprises, and often involves R&D-related decisions that are essential to the profit potential of the group. The structure puts considerable pressure on determining how the control framework of Chapter I of the 2017 OECD TPG applies in cases where control over risk is not as simple as identifying one decision-maker in the multinational enterprise.

In the Example 7 fact pattern, the nature of the activities of the multinational enterprise is clearly the provision of a service. Therefore, the revenue available to Companies A and B is collectively determined by the arm’s length relationship between Fund Co and Asset Co. How this service revenue should be divvied up between the two controlled participants appears to result in a transactional profit split, because “Comparables for such portfolio management services (i.e. 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” [Discussion Draft, Example 7, paragraph 100], the transactional profit split “…is found to be the most appropriate method for determining the profits of Company A and Company B as their operations are highly integrated and interdependent.” [Discussion Draft, Example 7, paragraph 99].

Although Deloitte Tax does not disagree that the transactional profit split may be the most appropriate transfer pricing method in this particular case, assuming that a reliable profit split key can be identified, Deloitte Tax believes that this example should make it clear that the mere fact that a benchmark that directly measures the relative arm’s length profit of participants in a controlled transaction is not available, does not necessarily mean that a transactional profit split method is always the most appropriate method under those circumstances. In addition, and as noted in our discussion of several previous examples, the parties’ contractual arrangement and whether they intend to share in the upside and downside of the risk realization (see paragraph 1.95 and Section D.1.2.1.5) are relevant considerations in determining the most appropriate transfer pricing method.

Example 7 provides the OECD the opportunity to discuss the application of the guidance provided in the Discussion Draft at Section C.5 (Splitting the profits). At arm’s length, it is unlikely that parties that cannot monitor each other’s decisions on costs to incur in the delivery
of the services or personnel to deploy in the provision of the services would agree on a profit splitting key that would create incentives for the other party to overspend (if the split key is proportional to costs incurred) or over-deploy or over-hire (if the split key is proportional to head counts). Again, the appropriateness of the split key itself will depend on the contractual provisions and whether or not both participants have visibility and control over the metrics reflected in the profit split key. Deloitte Tax encourages the OECD to take advantage of Example 7 to engage in such discussion.

Although the previous point is not directly related to the issue Example 7 was meant to address, it is relevant to the selection of a profit or loss split key and to the second of the “Specific questions for commentators” discussed in the third section of our comments below.

Finally, Deloitte Tax notes that it would be extremely helpful to have an example similar to Example 7 where critical R&D decisions are made by committee. Such an example should have one scenario in which only one legal entity is intended to assume the full suite of R&D economically significant risks, satisfying paragraph 1.94, and another one where the assumption of risk is intended to be fragmented among the legal entities participating in the committee decisions in accordance with 1.95.

**Example 8**

Example 8 appears to describe a fact pattern conducive to the use of development costs as a reliable measure of the contributions of the three parties to the transaction. Notwithstanding the example’s lack of a description of the contractual arrangement between the controlled participants, Deloitte Tax notes that the use of development costs incurred by each party based on the agreed overall development budget as a proxy for the level of the consolidated systemic risks borne by each participant is often not only appropriate, it is often the most reliable measure available. provided each party actively participates in reviewing and agreeing on the budget (which includes visibility and some level of control over the development expenses of other participants to the deal with incentive issues that are important at arm’s length (see our discussion of Example 7). See Philippe G. Penelle, “What is a Risk-Adjusted Return?,” Bloomberg BNA *Transfer Pricing Report*, Vol. 25, March 9, 2017.

**Example 9**

Example 9 appears to illustrate the difference in fact pattern that would lead to a transactional profit split of anticipated profits *versus* a profit split of actual profits. Notwithstanding the example’s lack of a description of the contractual arrangement between the controlled participants, Deloitte Tax notes that scenario 1 seems to appropriately provide Company A with a return that is calculated based on the *ex ante* probability-weighted potential cash flows associated with the resolution of the economically significant risks, while scenario 2 seems to appropriately provide Company A with an *ex post* return that provides some of the potential upside and downside of the subject risks.

Deloitte Tax suggests replacing the word “innovative” at paragraph 104 with the words “unique and valuable” to better align the narrative of Example 9 with the important concept of “unique and valuable contribution” relevant to the selection of the transactional profit split method as the most appropriate transfer pricing method.

Example 9 provides the OECD the opportunity to discuss more than just the selection of the most appropriate transfer pricing method. Example 9 provides fertile ground to discuss (i) the level of profit (Section C.4.2) and illustrate how such selection of level of profit to split is achieved by the guidance offered in the Discussion Draft, and (ii) the profit split key (Section C.5) and illustrate how such selection of profit split key is achieved by the guidance offered in the Discussion Draft.
Example 10

Example 10 appears to illustrate both the concept of highly integrated operations and the use of an asset-based splitting factor. The lack of information about the contractual arrangement between the parties is particularly troubling in this example, as a profit split of actual profits may result in the creation of a partnership between Companies A and B for tax purposes, an outcome that may be inconsistent with the tax posture of a particular multinational company.

The use of the term “asset-based” splitting factor is ambiguous and needs clarification. Certain assets, including Property Plant and Equipment, involve the commitment of costs that increases the systemic risk to the owner of the asset. These commitments of costs are reflected in accounting statements in the form of depreciation or amortization expenses. At arm’s length, any increase in systemic risk requires an incremental return commensurate with the increase in systemic risk resulting from such expenses.

In this particular example, it may be the case that the contractual arrangement between the controlled participants provides that Company A will receive an arm’s length compensation for its contribution to the profits of Company B, and Company B will receive an arm’s length compensation for its contribution to the profits of Company A, but the parties will not pool their costs and revenues to determine which party is entitled to what share of the consolidated profit.

Should the OECD decide to add examples to illustrate when a profit split of actual profits versus a profit split of anticipated profits is appropriate and vice versa, the fact pattern presented in Example 10 may be an appropriate vehicle to do so.
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.

Although a profit split of anticipated profits and a profit split of actual profits may appear to be closely related transfer pricing methods, they are not, and they are appropriate under very different accurately delineated transactions. A transactional profit split of actual profits aligns the transfer pricing outcomes with a transaction that is structured (by contract or by substance) so that the controlled participants share in the potential ex post upside and downside of all or some of the economically significant risks of the transaction. A transactional profit split of anticipated profits aligns the transfer pricing outcomes with a transactions that is structured (by contract or by substance) so that one or more of the participants share in the ex ante probability-weighted average of all or some of the economically significant risks of the transaction (first moment of the risk distribution).

By the time the question of the selection of the most appropriate transfer pricing method is examined, the subject transaction must have been fully accurately delineated. Fully accurately delineating a transaction requires the application of the six-step process outlined at paragraph 1.60. At the end of the process to accurately delineate a transaction, there should be no open question left as to which party is by contract or in substance assuming which economically significant risk (paragraphs 1.94, 1.95, and 1.105 and Section D.1.2.1.5), and whether that sharing is a sharing of ex ante risks or of ex post risks. Critical to that accurate delineation of the transaction is the contractual assumption of risks (Section D.1.2.1.2) that is “tested” through steps 4(i) and 4(ii), and possibly remedied through step 5 (Section D.1.2.1.5). As such, one would not expect Chapter II, including in the guidance on transactional profit splits, to require or include further information that is relevant to the accurate delineation of the transaction under Chapter I.

There are not many cases of an accurately delineated transaction under Chapter I that would support the transactional profit split of actual profits as the most appropriate transfer pricing method. Such a transaction requires each participant to the profit split (i) to be found to assume (within the meaning of paragraphs 1.94 or 1.95) at least one economically significant risk of the transaction through a unique and valuable contribution it controls (within the meaning of paragraph 1.65), or to be allocated such a risk through a Section D.1.2.1.5 allocation, and (ii) for the effect of the resolution of that risk on the objectives of the business to be closely intertwined with the resolution of other economically significant risks, so that each participant does not separately control the economic outcome resulting in the “shared assumption of economically significant risks, separate assumption of closely related risks.” In practice, this means at a minimum that all parties must agree on budgets and enforcement mechanisms for the agreement.
In a modern multinational enterprise, delineating a transaction that way does not occur by accident, it occurs because the transaction was intentionally set up that way (often as a result of the nature of the transaction itself), both from an operational standpoint and from a contractual standpoint. Multinational enterprises may be concerned about structuring their affairs in a way that could result in being subject to domestic partnership rules that can be very complicated.

The Discussion Draft attempts to find observable elements of a transaction that could indicate the appropriateness of a transactional profit split of actual profits. We suggest that the most important factor to look for when applying the concepts of Chapter I to an actual transaction is the contract itself, and what that contract provides in terms of the rights and obligations of each participant. We noted throughout our comments herein (as well as in our discussion of the examples provided at Annex I) that the Discussion Draft fails to remind taxpayers and tax administrations that by the time the guidance on transactional profit splits is expected to be applied, the subject transaction has already been fully accurately delineated. Therefore, either a contract allocating the ex ante economically significant risks and ex post economically significant risks has been validated through the accurate delineation of the transaction (see paragraphs 1.60, 1.94, 1.95, and 1.105), or it has been characterized or recharacterized through an application of step 5 (see Section D.1.2.1.5 and paragraph 1.105). Whichever may be the case, it is clear by then which participants to the transactions are sharing in the potential ex post upside and downside of risk realization, and which are not.

The relevant question is not whether the most appropriate method is the transactional profit split of actual profits versus the transactional profit split of anticipated profits, it is whether the most appropriate method is the transactional profit split of actual profits versus benchmarking the return directly or indirectly (for example, with adjustments) or is it the transactional profit split of anticipated profits versus benchmarking the return directly or indirectly.

The 2010 OECD TPG did not provide additional guidance on when is a transactional profit split of actual profits appropriate relative to a transactional profit split of anticipated profits. Understanding that the OECD is concerned about BEPS resulting from transactions whereby a party is the ex post claimant over upside and downside of risk realization it does not control and assume, Deloitte Tax believes that the guidance provided at Chapter I is more than sufficient to catch those transactions and authorize a tax administration to pursue step 5 of the six-step process outlined at paragraph 1.60 to reallocate that risk to the party (or parties) that does (or do) control that risk (see Section D.1.2.1.5). For example, in a contractual arrangement that provides for Company A to fund and assume the ex post risk of upside and downside of an R&D activity performed by Company B for a service fee, should the accurate delineation of the transaction conclude that Company A does not assume the R&D risks pursuant to paragraphs 1.60 and 1.94 or 1.95, such risk will be allocated through step 5 to Company B. The resulting accurately delineated transaction may provide a risk-free or risk-adjusted return to Company A, depending on whether or not Company A controls the funding of the R&D activity performed by Company B. This example illustrates that the selection of the most appropriate transfer pricing method is not a selection of the form of the profit split selected (actual profits versus anticipated profits).
Profit splits do not cure a lack of clarity in the delineated transaction, they are informed by clarity in the delineated transaction.

Deloitte Tax urges the OECD to compile all guidance relevant to the accurate delineation of the transaction in Chapter I. This includes moving the guidance in the Discussion Draft on “shared assumption of economically significant risks, separate assumption of closely related risks” to Chapter I. In addition, Deloitte Tax urges the OECD to clearly state throughout the revisions to the guidance on transactional profit splits that ultimately, a contractual arrangement that has been validated through the six-step process outlined at paragraph 1.60 ought to be respected, and the most appropriate transfer pricing method ought to align its resulting allocation of taxable income between participants to the subject transaction consistently with the intent of the commercial and financial relationship between the parties memorialized in the contract and validated through the accurate delineation of the transaction. When the accurate delineation of the transaction allocates the assumption of economically significant risks provided in the contract, the most appropriate transfer pricing method ought to align its resulting allocation of taxable income between participants to the subject transaction consistently with the accurately delineated transaction. Finally, Deloitte Tax urges the OECD to either remove paragraph 24 completely from the Discussion Draft (preferred) or to add to paragraph 24 references to paragraphs 1.94 and Section D.1.2.1.5 as equally important as paragraph 1.105. See our extensive discussion of that last point in our comments herein.

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.

From an economic perspective, which is of particular importance because the arm’s length principle seeks to reproduce open market outcomes, functions, and assets that require the commitment of financial capital that are not perfectly correlated with the market portfolio (general economic conditions) increase the systemic risk of the party making those commitments. This increase in systemic risk is reflected in a greater cost of capital (higher discount rate). A striking example of this general principle can be found by examining the cost of capital of early-stage biotechnology companies versus the cost of capital of mature life science companies. Early-stage biotechnology companies will have a greater cost of capital than mature life science companies because they have lower current cash inflows per dollar of committed research expenses. Economists will say that early biotechnology companies face greater operating leverage than mature life science companies. Since the profit split key is meant to measure the relative assumption of risks of each participant to the subject transaction, and since systemic risk is not directly observable, using as a proxy for relative assumption of systemic risk financial capital outlays commitments of each party (that are not perfectly correlated with the market portfolio) is a reasonable approach that is consistent with the arm’s length principle. As an example, if Company A is obligated to fund an R&D activity for
$1,000,000 and Company B is obligated to fund manufacturing capital expenditures for $500,000, *ceteris paribus* the increase in systemic risk from the transaction affecting Company A is roughly twice that of Company B. Therefore, using a profit split key of two thirds Company A for one third Company B leads to a reasonable approximation of an arm’s length result. For an extensive discussion of how certain costs translate into an increase in cost of capital, see Philippe G. Penelle, “What is a Risk-Adjusted Return?” Bloomberg BNA Transfer Pricing Report, Vol. 25, March 9, 2017.

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.*

Referring to the general economic principle discussed above, headcount in and of itself has no direct bearing on the assumption of systemic risks by parties to a transaction. Headcount is therefore generally not a useful profit splitting factor to achieve arm’s length results. However, the previous discussion makes it very clear that to the extent the financial capital outlays required to fund the headcount (i) are not perfectly correlated with the market portfolio (*e.g.*, one cannot hire and fire headcount when current revenue goes up and down to satisfy the funding obligations created by the contractual arrangement), and (ii) result from a legal obligation to fund them (the contract), then a profit splitting factor that captures the relative funding obligations of each party (including the headcount fixed costs, not the headcount itself) is appropriate and conducive to producing an arm’s length result. For example, assume that out of the $1,000,000 Company A is obligated to fund for its R&D activities, $300,000 pertains to fixed costs of the R&D headcount, $200,000 pertains to depreciation of R&D fixed assets required to perform the R&D activities, and $500,000 pertains to raw materials used in performing the R&D activities, designing an appropriate profit split key does not require weighing the three elements of systemic risk relevant to Company A, a simple addition of the dollar amounts at stake automatically weighs the importance of each of the three components of systemic risk in the profit split key. Therefore, we recommend eliminating head count as an allocation factor.

The principles outlined in our answer to the previous and current questions apply to all potential candidate profit split factors. The assessment as to whether or not a proposed profit split factor is conducive to producing an arm’s length result always starts with an assessment of the correlation of the proposed factor with the level of systemic risk assumption created in the contractual arrangement by the funding obligations that do not co-vary with the market portfolio. We believe this is the teaching of Chapter I.

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 our response below we interpret the question as asking whether when financial statements of participants in a transaction reflect different
expectations about domestic inflation (purchasing power of domestic currencies of each participant), an adjustment should be performed to ensure that the arm’s length result is expressed in real terms, rather in nominal terms.

Consider the financial projection of a foreign subsidiary in local currencies where funding obligations occur upfront (e.g., R&D phase), and revenues are expected to materialize later. Suppose that the financial projections reflect an expectation of the currency losing a significant amount of purchasing power after the funding phase occurs. Assume that the other participant in the transaction is a U.S. parent and further assume that the U.S. dollar is expected to maintain its purchasing power over the entire period of funding and exploitation. The financial projections of the foreign subsidiary will show increased margins as revenue growth is not only fueled by real growth expectations (maintaining the local currency purchasing power constant), it is also fueled by the expected loss of purchasing power of the local currency. When a currency loses its purchasing power it loses it against domestic real goods and services through inflation (increase in price levels), but also against other currencies.

Thus, the first key question is how the local-currency-denominated financial projections are translated into U.S. dollars for the purpose of the transfer pricing analysis. Without knowing which exchange rate is used for that purpose (e.g., a spot rate, a traded rate on currency futures) it is impossible to answer the question posed. In some instances, this issue can be addressed directly by the selection of the exchange rate used to translate one currency into another; in other instances, it cannot, and careful examination of the expected relative movements of currencies over the expected life of a transaction may be necessary.

Dear Jeff

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

Thank you for the opportunity to comment on the public discussion draft BEPS Actions 10: Revised Guidance on Profit Splits published on 22 June 2017 (the 'Discussion Draft'). Our comments are written from the perspective of the UK.

Additional guidance on the use of profit splits, and in particular the continued emphasis on the fact that the transactional profit split method should be used to price a transaction where it is the 'most appropriate method' is helpful. It remains the case that profit splits are complex, and costly for businesses and tax authorities to apply and audit. Profit splits are not the most appropriate method in cases where other methods and data provide a route to a simpler and/or more robust result. Where a party performs only simple functions, does not take on economically significant risks and does not make unique or valuable contributions the profit split method will not be most appropriate as it is unlikely that a share of profits or losses would reflect an arm's length outcome.

It is helpful that the guidance provides sufficient flexibility to ensure that profits and losses should be split on an economically valid basis that reflects the relative contributions of the parties to the transaction. A prescriptive list of criteria or allocation keys would be inappropriate as this would not allow sufficient flexibility for the complexities of different facts and circumstances in each case.

A series of examples with the same base facts but then additional factual developments throughout the series would be helpful to show the consequences of different facts being included. The current examples focus on the selection of the most appropriate transfer pricing method and it would be helpful if they were expanded to demonstrate the application of the profit split method and, in particular, the approach to determining profit splitting factors. It would provide further clarity if the examples could also be expanded to include other fact patterns e.g. circumstances where a revenue split is more appropriate than a profit split.

An increased use of the profit split method, with its inherent uncertainties, could lead to an increase in audits, disputes and double taxation. It is therefore essential that full and binding mutual agreement procedures and advance pricing agreements are available for situations involving profit splits. In particular, many profit splits that have been implemented to date have been on a bilateral (i.e. two countries) rather than multilateral (more than two countries) basis. There are a number of reasons for this, but one is that it is difficult to manage the subsequent tax audit and dispute process in relation to several jurisdictions with different timetables, and a transfer pricing adjustment in one country can have consequences for many others (it will affect all those participating in the profit or loss to be split). Advance pricing agreements are a key way for businesses to obtain certainty, but are not always practical (or offered by all countries). There are also increasing difficulties in managing the process as the number of participating countries increases from two. A practical answer would be for there to be a
requirement for profit splits to be audited jointly by the countries affected, with an automatic roll into a multilateral mutual agreement procedure for any adjustments agreed. This would be consistent with the overall objectives of the BEPS project and with existing transfer pricing guidelines on simultaneous tax examinations.

An additional useful safeguard would be a requirement that, where a tax authority asserts under audit that a profit split should have been used, agreement on the selection of the most appropriate method should be agreed with treaty partners (whether under MAP or less formally) in advance of further analysis being carried out.

Responses to the questions raised in the Discussion Draft are set out in the attached appendix.

If you would like to discuss any of the points raised in this letter, please do not hesitate to contact either John Henshall (jhenshall@deloitte.co.uk), Alison Lobb (alobb@deloitte.co.uk) or me (bdodwell@deloitte.co.uk).

We would be happy to speak on this topic at the Public Consultation meeting in November 2017 if it would be helpful.

Yours sincerely

W J I Dodwell
Deloitte LLP
Appendix

General Comments

The reordering of the sections of the proposed guidance to more closely follow the order in which the selection of a transfer pricing method would be approached is a helpful improvement.

The guidance should clearly state that there must also be a significant degree of parity between the parties in order for the profit split method to be appropriate. This may be linked to the sharing of risk in the overall undertaking. For example where the profits are split 90:10 between the parties, and the sharing of risk follows that ratio, this may result in both parties carrying significant risk relative to the size of their own operations, but would be unlikely to result in significant sharing of risk by the party taking the smaller percentage, relative to the size of the combined business.

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 analysis in paragraphs 44 and 45 that the splitting of actual profits is likely to be the most appropriate approach where the parties either share the assumption of the same economically significant risks or separately assume closely related, economically significant risks is helpful.

Further examples could be provided to illustrate this. Currently, the only example on the use of actual versus anticipated profits is Example 9 which is relatively straightforward and focusses on the jointly-shared risk criterion. Further examples would be helpful to illustrate the concept of closely related risks and other more complicated fact patterns.

Safeguards/dividing line between actual and anticipated profits

Undue emphasis should not be placed on the distinction between the use of actual and anticipated profit; the key issue to consider is what third parties agree or would agree in comparable situations.

A group may use the profit split approach to determine the split of anticipated profits before entering into a transaction. This profit split is then used in conjunction with anticipated revenue to set a royalty rate/licence fee for one of the parties. It may be the case that neither party receives the level of anticipated profits they expected, as actual revenues/costs may change.

It is then necessary to consider whether the parties would have agreed a fixed rate for one or more years based on the anticipated profits expected at the time of entering into the contract or would have included an adjusting mechanism to reflect a split of actual profits.

The level of adjustment embedded into the pricing policy and/or intercompany agreement to account for variation between anticipated and actual profits would be expected to reflect the level of participation in the risk/reward position with the function, asset and risk analysis relevant to the transaction (to the extent that third parties would be able or expected to also do so).
The more difficult it is to separate risks and assets between the parties, the more likely it is that an adjusting mechanism may need to be included to protect/compensate the parties, with the effect of bringing the implementation closer to a split of actual profits. Where the variation between actual and anticipated profits can be attributed to the performance of the individual parties then this may be grounds to re-assess the split to be used (for example, a third party agreement may contain minimum performance requirements or restrictions that would allow immediate termination of the contract).

The guidance should reflect the spectrum between a fixed payment or series of payments with no adjustments and comprehensive true-up adjustments to achieve an agreed share of actual profits or losses. The specific fact pattern of each case should then determine how the profit split method is applied.

**Timing**

The nature and timing of the transfer pricing analysis will be a factor as to whether actual or anticipated profits are used.

In many cases, third parties may use the profit split approach to determine the split of anticipated profits when agreeing a transaction, and this profit split is then used in determining pricing in advance. Any parties agreeing pricing in advance have to use anticipated profits. In some cases, particularly where there is uncertainty in determining the forecasts, an adjustment or renegotiation mechanism would be expected to exist.

In other cases, the profit split method will be used to test the results of transfer pricing positions determined under a different method pricing methods, in which case actual results are likely to be used.

**Complexity and cost**

The use of actual profits is more complex and takes more input from senior business people as the calculations need to be revisited annually to adjust the pricing policy to take account of changes in the business and the transactions being priced, or the way in which they are performed. The use of anticipated profits may therefore be proportionate to the size of the transaction.

**Changing businesses**

Anticipated profits splits are more likely to run the risk of obsolescence as supporting calculations may not accurately represent the up-to-date position in a dynamic business. The use of actual profits may be more appropriate where businesses are rapidly evolving.
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 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?

Paragraph 51 confirms that profits should be split on an economically valid basis that reflects the relative contributions of the parties to the transaction and thus approximates the division of profits that would have been obtained at arm’s length. The discussion of additional profit splitting factors therefore provides helpful illustrations of factors that could provide such an economically valid basis. There is a low risk of inappropriate use of factors where there is flexibility to choose the most appropriate factors for the facts and circumstances of each case.

Most of the examples in the Discussion Draft relate to the selection of the profit splitting method and/or the choice between splitting actual or anticipated profits. It would be helpful if some (or all) of the examples went on to address profit-splitting factors.

(a) Capital and capital employed

The focus on determining appropriate profit splitting factor(s) to reflect the key contributions to value in relation to the transaction is essential. Although other factors may be more commonly used, references to capital and capital employed should be retained to reflect scenarios where these factors help facilitate an arms’ length result.

Caution will be needed to ensure that these measures represent an appropriate profit splitting factor under the criteria of paragraph 51. For situations where capital and/or capital employed is the best fit, the guidance should note that the source of the capital should be considered and only taken into account to the extent that the capital was generated by the relevant business. References to work undertaken in the October 2015 BEPS Actions 8-10 Final Paper on revisions to Section D of Chapter 1 of the Guidelines to address capital-rich members of groups without any other relevant economic activities (e.g. cash boxes) would need to be taken into account.

(b) Headcount of similarly skilled and competent employees

Headcount is commonly used by third parties and also when undertaking a transfer pricing profit split analysis, and its inclusion would be consistent with the focus of the BEPS project on ensuring profits are aligned with value creation.

Headcount is a particularly helpful measure for a population of similarly skilled and competent employees. Headcount will be less suitable where the population includes small numbers of key individuals and larger numbers of employees undertaking routine work. A residual analysis could be undertaken so that the headcount of employees undertaking routine activities is given a routine return,
with the residual profit then split based on the relative value of more senior employees. This is consistent with the BEPS Actions 8-10 work looking at the importance of decision-making.

In some cases cost-based factors such as salary or remuneration may provide an accurate measure as proxies for value contribution. The use of remuneration costs is consistent with other cost based approaches and allows different profit splitting factors to be compared easily.

Headcount is generally much simpler to calculate or forecast than employee remuneration costs, especially where remuneration includes bonuses calculated by reference to the profits of the business and/or other complex formulae. Remuneration data is sensitive and can be difficult for a tax function to obtain. Where the payment of bonuses forms a significant part of employee remuneration and these bonuses are not paid for a delayed period after the year end, it may not be possible to accurately determine remuneration costs at the necessary time. As a result, headcount will in some cases be a more practical option, particularly where it is referenced to grade or banding within the organisation to account for seniority and decision-making.

Requiring the use of a more complex time-consuming factor, when it would result in limited differences to the end result, would be an unnecessary burden on businesses (and would most likely also be difficult for tax authorities to audit).

Different measures will be appropriate depending on the specific fact pattern and availability of data.

(c) Purchasing power parity

Routinely including adjustments for disparities in purchasing power would increase the complexity of the profit split methodology, and would introduce another layer of subjectivity to the calculation. There are a number of challenges with adjusting for purchasing power parity, not least of which is there are not reliable, up-to-date indices on costs that are readily available for all sectors and businesses. Encouraging the use of such adjustments is likely to create as many distortions as it solves and would increase the costs and time required to calculate a profit split.

In many cases, costs arising in a particular jurisdiction – jurisdiction A – may be a direct result of strategic decisions made by, and investment, know-how or capital provided by personnel located in another jurisdiction – jurisdiction B. In this situation, it would not be appropriate for purchase price adjustments to have the effect of moving profits attributable to this decision from jurisdiction B to jurisdiction A. This is particularly the case where jurisdiction A has been selected only because of its ability to lower costs.

However, if it can be demonstrated that, due to disparities in purchasing parity caused by macroeconomic factors, using market exchange rates to convert amounts denominated in foreign currencies would not fairly represent the relative value contributed by each party, then adjustments should be made. Consideration should be given as to whether and how third parties transacting similarly would take purchasing parity disparities into account.

(d) Other factors

The use of discounting for the time-value of money for a multi-year analysis will be particularly relevant if the pattern of profitability or remuneration of transactions is changeable and one party is being asked to defer their remuneration and/or bear initial losses in respect of the transaction.

In some cases, it will be appropriate to use more than one profit splitting factor. Guidance should be provided as to how different profit splitting factors should be weighted and further examples should be provided which illustrate this. In line with paragraph 63, the validity of such an approach should be supported by reliable objective data in order to limit arbitrary results.
In line with the reference in paragraph 15 to the relevance of industry factors, examples which illustrate the use of profit splits in a variety of relevant industries should be included e.g. automotive, software development etc.

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.**

In most profit-split examples involving a high level of integration, there would also be the assumption of shared economically significant risks (or the assumption of closely related risks) and/or the making of unique and valuable contributions.

A high level of integration is likely to be seen in businesses where there exists a virtual team of broadly equally skilled persons who may sit within different parts of the business and in different locations, but use technology such that one team member is interchangeable with another, and where discussion between team members is informal and free-flowing. Such an example would also most likely involve the sharing of economically significant risks but this would need to be confirmed in each case. This would also be an example of where the use of head count as a profit-splitting factor may be a pragmatic and cost effective approach.

‘Parallel’ vs ‘sequential’

The 2016 Discussion Draft contained comments on ‘parallel’ and ‘sequential’ integration as a means of distinguishing between cases where profit split might, or might not, be the most appropriate method. This was to some extent helpful as it indicated that some activities that happen in a defined order (e.g. research and development, manufacturing and sales) may not be sufficiently integrated such that profit split is appropriate.

**Other comments**

**Revenue splits**

Whilst the use of profit splits is appropriate in some cases, the difficulty of obtaining and analysing data remains. In some cases a revenue split is more appropriate than a profit split and the inclusion of examples to illustrate this would also be useful. Such an example could be where parties participate in a project which results in an increase in sales on a group-wide basis, but where each party retain full control of their respective cost bases.

**Arm’s length consideration**

It is important that any guidance on the use of profit splits should not be applied too mechanically, leading to a result departing the from the arm’s length principle. For example, the use of a split of anticipated profits to set a royalty rate between two parties, combined with unexpectedly poor results, could result in a situation where one of the parties is attributed more than 100% of the profits to be shared, and the other party is attributed a loss. Between third parties, such an outcome would result swiftly in termination of the agreement or renegotiation of the rates.
SUBJECT: PUBLIC DISCUSSION DRAFT ON “REVISED GUIDANCE ON PROFIT SPLITS”

15 September 2017

Dear Sir / Madam,

By means of this letter, EY would like to share its comments on the public Discussion Draft on “BEPS Actions 8-10: Revised Guidance on Profit Splits” (the Discussion Draft) as released by the OECD on 22 June 2017. We appreciate the opportunity to provide comments and to contribute to the public consultation and discussions about this topic. This letter presents the collective view of EY’s global international tax network.

Key comments
The Discussion Draft seeks to provide further guidance in respect of the use of the profit split method (PSM) for transfer pricing purposes. Our key comments and recommendations with respect to the Discussion Draft are as follows:

- It is critical to only apply the transactional PSM when this method is the most appropriate method in the given circumstances. EY does not believe that the Discussion Draft has provided sufficient clarity about the situations in which a profit split would be the most appropriate method to be used. In particular, we believe that:

  - The Discussion Draft takes the guidance in the exact opposite direction by more or less assuming that the one-sided transactional methods are only appropriate when contributions by both of the parties are non-unique and not that valuable.
  
  - The guidance seems to implicitly assume that one-sided methods can only be used when comparables with the highest degree of comparability exist. The absence of this seems to lead to the conclusion that the contribution is not benchmarkable and therefore unique and valuable. We recommend that guidance be added to illustrate how methods other than PSM can be reliably applied even in the case of unique and valuable contributions (UVCs) and in the absence of such “perfect” comparables.
  
  - The definition of a UVC is overly broad, which means that in many cases tax administrations may use that to seek the application of a PSM, even when a reasonable transfer pricing method (using one or more of the other methods) is being applied.
  
  - The introduction of the concept of “separate assumption of closely-related risks” would pull many cases into the realm of the PSM, even though other methods may provide outcomes that are equally reliable or more reliable.
Taking into account the above, we recommend that it be more clearly stated that the transfer pricing method selected by a taxpayer should be respected by tax authorities, unless an alternative method can be demonstrated to be clearly more appropriate. Tax authorities should not be allowed to replace the method used with a PSM just because the case at hand shows some of the features described in the Discussion Draft, or vice versa. Similarly, when using a PSM, the decision made by a taxpayer to split actual or anticipated profits should be respected unless demonstrated that an alternative is more appropriate. Moreover, challenges that arise for tax authorities as a result of information asymmetries should not be confused with the technical merits of the application of the most appropriate method rule.

We agree with the statement that contractual arrangements made by and between related parties should be the starting point for transfer pricing analysis, e.g. in respect of the shared assumption of economically significant risks (ESRs) or the separate assumption of closely related ESRs and that they should be respected unless the specific guidance of section D.1.2.1 of the Transfer Pricing Guidelines apply.

The Discussion Draft provides guidance on when to apply a PSM, using anticipated or actual profits, but provides only limited guidance on how the PSM is to be applied to either actual or anticipated profits. We believe that the Discussion Draft can primarily be strengthened by including additional guidance and (numerical) examples on how to apply profit splits, on a step-by-step basis.

We recommend that it be more clearly stated that the PSM can be applied as either or as both testing method and implementation method. Specifically, the PSM can be used as a method to test the arm's length nature of a royalty rate in a controlled license agreement. Alternatively, the PSM can be used as the form of consideration in a controlled license agreement.

The Discussion Draft does not mention that a public consultation will be held. Given the importance of the topic, we strongly recommend the holding of such consultation.

More detailed comments with respect to the Discussion Draft are presented below. If you have any comments or questions, please feel free to contact any of the following:

Ronald van den Brekel +31 88 407 9016 ronald.van.den.brekel@nl.ey.com
Kenneth Christman +1 202 327 8766 kenneth.christmanJr@ey.com
David Jones +44 20 7951 5326 djones1@uk.ey.com
Ben Regan +44 20 7951 4584 bregan@uk.ey.com
Marlies de Ruiter +31 88 407 7887 marlies.de.ruiter@nl.ey.com
Nicolas M Schaffer +1 612 371 6728 nicholas.schaffer@ey.com
Michel Verhoosel +31 88 407 3378 michel.verhoosel@nl.ey.com
Nobuo Mori +81 70 3813 6645 nobuo.mori@jp.ey.com

Yours Sincerely,

On behalf of EY

Ronald van den Brekel
Detailed comments

In support of our views on the proposed guidance and questions raised, we have prepared some overarching comments for consideration as well as some more specific comments. Lastly, we answer the specific questions raised for commentators.

Selection of the PSM

We agree that it is not necessary to only limit the use of profit splits to situations where actual profit splitting between third parties is observed and that the PSM can also be a means of establishing and/or verifying arm's length outcomes for controlled transactions. In this regard, we recommend an explicit statement or example explaining that another method can be used (e.g. a resale price method or a cost-plus method) for price setting purposes to implement a (ex ante) profit split and that a PSM can be used to evaluate or corroborate the outcome.¹

As an overall comment, we believe that the Discussion Draft jumps too quickly to the PSM as the most appropriate method. One of the main reasons is that “contributions” in the Discussion Draft, in particular in the examples, are quite quickly seen as UVCs. If a multinational enterprise (MNE) member makes a contribution that is a key source of (potential) economic benefit, and no highly reliable comparables can be found, that is in itself not an indicator that a PSM is the most appropriate method. The key question is whether the PSM would be the most reliable method to remunerate that an MNE member for its contributions. In many cases, the use of a “broad” comparable for the application of one of the one-sided methods may provide a more reliable outcome than a PSM, also because the application of a PSM may prove difficult in practice as acknowledged by the Discussion Draft. Therefore, we recommend a more explicit statement that the presence of UVCs at two (or more) sides of a transaction does not justify the presumption that a PSM is the most appropriate method, or at least not for a PSM involving the split of actual profits.

In addition, we believe that the introduction of the concept of “separate assumption of closely-related risks” may lead to the application of a PSM in many cases where the application of other (e.g. one-sided) methods provide outcomes that are equally reliable or more reliable than a PSM. The problem is that in an MNE environment, it is very common that both parties to a transaction are affected by the materialisation of related ESRs, and both parties play a role in controlling or mitigating the adverse outcome of such. Therefore, the introduction of this criterion would pull many cases into the realm of the PSM. We also recommend that it be clarified that the mere joint control of risks is not enough to consider the PSM to be the most appropriate method for the case at hand. As Chapter I of the Transfer Pricing Guidelines stipulates, control of risk should be distinguished from the assumption of risk. Multiple parties can perform activities that can be qualified as exercising control, while in those situations it may be that only one of these parties contractually assumes the risk. The risk framework in Chapter I would not lead to a re-allocation of the risk in these circumstances. We would welcome more guidance on how to remunerate parties that contribute to control over risk, but do not assume the risk itself, i.e., the situation as described in paragraph 1.105 of the Transfer Pricing Guidelines. If a party contributes to the control over risk, methods other than the PSM may be appropriate to remunerate the risk control functions performed. The choice of the method will depend on the value contributed by the control activity. It could be that the value contributed is reflected in a higher margin when applying a cost plus method or in

¹ If a PSM is used as a form of consideration, we recommend that the OECD makes clear that this use should not be considered evidence of the existence of a “de facto” partnership between the parties.
providing for a return that incentivises the party to perform the control functions well, which could be a profit share type of remuneration, but does not need to lead to the application of a PSM.

We believe that the Discussion Draft confuses issues like delineation of the actual transaction (in particular the issue of identifying ESRs with specificity, sharing of ESRs and the control over such risks), the issue of information asymmetry (in particular in relation to intangibles, where the hard-to-value intangibles guidance should guarantee appropriate pricing at the time of a transfer of an intangible), the choice of methods (in particularly by implicitly assuming that only a PSM can give a party a profit share in a transaction) and the setting of the margins of one-sided methods by valuing the contributions of the party to which the one-sided method is applied in combination with looking at the relative contribution of the other party to the transaction. This confusion is illustrated by some of the Discussion Draft examples. We will discuss examples 1 to 4.

In example 1, the economically significant research and development risks of Company A and S can be separated from each other, even though both intangibles are needed to come to a final product. The research by Company A is finished at the time it licenses the intangible to S. At that time, the intangible is likely hard to value, so that the guidance for hard to value intangibles (HTVIs) may apply. Setting aside the guidance on HTVIs, at the time of the licensing an arm's length price may be a lump sum payment (based on expected value of the finished product and the value contribution by Company B) or it could be some form of commensurate with income approach (e.g. by setting a royalty percentage which is based on the relative value contributed by each of the parties). The difference between the two ways of pricing is that in the case of a lump sum payment, Company A will not share in the way the market risk plays out. If a royalty percentage is set, Company A will share in how the market risk plays out. In both situations, the anticipated profits are used to set the price (value the lump sum / determine the royalty percentage). In this example, the contractual arrangements made by and between related parties should be respected unless the specific guidance of section D.1.2.1 of the Transfer Pricing Guidelines applies.

Also in relation to example 2, we see that the ESRs of Company A and Company B can be separated. Company A is assuming the development and production risks and Company B is assuming all the risks relating to exploitation. According to the Discussion Draft, the contributions by both parties are UVCs that need to be remunerated. While a PSM may be an appropriate method in this case, it would be helpful to clarify that other methods may be appropriate as well, e.g. by using a resale price method for price setting purposes. The margin in the resale price method might be determined by comparables with a somewhat lesser degree of reliability, by adjusting comparables for the “extra” contribution, potentially by performing a process contribution analysis. If the OECD would consider the determination of the margin based on a process contribution analysis a profit split, it would be helpful to explicitly state this.

In relation to example 3, our conclusion would be similar to our conclusion on example 2. Also in relation to example 4, one could come to the conclusion that the resale price method would be the most appropriate method to use, however, the margin will be set at a significantly lower level than the level of the margin in example 3. As, in our view, it is possible to conclude differently on the most appropriate method in the examples, we recommend further elaboration on why the contributions are considered unique and valuable and why application of a one-sided method would not be equally or more appropriate.

**Different uses of the PSM**

We appreciate that the revised guidance as per paragraph 46 seeks to further clarify the caution that should be taken to prevent the use of hindsight in applying the PSM. While we appreciate the additional emphasis, we note that revised wording (e.g. that profits to be split and the splitting factors “must
generally be determined on the basis of information known or reasonably foreseeable”) may be read as suggesting that the PSM cannot be used ex post to test the actual results. In our view, such ex post use of the PSM for price testing purposes (also in cases where other methods were used to set prices) can be useful and appropriate, so long as care is taken only to use information to split the profits that was known at the time of the transactions were entered into.

**Anticipated versus actual profits**

When determining whether anticipated profits or actual profits seems appropriate, the decisive factor according to the Discussion Draft is whether there is a shared assumption of ESRs or a separate assumption of closely related ESRs. It appears that specifically mentioning the separate assumption of closely related ESRs as an indicative factor for application of the PSM (on actual profits), leads to the wrong conclusions. The consequences of materialisation of the risks will play out differently when each of the parties assume different risks than when there is a sharing of the same risk. This is even the case if the risks are closely related. In a situation where parties are assuming separate risks, the party assuming the risk will be the one controlling the risk and will therefore be the party that should bear the costs of the materialisation of the risk. In those situations, a sharing of the costs of materialisation of the risks does not make economic sense, as a party that has no control over the specific risk will be required to share in the cost associated with the materialisation of the risk or will receive profits associated with a risk that it did not control. This seems contrary to the guidance in Chapter 1. This can be illustrated by the examples in the Discussion Draft where development on the one hand and the risk of marketing and sales on the other hand are considered as closely related risks. Transactions in many of these instances can be priced through a one-sided method. Therefore, it seems more important to identify whether the contractual arrangements (as accurately delineated) between the parties determine a sharing of the risk. As noted above, we would welcome guidance for the situations that parties other than the party assuming the risk is contributing to the control as described in paragraph 1.105 of the Transfer Pricing Guidelines. However, such contribution should not necessarily lead to application of a PSM.

Another important question in relation to using anticipated or actual profits is what the nature of the deviations could be that would lead to a difference between the anticipated and the actual profits. These could be tied to a broad set of costs that may or may not be related to a materialisation of shared risks. Even if these costs are tied to the materialisation of shared risks, it may be that the materialisation of the risk will impact the actual costs of each of the parties roughly in the same way, which would not make it necessary to create some form of “balancing” payments in the form of splitting the actual profits. Given the fact that splitting of actual profits is complex, it may be that parties would prefer to avoid these. We would assume that the use of actual profits to be split is appropriate in two situations: (1) the associated enterprises choose a profit split based on actual profits, as this reflects their contractual arrangements in relation to the allocation of risks that neither of the parties significantly controls, such as market risks; or (2) a profit split based on actual profits is the most appropriate method in the respective circumstances given the fact that the materialisation of shared risk is likely to impact the costs of each of the parties quite differently, which means that balancing payments will be required to reflect the sharing of the risks in an appropriate way.

**Application of the PSM**

Paragraph 44 mentions that “the assumption is that independent parties would have split combined profits in proportion to the value of their respective contributions (...)” and that “arm’s length parties can be assumed to split combined profits on the basis of their relative contributions to the creation of those profits”. We think this is generally correct and consistent with the activities of partners in partnerships.
(to the extent relative contributions can be assessed), but we think the Discussion Draft should provide more scope for taxpayers to use alternative approaches in determining the appropriate allocation of profits. For example, a bargaining analysis could also be a useful tool in assessing profit split outcomes.

The previous Discussion Draft on Profits Splits included an example on the application of the PSM using a RACI responsibility matrix (i.e. Scenario 6; paragraph 38 - 46). This approach relied on a RACI matrix and value drivers, identified as part of a thorough functional analysis. It would be helpful if the guidelines were to clarify whether this approach meets the criteria of being independent, verifiable, and supportable by comparable / internal data. In addition, we suggest that the OECD clarifies whether a process contribution analysis may be used, e.g. to deconstruct a value chain into different elements and to quantify the contribution per element using some of the factors mentioned in the Discussion Draft, or other data, including management interviews.

We also recommend that the OECD acknowledges that application of the transactional PSM using "broad" market comparability data aligns with the arm's length principle, if the data are sufficiently comparable to the intercompany transaction under review. Examples of market comparables could include licensing transactions, acquisition transactions or supply and distribution arrangements. The Discussion Draft can acknowledge that the use of these comparables is most likely to be possible in cases of internal comparables (i.e. transactions between an MNE and an unrelated party): the data necessary for application of the transactional PSM are typically available for transactions that an MNE has with unrelated parties, but not publicly available for transactions that are identified from database searches. For example, an MNE may license intangible property from an unrelated party and pay that unrelated party a royalty on revenue for use of that intangible property. The MNE may prepare financial projections estimating the profit it expects to earn from the exploitation of the intangible property licensed from the unrelated party. This data would allow for observation of how the MNE shares profits in the uncontrolled transaction with the unrelated party by dividing the royalty payment to the unrelated party (i.e. the licensor’s share of profits) by the total expected profit from exploiting the intangible.

When looking at what level the profits should be split, the contractual allocation of risks as accurately delineated should also be guiding. If the sharing of risks only relates to the revenue line, a revenue split would be appropriate.

EY would like to emphasize that the current Transfer Pricing Guidelines already include guidance which stipulates that synergetic benefits need to be allocated to the parties contributing to these benefits. It is not necessary to do so by using the PSM, but can also be done by adjusting the margins of one-sided methods. In addition, the updated Transfer Pricing Guidelines already include guidance which makes it possible to address information asymmetry in relation to transfers of intangibles by assuming the actual profits received are a proxy for the price set at the time such an intangible is transferred, which can also be its licensing associated parties. We believe that the suggestion that only a PSM allows parties to a transaction to share in the (anticipated) profits of a transaction reflects a misconception of the working of the existing transfer pricing rules.

**Specific questions for commentators**

Our thoughts with respect to the specific questions raised in the Discussion Draft are presented 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.

We refer to our comments above, which effectively cover this topic.

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. Capital or capital employed is used as a profit splitting factor in practice, e.g. with regard to financial services and this can be appropriate where capital (employed) is an appropriate indicator of contributions made to value creation. The existing guidance provides useful indicators when selection and application of capital or capital employed can be (un)reliable, e.g. whether components of the relevant formula can be manipulated by entering into unnecessary financial transactions, by the deliberate location of mobile assets, by requiring that particular companies within an MNE group maintain inventory levels in excess of what normally would be encountered in an uncontrolled company of that type, and so forth.

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 could be used as a factor, provided it is a good proxy for value-add as reflected by actual functions performed and risks controlled, and is better able to capture value-add than similar types of proxies such as labour costs (i.e. similarly skilled and competent employees would only be suitable to base a profit split on if they undertake similar functions and control similar type of risks).

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?

Adjustments for purchasing power parity may be useful in some circumstances where they would improve the reliability of the profit split methodology and provided application would not be unnecessarily complex and administratively burdensome.

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

The guidance should, in our view, not necessarily provide an exhaustive list of profit splitting factors that may be used in practice, but primarily stress flexibility of use of (different types of) profit splitting factors and potential application of multifactor keys, such that taxpayers can apply the profit split methodology taking into account their specific facts and circumstances. We would recommend including additional guidance on alternative profit split methodologies, e.g. based on process contribution analysis (e.g. using RACI matrix) and bargaining analysis. Finally, the guidance should, in our view, acknowledge that where (broad) market comparables, e.g. related to acquisitions, are available as profit splitting factors then such
data aligns with the arm's length principle and may result in a more reliable application of the PSM than applications that use profit splitting factors that are not based on market data.

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.

Global trading is an example where the PSM typically is the most appropriate method, given that in these circumstances the functions of the related entities are integrated and assets and thus risks are shared. However, the relevant factor may be more the sharing of the risk, than the integration. Further, integrated functions within a company that are similar in nature could, as a total, be remunerated using a one-sided method, such as a cost-plus. For example, if there is a matrix HRM organisation that services the top 200 managers of an MNE group, it does not matter much if such activity is remunerated by a cost-plus which is then split, or whether a cost-plus is applied to the local cost of each of the contributors.

Another example in which PSM is commonly applied is when confronting the problem of “asset synergy” by which we mean a circumstance in which the value of two or more assets (typically technology intangibles) together is greater than the additive value of the separate assets. As an example, consider a transaction involving two members of the same MNE group that are located in different jurisdictions. Assume Party A is located in Jurisdiction 1 and Party B is located in Jurisdiction 2. Party A has worldwide patents on Enzyme A. Party B has worldwide patents on Enzyme B. Neither Enzyme A nor Enzyme B is particularly valuable as a pharmaceutical because of marginal utility. However, combining Enzyme A and Enzyme B creates a drug that is very effective in treating certain diseases. Assume the worldwide value of Enzyme A is 30 and the worldwide value of Enzyme B is 40 but, combined, Enzymes A and B have a worldwide value of 300. In other words, combining Enzyme A and Enzyme B results in an increase in value of 230. Assume now that Party A transfers all its rights in Enzyme A to Party B. Determining the arm's length price of such a transfer raises the issue of how much of the 230 increase in value, attributable to synergy, will be captured by Party A at arm's length and how much of the 230 will be captured by Party B. In our experience, PSMs are often well suited to addressing this difficult issue because the standalone value of each party's contribution can be determined and used as a basis on which to assign returns.
Dear Sir or Madam,

First of all, we would like to thank you for giving us the opportunity to comment on the public discussion draft on the revised guidance on profit splits (the “Revised Guidance”). We firmly believe that subjecting your proposals to public scrutiny forms an essential part of building and maintaining credibility with taxpayers and tax administrations. Having said that, we hope you take our comments as constructive criticism aiming to achieve better and more widely accepted Transfer Pricing Guidelines and to create precise and sound conceptual foundations for applying the transactional profit split method (henceforth “PSM”). Although our remarks refer specifically to the Discussion Draft, they also apply in general to Section D.4 of the Revised Chapter VI of the Transfer Pricing Guidelines.

A. General comments

We note that the guidance on the transactional PSM – in line with other recent publications of the OECD and related institutions – has become increasingly abstract in its terminology and conceptualization. This renders it difficult not only to grasp intellectually but also to apply in practice. We understand that the OECD guidance has to depict a wide variety of individual circumstances. However, vague wording can leave scope for misunderstandings, and we advise the responsible committees to focus more on the practical application of their guidance.

In contrast, we welcome the practical illustrations listed in the annex to the Revised Guidance for the transactional PSM. Examples not only simplify and speed up the transfer of theoretical con-
cepts into practice. They also show which situations and circumstances the rule-setter had in mind when creating a guideline. We would welcome more examples illustrating the application of various transfer pricing rules proposed in the upcoming work of the OECD.

B. Application of the PSM

The Revised Guidance features three indicators for which the transactional PSM is considered to be the most appropriate method. These are cases in which

(a) each of the parties to a transaction makes unique and valuable contributions,
(b) business operations are highly integrated, or
(c) the parties to a controlled transaction jointly assume economically significant risks or separately assume closely related risks.

Although the Revised Guidance stresses that all three indicators are not mutually exclusive, their being identified as distinct indicators suggests that at least certain instances should be imaginable in which only one of them applies.

We suggest that these indicators be rearranged to improve the conceptual clarity and the overall consistency of the Transfer Pricing Guideline. In our opinion, option (c) should become the general rule for applying the transactional PSM, as – in a practical interpretation of the three terms – it appears difficult to imagine cases in which parties to a transaction can be considered to jointly make unique/valuable contributions or operate in a closely integrated fashion but do not together (separately) assume economically significant (closely related) risks. In other words, cases (a) and (b) overlap conceptually with or, rather, are instances of the more abstract case (c). This relationship was depicted logically in the 2016 draft. Also, option (c) relies more on the terminology, in particular the concept of “risk”, set out in the introductory parts of the Transfer Pricing Guidelines and, thus, forms part of its conceptual foundations. Options (a) and (b) instead introduce new terminology (“unique/valuable contributions”; “business operations”).

In regard to the phrasing of option (b), we suggest using the term “functions” instead of “business operations”. The term “functions” constitutes a fundamental element of the Transfer Pricing Guidelines. We are of the opinion that it would be simpler to use existing concepts wherever possible, as new terminology always carries the risk of further ambiguity.

Furthermore, we note that the Revised Guidance no longer includes the distinction between parallel and sequential integration. Under parallel integration, the previous draft on the guidance on profit splits captured cases in which multiple parties to a controlled transaction are involved in the same stage of the value chain. In the case of sequential integration, the parties to the transaction perform discrete functions in the value chain and it is often possible to find comparables for
each stage in the value chain. In our opinion, the omission of this distinction reduces the toolset provided by the Transfer Pricing Guidelines on applying the transactional PSM. Although the distinction may appear artificial to a certain extent and provoke discussions about the feared fragmentation of processes or value chains, it helped to structure the thinking about how business operations (or preferably "functions") may work together in an integrated manner. We would therefore support the reintroduction of this distinction, merely as an explanatory clarification in the paragraph/section on integrated operations to facilitate discussions, without any further consequences attached to either one, as this should help practitioners in particular to understand and apply the Transfer Pricing Guidelines.

C. Determination of profits to be split under the transactional PSM

After identifying the transactional PSM as the applicable and appropriate transfer pricing method in a given case, the relevant profits have to be determined. The guidance rightly states that the profits in question should be only those relating to the respective controlled transactions and that these profits (of two or more associated enterprises) need to be put on a common basis. Consequently, identifying the profits relating to the respective controlled transaction may involve separation and allocation. Determining profits on a common basis may comprise selecting in advance a (tax) accounting method, referring to other financial data and/or aligning any differences between accounting standards. While we fully agree with the guidance in these respects, we believe that the OECD's guidance remains silent on the aspects regularly leading to disputes between taxpayer and tax administration, i.e. how to identify the profits relating to a controlled transaction. Thus, we would welcome more detailed guidance in this respect.

Also, the guidance rightly highlights the role of actual or anticipated profits to be split. In this regard, the splitting of actual profits should apply only in cases in which both parties share the same economically significant risks or separately share closely related, economically significant risks. In contrast, splitting anticipated profits would be more appropriate if one party does not share the assumption of economically significant risks. While we agree with the basic message, we refer to our general introductory comments relating to the level of abstraction and difficulty of practical application. From our point of view, "sharing of the same or closely related economically significant risks" is an overly abstract concept. Rather, we believe the same message might be conveyed by taking as a basis the degree to which a party is able to influence the eventual outcome (i.e. actual profits). This may also be illustrated by Example 9 of the Revised Guidance. In scenario 1, company A contributes its know-how and trademarks while company B is active in distribution and marketing. Thus, while both companies make unique and valuable contributions, only company B – after the transactional PSM has been chosen – may actually influence the outcome. Consequently, anticipated profits should be split. In contrast, in scenario 2 both companies jointly perform distribution and marketing activities, i.e. both may influence the outcome. As a result, actual profits should be split. To summarize, we believe this to be a perfect example in
which less abstract and more precise language would render the Revised Guidance much more practically applicable.

As to the measure of profit to choose, we agree that, in general, operating profits should be used when applying the transactional PSM, but are of the opinion that situations might exist in which other measures of profit are more suitable. In consequence, we again suggest the concept of the degree to which a party is able to influence the eventual outcome (i.e. expenses, in this case) and whether or not both companies are able to influence the same/all or only certain types of expenses. For instance, if only one of the companies is responsible for distribution and marketing while the other company has no influence whatsoever in this regard, the profit measure should not include distribution and marketing costs. Thus, we believe the “ability to influence” to be the less abstract and more intuitive idea.

Furthermore, we take the view that the choice of profit measures might in some cases also justifiably be driven by the question of how difficult it is to isolate and allocate all operating costs/expenses of the companies concerned. While not entirely convincing as a concept, we believe that in some situations using “rougher” profit measures (e.g. gross profits) might be suitable simply because they are easier to determine, are less dependent on the underlying (tax) accounting method and are far less subject to controversy. Therefore, we suggest that the OECD might consider “ease of determination” as an additional criterion for choosing profit measures.

D. Method for splitting profits under the transactional PSM

After determining the relevant profits, it has to be decided how to split these profits between the parties involved. We fully agree with the Revised Guidance that determining the appropriate profit splitting factor(s) to achieve an arm’s length division of the relevant profits should reflect the principal contributions of the parties to the creation of those profits derived from the controlled transaction. These contributions to creating value and, thus, determining the relevant factors to use in splitting profits should be based on a thorough functional analysis of the controlled transaction and an analysis of the relevant industry.

However, in this regard we are concerned that in practice some countries still support a rather formulary type of a profit split, rather than a transactional-based split of profits. Therefore, we would encourage the OECD to include an additional explicit statement that determining profit splitting factor(s) may never result in a global formulary apportionment of profits, which is based on the information contained in the Country-by-Country Report, for instance. In this context, we oppose the inclusion of employee headcount (in contrast to employment costs) in the indicative list of potential profit splitting factor(s), only because they are “easy to use” and to obtain from Country-by-Country Reports by tax administrations in transfer pricing controversies. Moreover, employee headcount does not necessarily constitute a reliable measure for creating value, as it is generally difficult to verify whether the employees counted have similar skills.
and abilities. Instead, the levels of pay might be a more appropriate and easily objectifiable indicator in this respect.

Among other factors, profit splitting can be based on cost. The reliability of cost-based profit splitting factors depends on several issues, such as differences in the timing of expenses being incurred and value being created. We agree that, in some cases, it is more suitable to use the expenditure on a multiple-year basis. However, we would encourage the OECD to explicitly state that not only accumulated expenditure incurred in the previous and current years of the controlled transactions has sometimes to be used, but also budgeted costs for future years, which are reasonably foreseeable in advance. Besides, we suggest limiting the cost-based profit splitting factors to expenditure actually incurred or to be incurred. In our view, it is not appropriate to use cost savings or location savings as reliable profit splitting factors as indicated in the Revised Guidance due to the difficulty of verification and the ongoing controversy and considerable uncertainty as to the party/country to which they should be attributed.

We hope that these brief remarks will contribute to furthering the discussion on the topic.

Yours sincerely,

Dr. Xaver Ditz  Dr. Sven-Eric Bärsch  Dr. Christian Engelen  Dr. Carsten Erb
Dear Sirs,

Response from FTI Consulting to the OECD Public Discussion Draft on BEPS Action 10 (‘Revised Guidance on Profit Splits’):

We welcome this opportunity to comment on the OECD’s Revised Guidance on Profit Splits under BEPS Actions 10, published on 22 June 2017. We agree to have these posted on the OECD website.

We would like to thank you for the opportunity to provide further input on the discussion draft and hope our comments are helpful.

Yours faithfully,

Marvin Rust

Enc.

Additional Contributors:

- Kirsty McMillan
- Ruth Steedman
Introduction

Thank you for this opportunity to respond to the Revised Guidance on Profit Splits. The additional guidance is welcomed and helpful in determining both the selection of the transactional profit split as the most appropriate method and the application of the transactional profit split. We have made some introductory comments below as well as addressing the specific questions you raised in the paper.

We note that the language around sharing of risks has been largely removed and we welcome this approach in the new draft. We agree that risk sharing is a function of the application of the transactional profit split method of actual profits. However, we found the language around sharing of economically significant risks to be confusing and potentially misleading. We agree that the control of significant risks, albeit not necessarily the same risks, is generally required in order for the transactional profit split method of actual profits to be appropriately applied.

We also note that the language around the Value Contribution Analysis (“VCA”) has been removed which is also welcomed. Our concern was that the discussion of VCA would lead tax payers or tax authorities to believe it was a requirement in selecting the most appropriate method rather than a useful tool to aid in the structure of the functional, asset and risk analysis. It is therefore suitable to be used as a framework for considering which entities contribute to each value driver though does not in itself, provide an answer as to whether the profit split is the most appropriate method.

Finally, we welcome the new language on the method applying equally to profits and losses and believe it serves as a useful reminder and clarification.

Specific Answers to Questions

1. **Comment on factors which should be taken into account when determining whether a profit split of anticipated profits or a profit split of actual profits should be used.**

   The application of the transactional profit split of actual profits is likely most suitable for transactions whereby the two enterprises are both substantially engaged in ongoing functions which are expected to lead to the creation of the profit and are both responsible, in part, for the associated risks for that profit. This method is applicable in transactions with highly integrated activities focused on a shared business objective. It is this integration that eliminates the potential to use other methods and the focus on a shared business objective which leads to the splitting of actual profits as the most appropriate method.

   The application of the transactional profit split of anticipated profits is likely most suitable for transactions which are integrated but where one party has a lower level of involvement in the on-going business activities and therefore less able to influence the expected outcome.

   As such the key factors should be the level of activity and integration of ongoing functions and whether the two entities share a common business objective.

2. **Comments are also invited on the following profit splitting factors**

   a. **Capital and Capital Employed**
The existing references to capital and capital employed are useful and should be retained. When considering whether this is an appropriate profit splitting factor consideration needs to be given to how capital or capital employed drives the creation of value or intangibles. There needs to be a strong focus on how the capital is used in the business and whether the two parties within the profit split utilise their capital in a comparable way.

b. Headcount of similarly skilled and competent employees

This is a relevant profit splitting factor and one seen regularly in practise. It may be of particular relevance for senior employees within an organisation who collectively drive value but are not located in the same jurisdiction. This could include management committees or executive leadership teams. These functions are relevant as they are particularly hard to benchmark and remunerate separately and are therefore, often included within the profit split model.

c. Adjustments for purchasing power parity

We are unclear as to why purchasing power parity should be considered within a profit split method and welcome further guidance on this topic.

3. Examples of scenarios in which a transactional profit split is found to be the most appropriate method.

Please see examples provided in response to the previous draft.

Conclusion

In conclusion, the additional guidance is both welcomed and helpful. We have addressed your specific questions and trust that these responses are useful.
Grant Thornton discussion draft response

BEPS Action 10

Revised Guidance on Profit Splits
Grant Thornton International Ltd welcomes the opportunity to comment on the OECD public discussion draft on the Revised Guidance on Profit Splits issued on 22 June 2017. We appreciate the work that the OECD has undertaken on the wider BEPS project and would like to make the following comments on this further guidance.
General comments

We would first like to make some general comments. We appreciate the inclusion of examples in the draft, although in many of the examples, as currently drafted, we would question whether the profit split is in fact the most appropriate method.

We appreciate there is no longer an overt hierarchy of methods in the Guidelines, but most commentators agree that the profit split method is extremely subjective and hence only likely to be valid in rare circumstances and where other methods cannot practically be used.

We have noticed an increasing tendency for tax authorities in some countries to home in on profit split (in circumstances where there are profits) and we believe the OECD should provide a counterbalance to this unhelpful trend which adds greatly to the uncertainty faced by businesses.

We particularly welcome the statement in paragraph 2 that “References to “profits” in this section should generally be taken as applying equally to losses”. We respectfully submit that the word “generally” be removed from the sentence, and that everywhere the word “profits” appears in the draft it should be followed by the words “or losses”. The method should perhaps be renamed the transactional profit/loss split method (“TPLSM’). This would help remind users of the Guidelines that if the relevant value drivers are so integrated that profits should be split if things go well; the same applies to losses if they go badly.

The strengths and weaknesses section of the draft seems unbalanced. Paragraphs 6, 7, 8 and 9 all refer to purported strengths, whereas only paragraph 10 refers to weaknesses. We also disagree with paragraph 11, which appears to be another defence of the method, and in doing so, potentially moves away from the arm’s length principle.

We welcome the confirmation in paragraph 14 that a lack of readily available comparables does not lead automatically to profit split being the most appropriate method. Unfortunately this paragraph goes on to imply that profit split might almost be a default method unless “one party to the transaction performs only simple functions, does not assume economically significant risks in relation to the transaction and does not otherwise make any [emphasis added] contribution which is unique and valuable (e.g. contract manufacturing or contract service activities in relevant circumstances)”. This seems to us to go too far, and the guidance could be improved by indicating that in many – perhaps the vast majority – of circumstances, other methods could and should apply.

We comment below on each of the specific questions asked of commentators.
Specific questions

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 statement is made in paragraph 43 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”, i.e. the profit should be split between the related parties based on the specific risks/contributions of the entities involved. However, the accurate determination of the risks/contributions may in many cases prove to be difficult and open to interpretation.

The first point raised suggests that the splitting of actual profits should occur in rare circumstances where either:

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

b) Both parties separately assume “closely related” economically significant risks.

We note that paragraph 45 and Example 9 are intended to distinguish between actual and anticipated profit splits. We do not find the example particularly helpful in this regard. Whilst we appreciate the difference between the two scenarios, under scenario 1 of the example it seems unlikely that the profit split would be the most appropriate transfer pricing method and a licencing arrangement (CUP) may be more likely.

The draft continues in paragraph 46 by stating that the split should be “on the basis of the information known or reasonably foreseeable by the associated enterprises at the time the transactions were entered into”. We agree with this statement to the extent this would be the case between third party participants, and further agree that the starting point for delineation of any transaction should be the contract.

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.

We agree that capital or capital employed could be used as a potential profit splitting method where it is an important value driver. This will often be in the context of financial services businesses but could also in some circumstances be relevant for other capital-intensive industries such as heavy engineering. In integrated third party scenarios such as joint ventures, differential invested capital may be a factor in how profits are split.

b. Should headcount of similarly skilled and competent employees be included as a potential profit splitting factor, and if so, in what circumstances should it be relevant?
We believe that there may be instances where it may be appropriate to use headcount (taking into account considerations such as location and experience of the employee) of similarly skilled and competent employees as a potential profit-splitting factor. However, it is unlikely that headcount by itself would be a suitable factor in most circumstances. It is much more likely that headcount would need to be weighted by level of skill and contribution.

For instance, should companies A and B both be involved in the designing of highly valuable products, and there is one design leader in company A and two design leaders in company B, but their skill and contributions are weighted in the ratio of 2:1, the ratio for profit splitting in this case could be 50:50 (2×1:1×2).

Furthermore, we consider it is most likely that compensation, rather than headcount or even weighted headcount, will give a result closest to what third parties would agree between themselves, in scenarios where skilled people are performing integrated functions, such as global trading within financial services on a follow-the-sun basis.

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

We do not believe it would be appropriate to make adjustments for purchasing power parity, as businesses do not generally interact with each other, report, or pay tax, on a PPP basis and this is highly unlikely to be incorporated into third party agreements. Put another way, the profit to be split will not be calculated on a PPP basis, so adjusting the profit splitting factors using PPP seems rather inconsistent and illogical.

Finally, in this section, we do not propose additional profit splitting factors but reiterate the view expressed above in our general comments – profit split is highly subjective and should be used only rarely. Where it is used, it can potentially be made slightly less subjective by performing a residual profit split (this reducing the amount of profits to be divided up) and also by using several profit splitting factors, which themselves can be weighted by importance. In the global trading example, suitable factors might be trader compensation as well as assets under management, for example.

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

Some examples are outlined below.

Example 1

Global speciality chemicals trader. The senior traders, who had product know how as well as relationships with customers and suppliers, were based across several locations globally.

The supply chain was a highly integrated operation. Know-how and customer relationships were required at both ends of the supply chain

Where there was a different selling entity to the purchasing entity, it was not possible to distinguish either as a simpler party. Both parties made highly valuable contributions of intellectual property to the supply chain.

The profit split method was considered to be the most appropriate method with which to analyse the arm's length nature of the inter-company transactions, and because the value of
transactions was high, and numbers of transactions were low, it was possible to share the profits between both parties in proportion to their relative contributions to the value driving activities on a contract-by-contract basis.

Example 2

Company A (‘ACo’) transacts with its parent in country B (‘BCo’). Both ACo and BCo provide routine functions for each other and co-develop and maintain valuable intangible assets. Due to the highly integrated nature of the business, the profit split method has been selected as the most appropriate transfer pricing method.

ACo and BCo provide financial electronic trading platform services to the financial services sector by way of the group’s electronic trading platform and algorithms. As the business generates value by driving volume through its platform, transaction volume was selected as an appropriate metric with which to calculate the profit split between ACo and BCo.

Metcalfe’s law was chosen as an allocation key as this is a proxy for the exponential value associated with volume and the economies of scale generated by networks such as electronic trading platforms.

The residual profit attributable to ACo was calculated as follows: \((\text{A Transaction Volume})^2 / [(\text{B Transaction Volume})^2 + (\text{A Transaction Volume})^2] \times \text{Residual Profit}^*

*Residual profit is total combined profit of ACo and BCo and less the profit apportioned to the parties by virtue of the routine functions.

On behalf of the global network of Grant Thornton International Member Firms, with the contribution of our colleagues, Wendy Nicholls, Wayne Pisani, Chaid Dali-Ali, Charles Marais and Thomas Jepson we respectfully submit our response to the Discussion Draft on BEPS Actions 7: Additional Guidance on the Attribution of Profits to Permanent Establishments.

We are grateful for the opportunity to comment and would be pleased to discuss or clarify our response. Please contact the undersigned or any of the contacts below.

Yours Faithfully,

Francesca Lagerberg
Partner
Grant Thornton International

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<thead>
<tr>
<th>Grant Thornton Contact</th>
<th>E-mail</th>
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<tbody>
<tr>
<td>Wendy Nicholls</td>
<td><a href="mailto:wendy.nicholls@uk.gt.com">wendy.nicholls@uk.gt.com</a></td>
</tr>
<tr>
<td>Aude Delechat-Patel</td>
<td><a href="mailto:aude.se.delechat-patel@uk.gt.com">aude.se.delechat-patel@uk.gt.com</a></td>
</tr>
<tr>
<td>Matthew Harrison</td>
<td><a href="mailto:matthew.harrison@wkgt.com">matthew.harrison@wkgt.com</a></td>
</tr>
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September 15, 2017

VIA E-MAIL

Mr. Tomas Balco
Head, Transfer Pricing Unit
Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD Centre for Tax Policy & Administration
2 rue André-Pascal
75116 Paris
France
TransferPricing@oecd.org

Re: Comment on 22 June 2017 Discussion Draft on BEPS Action 10 (Revised Guidance on Profit Splits)

Dear Tomas,

This letter is submitted on behalf of the International Alliance for Principled Taxation (IAPT or Alliance) to provide you with the IAPT’s comments on the 22 June 2017 Discussion Draft on BEPS Action 10 (Revised Guidance on Profit Splits).

The IAPT is a group of major multinational corporations representing a variety of business sectors. The group’s purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally. The group participated actively as a stakeholder in the discussions leading to the October 2015 final reports from the OECD/G20 BEPS Project.

We thank the OECD for the opportunity to comment on this Discussion Draft and welcome the transparent process followed, including the release of a discussion draft that is not yet a consensus document and the holding of a further consultation meeting in November.

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1 The current membership of the IAPT is made up of the following companies: AB InBev S.A.; Facebook, Inc.; Microsoft Corporation; Procter & Gamble Co.; Repsol S.A.; and Tupperware Brands Corporation.
The Discussion Draft is an extremely important and sensitive document. The final guidance on profit split will to a large extent be the culmination of the OECD most recent work on risks and intangibles in particular.

The group’s comments are set forth in the Annex to this letter. I would be pleased to present them at the consultation to be held in November.

Sincerely yours on behalf of the Alliance,

Caroline Silberztein
Baker & McKenzie SCP
Counsel to the Alliance
ANNEX

IAPT Comments on the 22 June 2017 Discussion Draft on BEPS Action 10
(Revised Guidance on Profit Splits)

I - Executive summary

1. We thank the OECD for the opportunity to comment on the Discussion Draft on the Revised Guidance on Profit Splits that was released on June 22, 2017 (hereafter “the Discussion Draft”) and welcome the transparent process followed, including the release of a discussion draft that is not yet a consensus document and the holding of a further consultation meeting in November.

2. The Discussion Draft is an extremely important and sensitive document. The final guidance on profit split will to a large extent be the culmination of the OECD most recent work on risks and intangibles in particular. It is therefore essential that the final guidance be well balanced, technically very solid and grounded in Article 9 of the Model Tax Convention and the arm’s length principle, and consistent with the rest of the 2017 OECD Transfer Pricing Guidelines (hereafter “TPG”), especially the rest of Chapter II as well as Chapters I and VI.

3. With this in mind, we commend the OECD for this significantly improved document compared to the July 2016 discussion draft. In particular, we strongly support the following:
   a) a much clearer structure of the document;
   b) the addition at the start of a new section with strengthened language on “When is a transactional profit split method likely to be the most appropriate method?”;
   c) this Discussion Draft making a clear reference to the guidance at paragraphs 2.2 to 2.11 of the TPG on the selection of the most appropriate method;
   d) the acknowledgement in the Discussion Draft that "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" and that "depending on the facts of the case, 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".
   e) the deletion of the discussion of sequential integration versus parallel integration that was in the 2016 discussion draft;
   f) the removal of the statements from the 2016 discussion draft, according to which pricing negotiations by an uncontrolled party would typically take into account the profits it expects to derive from the transaction and those it estimates the other party may be likely to obtain, as these statements did not reflect the reality of competitive markets;
   g) the deletion of the section on Value Chain Analyses from the 2016 discussion draft;
   h) the clarification that both combined and residual profit split approaches are possible;
   i) a discussion of risks in relation to profit split that is more consistent with the guidance in Chapter I of the TPG;
   j) the statement on hindsight at paragraph 46.
4. We however think that the proposed guidance should be further improved in the following aspects (please refer to our detailed comments in the following sections of this letter):

a) The final guidance should in our view be more consistently grounded in Article 9 of the Model Tax Convention i.e. an assessment of what independent parties in comparable circumstances would have agreed. In particular, the fact that a party contributes to the creation of value means it should be compensated at arm’s length for such creation of value, by comparison to what independent parties would have agreed. **The profit split method should not become a first choice method or be selected just because a party contributes to the creation of value** (which is the purpose of all enterprises) where reliable evidence of price or profit determination between independent parties is available and such evidence shows that independent parties do not typically agree to split their profits (or losses). We find that this basic principle gets lost in particular in the series of examples in the Annex.

b) The discussion of the strengths and weaknesses of the profit split method remains in our view unbalanced with a strong bias towards the profit split method. While we acknowledge and understand that some countries may have their own policy considerations in this respect, we believe it is extremely important for the integrity of the TPG that the final OECD guidance does not underestimate the subjectivity and extraordinary complexity that are inherent in this method, the possibly wide-ranging outcomes depending on the assumptions used (e.g. whether to use anticipated or actual profits, or in relation to the selection of the splitting factors to list a few, i.e. fundamental questions on which the OECD itself currently has not reached consensus) and accordingly its potential for more numerous, complex and costly disputes.

c) The final guidance should in our view more affirmatively and consistently state that the presence of unique (i.e. non benchmarkable) and valuable contributions by each party to the transaction is a necessary condition for a profit split method to be appropriate. That is, where one party to the transaction makes non-unique contributions, the profit split method will not be appropriate, and a method based on comparables (where available) will be more appropriate consistently with the arm’s length principle and Article 9 of the Model Tax Convention. While this latter point is acknowledged in the Discussion Draft at paragraph 28, its relevance is unfortunately diminished by the subsequent discussion of “indicators”. Even where a profit split is found to be appropriate, non-unique contributions that are embedded in the transaction should still be compensated based on comparables (where available). Furthermore, we are very concerned that several examples in the proposed Annex fail to base the conclusion on analysis whether the parties make unique and valuable contributions and instead seem to rely on the performance of “important functions” and on the activities being “successful”. “Unique and valuable contributions” should not be replaced with “important contributions”; success or lack of success of activities performed by the parties should not be a factor in the selection of the most appropriate transfer pricing method.

d) Looking at the logical articulation of the draft guidance, we find that the discussion of “indicative factors” introduces significant uncertainty as to the selection of the most appropriate method, thus downgrading the existing guidance on the selection of the “most appropriate method” and more generally the clarity of the TPG and its role as a standard setter. We strongly recommend focusing the guidance in the TPG on clear criteria (i.e. whether or not each party to the transaction makes unique and valuable contributions) and avoiding listing and discussing indicative factors that, as acknowledged by the OECD itself at paragraph 4 of the Discussion Draft, may or may not lead to the selection of a profit split method — and are therefore unhelpful.

e) In particular, the section on highly integrated operations is too far reaching and in our view should be deleted. Alternatively, if it is retained, it should be clarified that high integration alone does not make a profit split method appropriate. The focus should be on whether the functions that are highly integrated are entrepreneurial ones i.e. involve unique and valuable contributions. The global trading of financial instruments example, to which the Discussion Draft
contains several references, illustrates this point by setting forth a scenario whereby several locations perform the full range of the global trading entrepreneurial functions, clearly stating that non-unique support functions do not warrant a profit split. The final OECD guidance should be unambiguous on the fact that where one party performs routine (non-unique, benchmarkable) functions that are highly integrated with unique, valuable contributions made by another party, the former party should not be remunerated using a profit split.

f) Further guidance would be welcome to clarify that the mere performance of DEMPE functions without the contribution of unique and valuable intangibles or the sharing of entrepreneurial risks does not warrant a profit split. This is a key area of ambiguity in the Discussion Draft, which is also largely reflected in the series of examples. One obvious case relates to contract R&D agreements whereby a party performs development functions but does not contribute any unique and valuable intangibles and does not share in the significant investment risk associated with the development. Such a party does not make a unique contribution and should not be compensated with a profit split, despite its arguably performing a DEMPE function. Another typical example relates to distribution agreements whereby a party “exploits” a brand in its market but does not make any unique and valuable contribution. Such a distributor should not be compensated with a profit split despite its arguably performing a DEMPE function. We are very concerned that the Discussion Draft opens numerous avenues for a systematic application of profit split to distribution activities irrespective of whether such activities are unique or benchmarkable.

g) We regret the deletion of the statement that was at paragraph 23 of the 2016 discussion draft that there is no need for profit split simply on account of group synergies alone. This was an important statement for a principled application of the arm’s length principle.

h) We find that it would be helpful to complete the analysis of how risk may impact profit split to address cases where the risk-taking party does not contribute any unique and valuable intangible. In such case, we believe that the risk-taking party should be compensated for its risk but not necessarily share in the profits associated with the intangible it does not contribute. [In making this comment, we fully acknowledge that according to the TPG, legal ownership of an intangible without the performance of DEMPE functions may not attract the intangible return.]

i) We find the discussion of the “shared assumption of closely related risks” technically flawed and recommend it be deleted. This is because where the two parties separately assume risks, by definition they separately assume the consequences of such risks materializing (or not). This is irrespective of whether the risks are “closely related”. Stating otherwise would introduce an internal inconsistency in the reasoning and would also be inconsistent with the new Chapter I guidance on risk.

j) We wonder why the cross-reference to the TPG 1.83 contract R&D example that was at paragraph 17 of the July 2016 discussion draft was removed. We find this deletion especially unfortunate given that the newly inserted Example 1, which concludes on the appropriateness of a profit split method in an R&D situation, does not state the conditions under which Company B performs its R&D activities and may therefore be interpreted as supporting the selection of a profit split method in a contract R&D scenario.

k) Finally, we note that in order to maintain the transactional focus of the profit split method, the analysis should focus on the transaction, not the entities or organizations (as this may be a formulary apportionment gateway). We included in our comments a few proposed edits where we found that the drafting was inaccurate in this respect.

5. We provide below further detailed comments on the above as well as a few other points.
II - Detailed comments on the proposed guidance

In order to facilitate cross-references, we have used the section numbering of the Discussion Draft in our comments below.

C.2 When is a transactional profit split method likely to be the most appropriate method?

“Indicators”, “factors” versus selection criteria

6. At paragraph 4, the Discussion Draft states that:

However it is important to note that there is no deterministic rule for establishing when a particular transfer pricing method is the most appropriate method and a transactional profit split method should not be automatically selected on the basis that one or more of the listed indicators applies. Similarly, the absence of one or more of these indicators should not prevent a transactional profit split method from being applied where it is determined to be the most appropriate method.

7. At paragraph 13, the Discussion Draft indicates that:

[...] other indicators could include a high level of integration in the business operations to which the transactions relate and the shared assumption of economically significant risks (or the separate 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 often be found together in a single case.

8. We fully agree that (i) a high level of integration in the business operations to which the transactions relate and (ii) the separate assumption of closely related economically significant risks by the parties to the transactions cannot be determinative in the selection of a profit split.

9. That being said, we are concerned that the emphasis given in the Discussion Draft to these “indicators” and in particular the above-quoted language may introduce significant uncertainty: a taxpayer could select the method that it considers to be the most appropriate one based on the OECD guidance and a tax administration could substitute another method to it on the basis of the presence of some of the indicators described in Section C.2, or on the contrary despite the absence of such indicators. We therefore urge the OECD to clearly state at the beginning of Section C.2 that:

- the selection of the most appropriate method should be on the basis of the guidance at paragraphs 2.2 to 2.11 of the TPG i.e.:
  - the strengths and weaknesses of each method (we include in Section C.2.1 below some suggestions to rebalance the description of the strengths and weaknesses of the profit split method);
  - the nature of the transaction, i.e. whether or not each party to the transaction makes unique and valuable contributions (that is, contributions that are not benchmarkable and are significant to the creation of value). By contrast, where one party of the transaction makes no unique and valuable contribution, a profit split will not apply to such party as its contributions can be more reliably tested using a one-sided method; and
  - the availability and reliability of comparables (keeping in mind that the unavailability of comparables does not necessarily make a profit split method appropriate);
- the other “indicators” described in Section C.2.2 (“high integration” of business operations; separate assumption of “closely related” risks) are not sufficient by themselves for a profit split method to be the most appropriate method. In fact, we find the discussion of these two “indicators” technically flawed and strongly recommend deleting it to avoid creating confusion. If it is to be retained, however, we offer some suggestions to ground it more solidly in the arm’s length principle, see comments on Section C.2.2 below.

C.2.1 Strengths and weaknesses of the transactional profit split method

Strengths:

10. Paragraph 8 indicates that the profit split method can offer flexibility “by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises”. We believe this is a misleading statement which could open up an avenue to select a profit split method in all kinds of situations, on the basis that there are almost always specific, facts and circumstances in associated enterprises that are not present in independent enterprises. We therefore recommend deleting this sentence or further clarifying what its intended meaning is.

11. Paragraph 8 further provides that "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 the risks associated with the transaction". This however is not a specific strength of the profit split method as other OECD-recognized transfer pricing methods also are able to reflect the actual outcomes the circumstances of the risks associated with the transaction. Further, what is more important is to determine whether the selected transfer pricing method ought to allocate risk among the parties and if so how. The profit split method may not be appropriate in cases where one of the parties to the transaction does not assume risk – hence should not be allocated the actual outcomes of the risks associated with the transaction. We therefore do not agree that determining profits that vary with the actual outcomes of risks should be regarded as a strength of the profit split method.

12. Paragraph 9 provides that “a further strength of the transactional profit split method is that both parties to the transaction are directly evaluated as part of the pricing of the transaction”. However, the fact that each party to the transaction is evaluated may be a weakness rather than a strength, especially in terms of complexity. The key point is therefore to determine whether or not it is appropriate to evaluate each side of the transaction – and to do so in appropriate cases and only in appropriate cases.

13. We therefore suggest the following edit to paragraph 9:

*a further strength feature of the transactional profit split method is that both parties to each side of the transaction are directly evaluated as part of the pricing of the transaction. Depending on the case at hand, this may or may not be appropriate. Note that evaluating both sides of the transaction in cases where one party makes only non-unique (i.e. benchmarkable) contributions would create undue burden and uncertainty and would not be appropriate under the arm’s length principle.*
Weaknesses:

14. While the Discussion Draft correctly acknowledges that a profit split method may be difficult to apply, the discussion at Section C.2.1 of the weaknesses that are inherent in the profit split method is moderately convincing about the magnitude and reasons for such difficulties. Some of these difficulties are however illustrated in Sections C.4 and C.5 of the Draft, see for instance:

- "where cost-based profit splitting factors are used that are based on data extracted from the taxpayers’ profit and loss accounts, it may be necessary to draw up transactional accounts that identify those expenses that are related to the controlled transaction at hand and those that should be excluded from the determination of the profit splitting factor" (paragraph 61);

- "cost-based profit splitting factors can be very sensitive to differences and changes in accounting classification of costs. It is therefore necessary to clearly identify in advance what costs will be taken into account in the determination of the factor and to determine the factor consistently among the parties" (paragraph 67);

- "a significant issue for the reliability of cost-based splitting factors is the determination of the relevant period of time from which the elements of determination of the profit splitting factor(s) (e.g. assets, costs, or others) should be taken into account" (paragraph 68).

15. We therefore recommend at a minimum a cross-reference in C.2.1 to the difficulties of application of the profit split method that are described in Sections C.4 and C.5 of the Draft.

16. Further, we regret that the Discussion Draft does not draw any consequence from such difficulties in terms of appropriateness of the method or guidance for application. One obvious consequence should be to warn against a broad selection of the profit split method as it would inevitably make the arm’s length principle more uncertain, subjective and complex to implement, leading to significant administrative burden and disputes.

17. Paragraph 10 currently focuses on practical difficulties but seems to suggest that these difficulties in substance refer to an additional workload on the taxpayer but nothing that is out of reach. In reality, a profit split method is an extremely complex method for taxpayers to apply and for tax administrations to audit. This complexity and its implications in terms of costs and resources for both the taxpayer and the tax administration should not be understated. It is primarily due to the volume and nature of information needed to apply the method.

18. The second sentence of paragraph 10 (“On first review, the transactional profit split method may appear readily accessible […]”) is far from the reality and should in our view be deleted. The third sentence stating that “associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates” seems to suggest that the complexity resides in a lack of transparency on the part of MNEs, which would be an incorrect statement.

19. Tax administrations that want to substitute a profit split for another method applied by a taxpayer should acknowledge that this may lead them to require analytical segmented data about the combined profits of a transaction and splitting factors that is often not available in the MNE’s accounting system and may be very onerous to prepare. The accounting difficulties are significantly understated.
in the Discussion Draft. For instance, the wording in the middle of the third sentence of paragraph 10 should be corrected as follows:

\[...\] would require stating creating books and records on a common basis.

20. Furthermore, based on our experience, not all tax inspectors have the required technical background to audit such complex determinations, leaving aside the ability to make their own profit split determinations in an audit. This is because a profit split involves analyzing accounts from foreign parties, which typically are stated in differing accounting standards not all tax inspectors can be familiar with. This is also because it requires considerable cost allocations that are business specific and based on management decisions, not on statutory accounting. Profit splits are far more complex to determine and audit than one-sided methods. A broad application of the profit split method can be an issue for tax administrations that have scarce resources and this should be kept in mind in order not to encourage (in particular developing) economies to broaden the use of profit split in situations where this method is not the most appropriate one.

21. Further, profit split determinations are typically uncertain. There is typically a significant degree of subjectivity in the analytical determination of the profit to be split because the consolidated profit earned by several entities on one transaction is generally not identified as such in the statutory accounts and an analytical segmentation has to be performed, typically for the sole purpose of the profit split determination. When the profit to be split is the operating profit, operating expenses, depreciation and amortization need to be analytically allocated to various business transactions. Further, the selection of the allocation keys that will be used to split the profits and their determination may also be subjective, and the selection of one or another may lead to wide-ranging outcomes, creating a huge potential for double taxation and disputes.

22. The OECD should better acknowledge these complexities and uncertainties and note that the profit split method should be reserved for cases where the contributions by the parties are both unique and valuable. If one party makes contributions that are not unique, a simpler and more reliable method based on comparables will be more appropriate.

23. We find that the statement at paragraph 11, which downplays the relevance of the profit split method being rarely used among independent enterprises, is in contradiction with the statement at paragraph 15 according to which it is relevant to consider whether independent parties do commonly use profit splitting in similar situations. We support paragraph 15 which is grounded in the arm’s length principle and recommend deleting paragraph 11 and replacing it with the following:

\textit{A profit split method would not be the most appropriate method in cases where there is evidence that independent parties would agree on another method and that such other method can be applied in a reasonably reliable manner. Doing otherwise would be inconsistent with the arm’s length principle as embodied at Article 9 of the Model Tax Convention. Further, if information is available that independent parties do commonly use profit splitting approaches in similar situations, careful consideration should be given to whether the transactional profit split method may be the most appropriate method for the controlled transactions. [Note: This last sentence is currently found at paragraph 15 of the Discussion Draft]}
C.2.2 Nature of the transaction

*Unique and valuable contributions by each party: a necessary condition for a profit split method to be appropriate*

24. At paragraph 13, we suggest the following edit:

> the existence of unique and valuable contributions by each party to the controlled transaction is perhaps the clearest indicator that is a necessary condition for a profit split method may be appropriate.

25. “Unique and valuable contributions” should not be replaced with “important contributions” ; success of activities or lack of success should not be a factor in the selection of the most appropriate transfer pricing method.

26. Several examples in Annex fail to base the conclusion on analysis whether the parties make unique and valuable contributions and instead seem to rely on the performance of “important functions” and on the activities being “successful”. This is technically erroneous as it is not aligned with the arm’s length principle set out in Article 9.

27. As rightly pointed at paragraph 2 of the Discussion Draft, where a transactional profit split method is determined to be the most appropriate method, it should generally also apply, and apply in the same way, regardless of whether the transaction(s) result in a relevant profit or loss.

28. The selection or non-selection of the profit split method should be based on objective criteria, not on the success or lack of success of the business operations. Doing otherwise would be extremely detrimental to a principled application of the arm’s length principle. This concern arises with several proposed Examples in the Annex and resonates with a practice that many taxpayers experience in a number of countries, where tax administrations argue for a profit split in the event of a profitable business and for a transaction net margin method in the event of a loss-making business or of unsuccessful local activities.

29. In the same vein, we find that in several examples, the Discussion Draft seemingly confuses “important functions” with “unique and valuable contributions”. The threshold for a function to be “important” or “successful” is a much lower threshold than the one which applies to characterize a “unique and valuable contribution”. Doing a “good job” is not a unique and valuable intangible – contract manufacturers, service providers and low risk distributors are all supposed to do a good job, as a matter of survival. There are many “important” and “successful” functions that are found in uncontrolled transactions, i.e. that are not unique. Article 9 of the Model Tax Convention does not support the substitution of a profit split to a traditional method or TNMM in those cases.

**Transactions involving unique and valuable intangibles; clarification with respect to DEMPE functions**

30. The new Chapter VI puts a strong emphasis on the significance of the performance of development, enhancement, maintenance, protection and exploitation (“DEMPE”) functions for the intangible owner to be allocated the returns from the intangibles it owns. Questions relating to the appropriateness of a profit split method already arise in practice in cases where an entity that is not
the owner of the intangible performs some of the DEMPE functions. We recommend strengthening the draft language at paragraph 17 of the Discussion Draft as follows:

*Where each party to the transaction legally owns unique and valuable intangibles that are relevant to the transaction, it will also be necessary to consider whether, under the accurate delineation of the transaction, they each assume the economically significant risks relating to those intangibles, e.g. risks related to development, obsolescence, infringement, product liability and exploitation (see paragraphs 6.65 to 6.68). The mere performance of development, enhancement, maintenance, protection and exploitation functions by a party that is not the owner of the intangible does not suffice to make a profit split appropriate between that party and the intangible owner.*

31. We support the statement at paragraph 14 of the Discussion Draft that a profit split method is not appropriate just because an entity participates in the development of an intangible through contract R&D or contract service activities. See for instance paragraph 1.83, which we recommend should be cross-referenced in the final profit split guidance for the sake of clarity. We suggest clarifying that such contract service activities include marketing support services and other non unique support activities such as the collection of feedback on possible improvements to a manufacturing process or brand positioning.

32. In our view, the greatest difficulties will arise with the notion of “exploitation”, as this notion is not defined in the revised Chapter VI, leaving the guidance open to wide-ranging interpretations. Differing interpretations of the meaning of the word “exploitation” in the context of the revised Chapter VI will lead to disputes about the circumstances where a profit split method is appropriate.

33. As an example, assume that a brand owner funds, develops, enhances, maintains and protects a trademark. It enters into a distribution agreement with an affiliated company to distribute products under the trademark it owns. Some tax administrations have argued that in such a case, the affiliated distributor “exploits” the trademark and should therefore be entitled to a share of the intangible return. We believe that this would be an incorrect outcome, inconsistent with the arm’s length principle because in the vast majority of cases, independent distributors would not be entitled to a share in the residual profit in comparable circumstances. In such a case, the brand owner exploits the trademark by putting in place distribution contracts. We find Examples 3 and 4 confusing in this respect.

34. Generally speaking, we are concerned that the Discussion Draft opens numerous avenues for a systematic application of profit split to distribution activities irrespective of whether such activities are unique or benchmarkable. It is unclear to us whether this reflects a consensus position of all OECD member States. We see a huge potential for disputes in this respect (disputes are in fact already arising in this respect).

35. The same issue arises for contract manufacturers who use technology put at their disposal by a foreign associated enterprise: should a contract manufacturer be regarded as “exploiting” the intangibles put at its disposal by the principal? We think that a profit split is not appropriate in the case of a contract manufacturer. We support paragraph 14 and Example 6 in this respect.

36. We believe that it is essential to the sustainability of the arm’s length principle and Guidelines that the profit split method should not become a default method. We therefore urge the OECD to clarify that a profit split method is not appropriate just because a party contributes to the development,
enhancement, maintenance, protection of intangibles, in cases where these functions can more appropriately be compensated using a one-sided method.

37. Furthermore, we recommend that the OECD clarify that the mere fact that an entity uses or exploits the intangibles of an associated enterprise does not entitle such entity to share in the combined or residual profit from the intangibles. As noted at paragraph 14 of the Discussion Draft, a profit split method is generally not the most appropriate method for a service provider or manufacturer who performs routine functions that are similar to those of comparable independent service providers or manufacturers. We recommend that paragraph 14 be completed to state that the same is true for limited risk distributors:

Where the accurate delineation of the transaction determines that one party to the transaction performs only simple functions, does not assume economically significant risks in relation to the transaction and does not otherwise make any contribution which is unique and valuable (e.g. limited risk distributors, contract manufacturing or contract service activities in relevant circumstances), a transactional profit split method typically would not be appropriate since a share of profits (which may be impacted by the playing out of the economically significant risks) would be unlikely to represent an arm’s length outcome for such contributions or risk assumption.

Other “indicators” : a confusing discussion that downgrades the guidance on the selection of the most appropriate transfer pricing method

38. We find the end of paragraph 13 quoted below confusing:

other indicators could include a high level of integration in the business operations to which the transactions relate and the shared assumption of economically significant risks (or the separate 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 often be found together in a single case.

39. Our understanding is that the OECD’s intention is to present these two factors as “indicators” i.e. not determinative criteria. We strongly agree that a high level of integration in the business operations and the separate assumption of closely related economically significant risks are at most indicative factors, but not determinative criteria for a profit split method to be applicable.

40. However, from a logical point of view, we find the discussion of such “indicators” unhelpful. If the guidance means that a profit split method may or may not be appropriate irrespective of the presence of absence of these “indicators”, we do not find the inclusion of a discussion of such indicators (or “factors”) particularly enlightening. We even find that it downgrades the relevance of the guidance, because it introduces uncertainty as to how to select the most appropriate method, despite the efforts that were made by the OECD to provide guidance at paragraphs 2.2-2.12 of the TPG.

41. We therefore would advise deleting the discussion of these two “indicators” or, in the event they are retained, further clarifying their role as non-determinative factors (by contrast to the existence of unique and valuable contributions by each party which in our view should be a necessary, threshold condition).
C.2.2.2 Highly integrated business operations (and specific question #3 to commentators)

42. Paragraph 19 states that most MNE groups are integrated to some extent. Our experience is that most MNE groups are highly integrated. In today’s world, business models and supply chains are global and integration is a the basis of efficient governance. We do not see high integration or “inter-dependency” as a factor, an indicator or even a pointer that should lead to the selection of a profit split method.

43. As noted at paragraph 20, in its 2010 Report on the Attribution of Profits to Permanent Establishments (“AOA”), the OECD considered the application of a profit split method to the global trading of financial instruments on the grounds that such activities may be highly integrated. In effect, we agree that where such global trading activities are highly integrated, e.g. under the integrated model described at paragraph 141 of Part II of the AOA, a profit split method may be appropriate. This is because the activity then involves several locations each of which has the capacity to perform the full range of trading and risk management functions necessary to conduct the business and thus performs and entrepreneurial role (assuming it also supplies its own capital), while each location cannot act independently but must co-operate. In such a case, a split of either the residual or the combined profits may be appropriate because the parties that are highly integrated are in essence co-entrepreneurs, and their integrated activities consist in unique, valuable contributions by each of them.

44. That being said, support, the AOA clearly acknowledges that middle office or back office functions that are benchmarkable would generally not be compensated through a profit split method (see AOA paragraphs 143-147). Non-unique (i.e. benchmarkable) contributions should be tested based on comparables, not on a profit split method. In effect, Article 9 of the Model Tax Convention and the arm’s length principle clearly state that the remuneration of the transaction should be set by reference to comparables where they exist.

45. The global trading example cannot be compared to the one of a contract manufacturer that is highly integrated in the supply chain but does not make unique and valuable contributions, i.e. for which comparables exists and that do not generate non-routine profits.

46. In response to question 3 to commentators, our analysis is that if the OECD intends to provide an additional example of highly integrated operations for which a profit split method would be appropriate, it should set forth a fact pattern that has the same characteristics as the global trading of financial instruments in terms of uniqueness and value of the contributions made by each party to the transaction.

47. While high integration of unique and valuable contributions (such as in the global trading example) can lead to a profit split being appropriate, high integration of support functions or benchmarkable activities should not lead to the selection of a profit split method. This is because support functions that are benchmarkable are more reliably remunerated based on comparables, and generally do not warrant a split of the residual profit (or loss).

48. This illustrates why we urge the OECD to clarify that the existence of unique and contributions by all the parties is always a necessary condition for the profit split method to be appropriate, and that high integration is not a determinative factor. This would be consistent with the proposed language at paragraph 14.
49. If the discussion of high integration is retained, we therefore recommend the following edits to paragraphs 19-21:

19. Although most MNE groups are integrated to some extent, a particularly high degree of integration in certain business operations is an indicator for the consideration of the transactional profit split method. A high degree of integration means that the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with, and cannot reliably be evaluated in isolation from, the way in which another party to the transaction performs functions, uses assets and assumes risks. 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 such cases, a profit split method will not be the most appropriate method. This needs to be borne in mind in considering which transfer pricing method is the most appropriate in a particular case. See Example 6.

20. In some cases the parties may perform functions jointly, own unique and valuable assets jointly and/or share assumption of entrepreneurial risks to such an extent that it is impossible to evaluate their respective contributions in isolation from those of others. As an example, the transactional profit split method can be applied to the global trading of financial instruments by associated enterprises. See in Part III, Section C of the Report on the Attribution of Profits to Permanent Establishments and Example 7.

21. Another example may be where the integration between the parties takes the form of a high degree of inter-dependency. For example, profit split approaches may be used by independent enterprises engaged in long-term arrangements where each party has made a significant contribution (e.g. of an asset) whose value depends on the counterparty to the arrangement. In this kind of case, where each party makes such a contribution, and is dependent on the other party, some form of flexible pricing that takes into account the risks assumed by each party arising from its dependence on the other party may be observed.

Synergies

50. Paragraph 22 contains a reference to possible synergies among intangibles. While we do not disagree with the proposal, we recommend clarifying that the point relates to unique and valuable contributions only and that the intention here is not to address synergies in relation to benchmarkable functions. Synergies are addressed at paragraphs 1.157-1.173 of the TPG. The example at TPG 6.94 relates to possible synergies among valuable intangibles. We therefore recommend clarifying the proposed language as follows:

22. Where each party to a transaction makes unique and valuable the contributions that are highly inter-related or inter-dependent upon each other, the evaluation of the respective contributions of the parties may need to be done holistically. For instance, the contribution by each party may be unique and valuable, or and in some cases 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 paragraph 6.94 for an example of synergies among valuable intangibles and paragraphs 1.157-1.173 for general guidance on synergies.

51. We note that at arm’s length, cross-licenses are a common response to situation where the contribution by each party is unique and valuable, including where they may have a greater value when considered in combination than on a standalone basis. That is, between independent parties, the
desire to combine unique and valuable intangibles does not necessarily translate into a profit sharing agreement.

52. We regret the deletion of the statement that there is no need for profit split simply on account of group synergies alone (paragraph 23 of the 2016 discussion draft).

53. We recommend making paragraph 24 more technically accurate as follows:

Where 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. The first party should receive an arm’s length remuneration for its contribution. See paragraph 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 transactional profit split is the most appropriate method in the case.

C.2.2.3 Shared assumption of economically significant risks, separate assumption of closely related risks

Risk may be one unique, valuable contribution among others and may not warrant sharing in profit from the whole transaction if there are other unique, valuable contributions

54. At paragraph 25, we note that if the parties share the assumption of economically significant risks but one of them only contributes unique, valuable intangibles, then the parties would logically share the profit or loss from the risks, not from the intangibles.

55. We think that it would be incorrect to consider that the sharing of risk automatically leads to a profit split method being the most appropriate. In effect, in a profit split method, the combined profit or residual profit from the transaction is being shared. The profit to be split may derive from a range of contributions beyond the specific risk sharing, such as unique and valuable intangibles contributed by one party only, as well as other risks that may be assumed by one party only.

56. At arm’s length, where each party to a transaction agrees to share a particular risk, it typically shares the consequences of that risk, but not necessarily the profits from the whole transaction as the latter may have much broader inputs and implications than the mere sharing of that risk.

57. In our view it follows that under the arm’s length principle, where each party to a controlled transaction assumes unique and valuable risks (i.e. economically significant risks that are not found in the comparables and cannot be adjusted through a comparability adjustment), each of them should be allocated the profit (or loss) associated with the specific risks it assumes, in accordance with the guidance at paragraphs 1.100 - 1.106 of the TPG. If multiple parties share the assumption of a given risk, they should also share the profit (or loss) associated with the assumption of such risk. On the other hand, they should not necessarily share the profit from other inputs to the transaction, such as unique and valuable intangibles they do not contribute, or other risks they do not share.

58. If only one party to the transaction contributes the unique and valuable intangibles while multiple parties assume risks, the former should be the only one entitled to the profit derived from the
intangibles contributed, while the latter would each be allocated the profit (or loss) associated with the assumptions of the specific risks they co-assume, in accordance with the guidance in Chapter I.

59. Despite the strong emphasis of the TPG on risk, it is important to recognize that every business assumes some important risk. At arm’s length, an independent contract-manufacturer, service provider or distributor assumes operational risks as well as the risk of losing clients and being out of business. The market - and therefore the arm’s length principle - does not compensate the assumption of such risks through a sharing of intangible related profits with principals.

60. On the other hand, cases where an associated enterprise assumes significant risks that are not assumed by independent comparable enterprises would support the allocation of profits (or losses) to the risk-bearing associated entity that go beyond the returns earned by comparable enterprises. Depending on the nature of the risk at hand, a comparability adjustment may be performed to adjust the comparables and take the additional risk into account.

**Separate assumption of closely related risks:**

61. We disagree with the following statement at paragraph 26 which in our view is technically erroneous:

* A transactional profit split may also be found to be the most appropriate method where, according to the accurately delineated transaction, the various economically significant risks 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.

62. There are many situations at arm’s length where the risks borne by one entity are influenced by other parties’ risks and actions. It does not follow that the parties will share the profits or losses deriving from those risks. A good example of independent parties being impacted by separate (not shared) risks is one party’s dependence on a critical component solely sourced from a second party. If the second party’s business fails, the first party could be out of business. In such transactions however the first party would typically not agree to share profits with the second party.

63. In fact, we regard the proposition at paragraph 26 as internally inconsistent : if the accurate delineation of the transaction shows that significant risks in relation to the transaction are *separately assumed by the parties*, then the profits or losses arising from the (non)materialization of those risks should be *separately borne*. Otherwise, if the profits or losses derived from the (non)materialization of the risks are *jointly shared*, this means that the parties *jointly assume the risk*, contrary to the outcome of the accurate delineation of the transaction. This is an internal contradiction.

64. **We therefore strongly recommend all the references to the separate assumption of closely related risks to be removed from the final guidance.**

**C.2.3 Availability of reliable information**

65. The arm’s length principle of Article 9 of the Model Tax Convention is very clear that where the price of a transaction is comparable to what would be agreed between independent parties, it should not be reassessed by tax authorities. Accordingly, paragraph 28 should be amended as follows:
66. We strongly support the last sentence of paragraph 28 (“a lack of comparables alone is insufficient to warrant the use of a transactional profit split.”).

2.2.4 Conclusion

67. For the reasons explained at paragraphs 6-9, 38-49 and 61-64 of this letter, we would prefer the discussion of “highly integrated operations” and “separate assumption of closely related risks” to be removed from the final guidance.

68. If however it is retained, we fully agree that "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". We would suggest that these sentences be moved to the front of the section in order to more clearly set the framework in which this discussion takes place.

69. As an additional comment, we find that the conclusion at Section 2.2.4 could be improved by stating that the selection of the most appropriate method has to be made consistently with the arm’s length principle, i.e. with what independent parties would agree (or have agreed) in comparable circumstances; and that as a consequence a profit split method is not appropriate where another method (CUP, cost plus, resale minus or TNMM) can be applied using reliable comparables.

70. The extreme complexity and the broad uncertainties that are inherent in profit split methods should also be better acknowledged, in order not to present this method as a panacea.

71. Tax administrations that advocate a broad use of the profit split method should commit to eliminate in mutual agreement procedure any double taxation that may result from the selection and application of this method or submit the case to binding arbitration. It should be recognized that the broader the use of the profit split method, the more tax administrations will need to invest resources in transfer pricing administration, both at enforcement and dispute resolution levels.

72. We find that the Discussion Draft does not sufficiently reflect the direct correlation between, on the one hand, a possible broadening of the use of profit split methods and, on the other hand, an inevitable increased complexity of tax audits and increased number of cross-border disputes and mutual agreement procedures. Disputes will inevitably arise about both the appropriateness of the profit split method and the determination of the profit (or loss) to be split and splitting factors.

C.3 Guidance for application - in general

73. At paragraph 31, we agree that "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".
74. At paragraph 32, while we agree that "if 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 and the criteria or profit splitting factors to be agreed in advance of the transaction", we think that provisions that allow changes to those criteria or splitting factors based on actual experience may be appropriate, subject to the new splitting factors meeting the other requirements listed at paragraphs 32-33.

**Retaining the transaction focus of the profit split method**

75. At the end of paragraph 26, we note that the risks should pertain to the transaction that is subject to the profit split, not to the business operation. The OECD refers throughout the document to a transactional profit split. The wording in the Discussion Draft should be carefully reviewed to retain this transactional focus. See for instance:

- Paragraph 9: *a further strength feature of the transactional profit split method is that both parties to each side of the transaction are directly evaluated as part of the pricing of the transaction.*
- Paragraph 16: *their use in business operations the relevant transaction represents a key source of actual or potential economic benefits;*
- Paragraph 26: *The economic significance of the risks should be analysed in relation to the business operations of which the relevant transactions are a part, rather than in respect of their importance to the individual enterprise.*
- Paragraph 82: *Company A and 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 transaction.*
- Paragraph 85: *the risks assumed by Company B are not economically significant for the business operations transaction.*

**C.3.1 Approaches to splitting profits**

76. At paragraph 34, we think that the last sentence should read *a two-stage "residual analysis" may will generally be appropriate.*

**C.3.1.1 Contribution analysis**

77. At paragraph 36, we suggest adding that cost contributions (e.g. development expenses incurred) can be an appropriate proxy to measure relative value and are present in arm’s-length transactions.

**C.3.1.2 Residual analysis**

78. At paragraph 37, 2nd sentence, we suggest deleting the language in parenthesis which in our view inappropriately diminishes the importance of comparables and one-sided methods. The sentence would be more accurate and clearer without the parenthesis:

*Where the contributions of the parties are such that some can be reliably valued by reference to a one-sided method and benchmarked using comparables (e.g. because the risks assumed in relation to these contributions are not shared, the integration in relation to these transactions is low, and the contributions are not unique and valuable), while others cannot, the application of a residual analysis may be appropriate.*
79. Further, consistently with our comments at paragraphs 6-9, 38-49 and 61-64 above, we recommend the following deletion:

Thus, it would generally not account for the return that would be generated by a second category of contributions which may be unique and valuable and/or are attributable to a high level of integration or the shared assumption of economically significant risks.

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

80. The first sentence of paragraph 39 is inaccurate, while the third sentence is correct. We therefore suggest deleting the first sentence and moving the third one upfront, as follows:

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. The relevant profits to be split should only be those arising in relation to the controlled transaction or transactions under review. It is essential to identify the level of aggregation, see paragraphs 3.9-3.12.

C.4.1 Actual or anticipated profits

81. At paragraph 44, consistently with our comments at paragraph 6-9, 38-49 and 61-64 above, we recommend the following deletions:

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. These kinds of risk assumption may occur in scenarios where the business operations are highly integrated and/or each party makes unique and valuable contributions.

82. We strongly support the statements at paragraph 46 regarding the need to avoid hindsight.

Specific question to commentators:

83. In cases where a profit split method is found to be the most appropriate method, the determination whether to split anticipated or actual profits should reflect the sharing of the risks among the parties, as determined through the functional analysis of the transaction.

84. We note that this complex question is one further illustration of how complex and subjective the application of a profit split method is in practice. It should be acknowledged and cross-referenced in Section C.2.1 of the Discussion Draft that lists strengths and weaknesses of the method.

C.5  Splitting the profits
85. We support the following statement at paragraph 53:

where there is no more direct evidence of how independent parties in comparable circumstances would have split the profit in comparable transactions, the allocation of profits may be based on the relative contributions of the parties, as measured by their functions, assets used and risks assumed.

C.5.1 Profit splitting factors

86. At paragraph 54, we believe that the functional analysis remains the cornerstone of transfer pricing analysis and accordingly should come first and be reaffirmed:

As noted above, arm’s length parties can be assumed to split profits on the basis of their relative contributions to the creation of those profits. The division of the relevant profits under the transactional profit split method is generally achieved using one or more profit splitting factors. The determination of appropriate profit splitting factor(s) should, therefore, reflect the key contributions to value in relation to the transaction. The functional analysis and an analysis of the context in which the transactions take place (e.g. the industry and environment) may be helpful are essential in the process of determining the relevant factors to use in splitting profits, including determining the weighting of applicable profit splitting factors, in cases where more than one factor is used. The determination of appropriate profit splitting factor(s) should, therefore, reflect the key contributions to value in relation to the transaction.

87. We support the following statement at paragraph 56:

while costs may be a poor measure of the value of intangibles contributed (see paragraph 6.142), the relative costs incurred by parties may provide a reasonable proxy for the relative value of those contributions where such contributions are similar in nature.

C.5.2 Internal data

88. We support the following statement at paragraph 59:

Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the relevant profits, consideration should be given to internal data, which may provide a reliable means of establishing or testing the arm’s length nature of the division of profits.

89. At paragraph 60, we agree that:

certain assets, such as self-developed intangibles, may not be reflected on the balance sheet at all, and accordingly must be separately evaluated. In this regard, valuation techniques, such as those based on the discounted value of projected future income streams or cash flows derived from the exploitation of the intangible may be useful.

Specific questions to commentators:

90. We agree that capital or capital employed can be a valid profit splitting factor in appropriate circumstances. In effect it reflects the reality of business i.e. investors deploy capital and assume risks
and bear the upside and downside consequences of the risks they have assumed on the capital they have invested.

Annex 1 - Proposed examples

91. We acknowledge the considerable work done by the Working Party to produce a series of ten examples and we recognize that this is an extremely difficult undertaking.

92. That being said, we think that further work is needed for these examples to provide better clarity and helpfully illustrate the proposed guidance. In particular, the examples need to be more systematically grounded in a review of the criteria that are relevant to the selection of the most appropriate method (see TPG 2.2-2.11 as well as paragraph 3 of the Discussion Draft).

93. We are especially concerned that several of the examples fail to base the conclusion on an analysis whether the parties make unique and valuable contributions and instead seem to rely on the performance of “important functions” and on the activities being “successful” or “cutting edge”. “Unique and valuable contributions” should not be replaced with “important contributions”; success or lack of success of activities performed by the parties should not be a factor in the selection of the most appropriate transfer pricing method.

1.1 Example 1 (Pharmaceutical industry)

94. As a preliminary remark, we note that the example could more clearly distinguish pre-clinical trials research (including fundamental research) which may lead to a registered patent, and clinical trials (phases I to IV) which may lead to an authorization to market a new compound. It would be clearer to state that:

   Company A owns a patent for a new pharmaceutical formulation. Company A designed, funded and performed the pre-clinical research leading to the granting of the patent, and designed the clinical trials and performed the research and development functions during the early stages of the development of the product, leading to the granting of the patent.

95. More importantly, we find that some essential facts are missing from the example, without which it is not possible to affirmatively conclude on the selection of a profit split method.

96. One essential fact that is missing in this example relates to the funding of the R&D and bearing of the associated risk of failure. We assume that Company A funded the pre-clinical trials research that lead it to own the patent and borne the associated failure risk. However, while it states that Company S conducts the subsequent development and enhancement of the products that lead to the regulatory authorization, the example remains silent as to whether Company A, Company S or both Companies A and S fund such activities. The conclusion of the example cannot be the same if Company S funds said development and bears the associated risk, or if Company A funds said development and bears the associated risk, with Company S operating as a contract developer.
97. Another essential fact that is missing from the example is whether Company A, Company S or both Companies A and S share the risks from the subsequent manufacturing and distribution of the products.

98. Assuming that the example would be revised so that Company S funds the subsequent development and bears the associated development risk and that S also bears the risks from the subsequent manufacturing and distribution of the products, a profit split method would in effect be the most appropriate because each of Company A and Company S would have made unique and valuable contributions.

99. On the other hand, if the facts are that Company A funds the subsequent development and bears the associated development risk with Company S acting as a contract developer, and that Company A also bears the risks from the subsequent manufacturing and distribution of the products with Company S acting as a low risk distributor, a profit split method would not be appropriate. In effect, the functions performed by Company S in such a case would not be unique. They would be benchmarkable functions that can more appropriately be remunerated through another transfer pricing method.

100. There is of course a broad variety of other possible factual scenarios between these two. A cross reference to the example at paragraph 1.83 of the TPG would be helpful to clarify that this new Example A does not address contract R&D.

101. Finally, it is in our view extremely important to revise the example so that the selection (or not) of the profit split method is not based on whether the development of the products is successful, and not to confuse “important functions” with “unique and valuable contributions”.

### 1.2 Example 2 (Tea)

102. We read the example as suggesting that A Co makes unique and valuable contributions consisting in the properties of the soil together with the cultivation methods (which give A Co’s tea a highly sought after flavor) and its extensive proprietary know-how to mix the various teas.

103. We recommend clarifying whether the functions, assets and risks of A Co are really unique, i.e. whether or not B Co has other options realistically available to acquire tea of comparable quality from third parties. In the latter case (where third parties exist that produce comparable tea), it should be clarified whether they split profits with independent brand owners / distributors comparable to B Co. If yes, a profit split may be appropriate between A Co and B Co; if not, another transfer pricing method that reflects the conditions that better would be agreed between independent parties should be selected, according to Article 9 of the Model Tax Convention.

104. In our view, Example 2 should be revised in order to base the selection or non-selection of the profit split method on the identification of unique and valuable contributions made by the parties, and should not suggest that a profit split method is appropriate because A Co produces a product of high quality.

105. Another question which arises is whether the qualities of the soil and the origin of the tea (which is featured in the brand) consist in unique and valuable intangibles or location specific advantages.
Finally, it would certainly relevant in this example to further clarify what the respective roles of A Co and B Co’s marketing activities are in making the taste of the tea produced and blended by A Co so appreciated by worldwide customers. The conclusion of the example may not be the same if A Co has developed a strong marketing intangible, making its tea and origin well known and appreciated, with B Co further enhancing and promoting the intangible through marketing and distribution activities; or for instance if A Co’s production was unknown from the public, with B Co developing a leading trade mark and offering a portfolio of branded teas to its customer base, leading and funding the marketing efforts to make this taste and origin “fashionable”.

**1.3 Example 3 (marketing and distribution)**

Alternatively, if it is retained, this example should be revised in order to avoid giving the impression that the selection of the profit split method is grounded in the fact that the marketing and distribution activities of Company B are successful and “create value”. We provide below some comments to revise the example if it is retained.

Company A is responsible for the product design, research and development and manufacturing. Although this is not expressly stated, we assume that Company A is the owner of the design and technology (this should be stated in the example).

Company B undertakes the marketing functions and the global distribution of the goods. It is unclear whether Company A, Company B or another entity is the owner of the trade mark (this also should be clarified).

We understand that the selection of the profit split method in this example primarily relies on the fact that while Company A assumes the risks relating to the design, development and manufacturing of the product and that Company B assumes the risks relating to the marketing and distribution, those risks are closely inter-related and inter-dependent upon each other. As explained at paragraphs 61-64 of this letter, we believe that the separate assumption of closely related risks should not be regarded as a criterion for a profit split method to be appropriate – it might be an indicative factor at most to verify whether each party makes unique and valuable contributions.

Our main comment in relation to this example relates to the characterization of the marketing and distribution activities performed by Company B.

Describing Company B’s marketing activities as “cutting edge” is very vague and does not make these activities a unique contribution. The example would be clearer and more solidly grounded in the arm’s length principle and in the rest of the TPG if it also provided that Company B is the owner of the trademark (in relation to which it performs the marketing activities described in the current example).

Similarly, providing that Company B has developed “a sophisticated algorithm to get feedback from customers on the performance of their products” does not make a unique intangible. Algorithms and Customer Relationship Management software are very common today.

In real life, we find that the line between Example 3 and Example 4 as currently drafted is particularly blurred and would recommend deleting Example 3.

**1.4 Example 4 (marketing and distribution)**

115. The conclusion of Example 4 is that a profit split may not be the most appropriate method as it is likely that the appropriate return to Company B can be determined using a one-sided method.

116. We agree that where the appropriate return to Company B can be determined using a one-sided method, a profit split method is not appropriate.

117. We are however concerned that the example may be read to suggest that the reason for the contributions of Company B being benchmarkable (i.e. non unique) is that they are more limited and do not significantly enhance the value. This would be an erroneous technical analysis. There are non-unique, benchmarkable functions that do enhance the value: in real life, businesses would not hire third party distributors if the latter did not contribute to the creation of value for the former.

118. Our concern is therefore to avoid suggesting that a profit split method is appropriate where the distributor is successful (as in Example 3), and inappropriate where the distributor is not successful (in practice most likely leading to a transactional net margin method with the distributor as the tested party); or to put it differently, a sharing of the residual profit in profitable cases but a guaranteed profit margin in loss making or low profit scenarios.

1.5 Example 5 (Web crawler)

119. We note that “scaling-up the web crawler” to meet potential customers’ needs is not unique: for example, end-user software has to be translated into local languages to meet customer needs but translation is a commodity.

120. For this example to be technically grounded in the arm’s length principle, we recommend that it state that a profit split method is likely to be appropriate only if no comparable uncontrolled transaction exists to reliably apply another method to price the transfer of the program by WebCo to ScaleCo. Otherwise, the profit split method may not be appropriate in this case.

121. Further, consistently with the guidance in Chapter I of the TPG and draft guidance at paragraph 32 of the Discussion Draft, this example should be completed to emphasize the need to consider the sharing of post-sale risks between the parties (and performance of related control functions). In effect, identifying the contributions of the parties to the bearing of the post-sale risks is essential both to determine whether a profit split is appropriate and if so how it should be applied.

1.6 Example 6 (contract manufacturing)

122. We find Example 6 helpful, especially as it clarifies the proposed guidance on highly integrated operations by providing for a cumulative criterion that each party to the transaction make unique and valuable contributions.

1.7 Example 7 (asset management)

123. This example states that a profit split method can be regarded as most appropriate despite the existence of comparables:

“While Company A and Company B provide valuable services, an active arm’s length market for portfolio management services indicates that these services are not unique. Comparables for such portfolio management services (i.e. the services performed by Company A and B together) are available, but these provide no information on how to split those profits between Company A and Company B.”
124. We disagree with this statement. Where comparable uncontrolled transactions exist that allow the determination of the price of the intragroup services rendered (as is typically the case for portfolio management services), a comparable uncontrolled price method should be preferred.

125. In our view, the issue with this example stems from the absence of certain key facts. It is silent on the remuneration of ASSET Co (which likely owns the reputable trade name, was able to attract and contract with FUND Co, and plays a role in the investment strategy) and on which party(ies) bear(s) the regulatory risks.

126. It is unclear whether ASSET Co is the entrepreneur which should earn the residual profit and subcontract non unique services to Company A and Company B, or whether ASSET Co, Company A and Company B are three co-entrepreneurs. It its current format, we find the example problematic.

1.8 Example 9 (retail fashion industry)

127. Example 9 indicates that the contributions of both Company A (brand owner) and Company B (distributor) are unique and valuable. We are highly concerned with this because the description of the contributions made by Company B does not correspond to unique and valuable contributions: Company B distribute the products and introduce the trademark in the new market by performing innovative marketing activities. This is a typically non-unique, benchmarkable distribution activity. The fact that it provides value to the group means that it must be remunerated at arm’s length, not that a profit split method is the most appropriate method. Otherwise, on the basis of such an example, the profit split method could be regarded as being the most appropriate method for all distributors, or all opening of distributors in new markets, which clearly is not what would happen between independent parties and therefore is inconsistent with the arm’s length principle and Article 9 of the Model Tax Convention.

128. We therefore urge the OECD to either delete this example or amend the conclusion to state that a profit split method is generally not appropriate for distribution activities.

1.9 Example 10 (high integration in the automotive industry)

129. As explained at paragraphs 42-49 of this letter, we believe that high integration should not be regarded as a criterion for a profit split method to be appropriate; a profit may be appropriate only if each of the highly integrated operations involve unique and valuable contributions by each party.

130. While this example states that Company A and Company B have each developed valuable and unique know-how in their respective manufacturing processes, information on the ownership of other key intangibles is missing in this example. In particular, the example should state the entity(ies) that own the technology and the trademark, as well as the enterprise that is responsible for and controls the global supply chain. With the facts as stated, we can imagine many scenarios:

- Company A and Company B may each own their technology and brands, with each of them distributing the vehicles manufactured by the other; or
- both of them may manufacture and distribute vehicles under a technology and trademark that is owned by one of them (say Company A); or
- both of them may manufacture and distribute vehicles under a technology and trademark that is owned by a third entity (say the Company P, parent company of Companies A and B); or
- etc.
131. Lacking information on these key facts, we find it impossible to affirmatively conclude on the example. This is because we cannot determine whether Company A and Company B are two entrepreneurs who may split residual profits between them, or whether one or both of them is (are) entitled to routine remuneration for manufacturing and distribution activities.

In particular, we do not think that the fact that “Company A and Company B are engaged in a complex web of intragroup transactions where the performance of each company heavily depends on the capacity of the other to provide the different components” is a sufficient circumstance to support the selection of a profit split method as the most appropriate method.
Dear Sirs

We welcome the opportunity to comment on the Discussion Draft: BEPS Action 10 – Revised Guidance on Profit Splits (the “Discussion Draft”) https://www.oecd.org/ctp/transfer-pricing/Revised-guidance-on-profit-splits-2017.pdf issued 22 June 2017. We appreciate the time and effort that has gone into this draft.

Profit splits should only be used in limited circumstances where the actual transaction under consideration is one that would be subject to a similar methodology when negotiating with unrelated parties. Profit splits are the rare exception and there is a danger that the current draft will give the opposite impression. The guidance should be absolutely clear that the Transaction Profit Split Method (TPSM) is only of limited application and it is certainly not the default method.

We believe that OECD needs to provide more detail to ensure the guidance can create greater tax certainty and enhance taxpayer-tax authority relationships. We believe there needs to be greater clarity about the meaning of the term “unique and valuable” so that it can’t be used, as is the danger of the present draft, to give the impression that TPSM can be used more often than is appropriate.

Yours faithfully,

Ian Young
ICAEW Tax Faculty, International Tax Manager
ICC Comments on the 22 June 2017 OECD Discussion Draft: Revised Guidance on Profit Splits

The International Chamber of Commerce (ICC), as the world business organization speaking with authority on behalf of enterprises from all sectors in every part of the world, welcomes the opportunity to comment on the OECD Discussion Draft on the Revised Guidance on Profit Splits (22 June – 15 September 2017) (the “2017 Current Discussion Draft”).

ICC commends the work of the OECD in the current Discussion Draft which reflects an appropriate level of evolution from prior drafts and inputs from a wide range of commentators. The alignment of value creation and profits, so long as truly based on the touchstone of the arm’s length standard, is an important step in implementing the BEPS measures.

In view of the Country-by-Country reporting requirements spreading across the world, as well as the implications of the Multilateral Instrument, it is widely believed that there will be an ever-increasing focus of tax administrations on protecting their respective tax bases via examination of transfer pricing, permanent establishment (PE), and related matters. Typically, multinational enterprises (MNEs) can be expected to utilize one-sided transfer pricing methodologies while tax authorities are likely to at least consider two-sided methodologies. This, in turn, can be expected to lead to a proportional expansion of disputes and resultant controversy. Accordingly, it is critically important for all parties for the criteria of value creation and profit/loss alignment to be defined as clearly as possible.

Our comments on the 2017 Current Discussion Draft follow:

A. Specific Questions for Commentators: The areas upon which input was specifically requested follow with our comments:

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.

   ICC Comment: The factors should reflect those elements that unrelated parties would take into account. The 2017 Current Discussion Draft at ¶ 52 properly notes the potentially critical role of data from uncontrolled transactions, including JV, licensing, manufacturing, or other agreements (“Uncontrolled Data”). In our experience of involving MAP, APA, and other transfer pricing matters, such data is often available to provide guidance. In every case, efforts should be made to locate and utilize such data.

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.

   ICC Comment: It is our view that capital and capital employed can be important determinative factors and, as such, the references should be retained. However, it is not necessarily the case that capital will be solely allocated to the specific transaction. For example consider the simple circumstance in which one party to a transaction will dedicate a portion of production assets, or a portion of production capacity to the transaction. In such a case the appropriate measurement of assets dedicated to the transaction will be an important determinative factor. Since the proper allocation of capital can be a subjective factor, the guidance should make clear its importance as a profit splitting factor should be proportional to its relationship to underlying risk or intangible factors. Where possible, the demonstration of such relationship may be useful.
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?

ICC Comment: Yes, however it may be useful to emphasize that these factors may only be useful to the extent they are proportionally linked or correlate with the profit potential of the transaction under consideration. Further the concepts of skilled and competence can be subjective and may not be uniformly agreed upon. Additionally it may be necessary to establish appropriate weighting amongst different pools of employees and between different profit split factors to ensure a proper delineation of value creation. Again, where possible the demonstration of the relationship or rationale underlying this relationship ought to be included in the associated documentation.

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?

ICC Comment: Purchasing power parity” can be viewed in a similar context to currency in that both may impact the measurement of the contributions of parties to a transaction. Examples can be cited where contributions are measured on the basis of value and a parity adjustment may not be required, as well as measured on costs where relative cost differentials are not the fundamental value driver, and adjustments required. In the latter, as noted in D.6.2 of the guidelines parity is often viewed by developing countries as a local intangible asset. Accordingly, it would be appropriate to provide that in such cases a parity adjustment may be appropriate to the extent of its proportional relationship to risk or unique and valuable intangibles is established.

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

ICC Comment: the ICC would recommend the following additional considerations in respect of profit splitting factors:

i. In view of the availability of Uncontrolled Data, it would be appropriate to require that a requirement for use of the transactional profit split include an explanation of the availability of such data.

ii. In considering the application of the transactional profit it is important to recognize that independent parties may measure the full benefits with reference to factors outside of the profit arising from the transaction and may agree to a split of profits different form that implied by the value of direct contributions. Examples might include the circumstance in which the transaction involves a complimentary product, access to a broader customer base, opportunities for risk diversification, or the development of successor technologies. While the guidelines emphasize the importance of understanding industry factors and considering fully business circumstances, and explicit reference to such outcomes and the development of examples may be useful in reducing future controversy.

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.

ICC Comment: In prior versions of the profit split discussions drafts, as well as the overall discussion of Actions 8 – 10, the role of value chain analysis has been highlighted. This element is only lightly addressed in the 2017 Current Discussion Draft. It would be helpful for the final version to include a detailed example of a value chain situation with resultant transactional profit split analysis. ICC would be pleased to cooperate in the development of such an example, reflecting experience in actual case resolution. We note that a value chain analysis may only be an appropriate method in particular circumstances and it may be an unsuitable method in other circumstances.
B. Additional Comments:

1. As stated in the Guidelines, for the most part, the arm’s length principle does not require the application of more than one method (to evaluate a transaction) and ICC agrees the use of more than one method ought not to be necessarily be required. Nonetheless, in our experience in planning, documentation, and controversy contexts, transactional profit split analysis may be used as a means of assessing the strength of the positions of MNEs or tax authorities, as the case may be. To the extent, such testing or secondary analysis has been considered its inclusion in the documentation of MNE’s or positions taken by tax authorities may be useful. Such analyses may be additionally valuable in assessing the implications of Country-by-Country documentation.

2. The discussion draft at ¶ 67 provides that where location savings are retained and included in the profit to be split, the manner in which to allocate such savings should take into account the guidance provided in D.6 of Chapter I. Examples demonstrating the proportion of the location savings to be included and the manner of allocation in the context of a profit split would be helpful.

3. The discussion draft in various instances discusses the importance of weighting of factors in the application of a profit split. ICC recommends that while not prescriptive, the examples in Annex 1 be expanded to demonstrate the application of value and risk weighting of profit split factors,.
The International Chamber of Commerce (ICC) Commission on Taxation

ICC is the world business organization, whose mission is to promote open trade and investment and help business meet the challenges and opportunities of an increasingly integrated world economy.

Founded in 1919, and with interests spanning every sector of private enterprise, ICC’s global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments.

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The ICC Commission on Taxation promotes transparent and non-discriminatory treatment of foreign investment and earnings that eliminates tax obstacles to cross-border trade and investment. The Commission is composed of more than 150 tax experts from companies and business associations in approximately 40 countries from different regions of the world and all economic sectors. It analyses developments in international fiscal policy and legislation and puts forward business views on government and intergovernmental projects affecting taxation. Observers include representatives of the International Fiscal Association (IFA), International Bar Association (IBA), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe and the United Nations Committee of Experts on International Cooperation in Tax Matters.