Public Consultations on Transfer Pricing Matters

6-7 November 2017

OECD Conference Centre
2 rue André Pascal
Paris 16th, France
PUBLIC CONSULTATION ON THE REVISED GUIDANCE ON PROFIT SPLITS

AGENDA

6 November 2017

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## AGENDA – PUBLIC CONSULTATION ON PROFIT SPLITS

**MONDAY 6 NOVEMBER 2017**

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<td>09:00 - 09:30</td>
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<td>09:30 - 10:00</td>
<td><strong>I. REVISED GUIDANCE ON PROFIT SPLITS: GENERAL SCOPE, DIRECTION, OBJECTIVES</strong></td>
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<td>- Co-Chair of Working Party No. 6</td>
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<td>- BIAC</td>
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<td>- BEPS Monitoring Group</td>
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<td>10:00 - 11:00</td>
<td><strong>II. SELECTION OF THE TPSM AS THE MOST APPROPRIATE METHOD, UNIQUE AND VALUABLE CONTRIBUTIONS</strong></td>
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<tr>
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<td>This session will address the issues raised regarding the criteria for the selection of the TPSM as the most appropriate method, with a focus on unique and valuable contributions</td>
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<td>Introduction by a WP6 Delegate</td>
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<td>Speakers:</td>
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<td>Keidanren</td>
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<td></td>
<td>1. The solely existence of unique and valuable contributions does not guarantee that the TPSM be the most appropriate method.</td>
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<td>BDO</td>
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<td>2. Contributions that are not necessarily ‘unique and valuable’ per se but the combination of contributions may be unique and valuable.</td>
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<td>Astra Zeneca</td>
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<td>3. Unique and valuable contributions at different stages of the value chain.</td>
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<td>Open Discussion</td>
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<td>11:00 - 11:30</td>
<td><strong>REFRESHMENT BREAK</strong></td>
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<td>11:30 - 12:15</td>
<td><strong>III. INTEGRATION</strong></td>
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<td>This session will address the issues raised regarding the integration of business and its relevance to the TPSM</td>
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<td>Introduction by a WP6 Delegate</td>
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<td>Speakers:</td>
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<td>WU Transfer Pricing Centre</td>
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<td></td>
<td>1. How to define integration</td>
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<td>International Alliance for Principled Taxation</td>
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<td>2. High integration or inter-dependency should not be considered as an indicator</td>
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<td>Mr. Müller</td>
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<td>3. Business integration (freight forwarders)</td>
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<td>4. Objective factors that reflect integrated operations</td>
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<td>Open Discussion</td>
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<td>12:15 - 13:00</td>
<td><strong>IV. INTERACTION WITH THE GUIDANCE IN CHAPTER I AND RISK SHARING</strong></td>
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<td>This session will address the issues raised regarding the interaction between the additional guidance on profit splits and the guidance provided in Chapter I of the TPG and the relevance of risk sharing (particularly, the shared assumption of economically</td>
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</table>
significant risks and the separate assumption of closely related risks)

Introduction by a WP6 Delegate

Speakers:

Deloitte Tax
1. Interaction of the DD with paragraphs 1.94 and 1.105 of the TPG
Silicon Valley Directors Tax Group
2. Separate assumption of closely related risks
KPMG
3. Shared assumption of risks, shared control of risks

Open Discussion

13:00 - 14:15 LUNCH

14:15 - 15:15 V. SPLITS OF ACTUAL AND ANTICIPATED PROFITS, PROFITS TO BE SPLIT

This session will address the issues raised regarding 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 and the selection of the profits to be split

Introduction by a WP6 Delegate

Split of actual and anticipated profits

Speakers:

PricewaterhouseCoopers
1. The sharing of economically significant risk as the criteria for splitting the actual or the anticipated profits.
Tax Executives Institute
2. One-off transactions and the split of anticipated profits.
Deloitte UK
3. Spectrum between the split of anticipated and actual profits.
Taj
4. Other profit splitting structures

Profits to be split

Speakers:

IHG and USCIB
1. Risk and defining what profit should be split: net profit, gross profit, revenues

Open Discussion

15:15 - 16:00 VI. EXAMPLES

This session will address the main issues raised regarding the set of examples included in the additional guidance on profit splits

Introduction by a WP6 Delegate

Speakers:

Grant Thornton
1. TPSM not being the most appropriate method in some of the examples
NFTC (confirmation pending)
2. Retrospective application of the TPSM
Satis Res
3. Lump sum payments and sales royalties as scenarios of split of anticipated and actual profits.

Open Discussion

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<td>16:30 - 17:30</td>
<td>VII. HOW TO SPLIT PROFITS</td>
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</table>

This session will address the issues raised regarding splitting factors

Introduction by a WP6 Delegate

Speakers:

- **BEPS Monitoring Group**
  1. Capital and headcount as splitting factors
  2. Alternative ways to split profits
  3. Including adjustments to profit splitting factors

Open Discussion

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<td>CLOSING REMARKS</td>
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Speakers:

- Co-Chair of Working Party No. 6
- BIAC

PUBLIC CONSULTATION ON THE REVISED GUIDANCE ON PROFIT SPLITS
PUBLIC CONSULTATION ON THE REVISED GUIDANCE ON PROFIT ATTRIBUTION TO PERMANENT ESTABLISHMENTS

AGENDA

7 November 2017
OECD Conference Centre, Paris

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### AGENDA – PUBLIC CONSULTATION ON ATTRIBUTION OF PROFIT TO PERMANENT ESTABLISHMENTS

**TUESDAY 7 NOVEMBER 2017**

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<td>9:00 - 9:30</td>
<td>REGISTRATION</td>
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<tr>
<td>09:30 - 10:15</td>
<td>I. DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS: GENERAL SCOPE, DIRECTION, OBJECTIVES</td>
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<tr>
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<td>This session will address the scope, the approach to be used and the final status of the additional guidance</td>
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<td><strong>Introduction:</strong></td>
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<td>‒ BEPS Monitoring Group</td>
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<td>10:15 - 11:00</td>
<td>II. INTERACTION BETWEEN ARTICLE 7 AND ARTICLE 9</td>
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<td>This session will address the interaction between Article 7 and Article 9, focusing on the order of application of both articles and whether the outcomes under Article 7 and 9 should be aligned, especially with regards to risk</td>
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<tr>
<td></td>
<td><strong>Introduction by a WP6 Delegate</strong></td>
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<td><strong>Order of application of Article 7 and 9</strong></td>
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<td><strong>Speakers:</strong></td>
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<td>‒ <strong>UNIL Tax Policy Centre</strong></td>
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<td>1. Article 9 should precede Article 7 analysis.</td>
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<td>‒ <strong>PricewaterhouseCoopers</strong></td>
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<td>2. Order of application suggested by paragraphs 112 and 234 of the 2010 Report.</td>
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<td>‒ <strong>Silicon Valley Directors Tax Group</strong></td>
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<td>3. The order of application and its impact on other issues, e.g., withholding tax.</td>
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<td>11:00 - 11:30</td>
<td>REFRESHMENT BREAK</td>
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<td>11:30 - 12:15</td>
<td>III. INTERACTION BETWEEN ARTICLE 5, 7, 9</td>
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<tr>
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<td>This session will address the interaction between Article 5 and Article 9</td>
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<td><strong>Introduction by a WP6 Delegate</strong></td>
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<td><strong>Consistency between Article 5, 7 and 9 (especially for risk)</strong></td>
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<td>‒ <strong>WU Transfer Pricing Centre</strong></td>
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<td>1. Analysis of SPF and control functions under the second step of the AOA approach.</td>
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<td>‒ <strong>MAISTO</strong></td>
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<td>2. Deviation between SPF and control functions</td>
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<td>‒ <strong>KPMG</strong></td>
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<td>3. Risk control functions attributed to the intermediary cannot be deemed to be performed “on behalf” of a non-resident</td>
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<td><strong>Open Discussion</strong></td>
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</table>
### Public Consultation on the Revised Guidance on Profit Attribution to Permanent Establishments

#### IV. Examples 1 and 2

This session will address the issues raised regarding Example 1 and 2 of the DD, in particular the allocation of rights and obligations to the DAPE.

*Introduction by a WP6 Delegate*

**Speakers:**

- **International Alliance for Principled Taxation**
  1. Characterization of the internal dealings

- **USCIB**
  2. Alignment of the language of the examples with the language of the 2010 Report

- **Tax Executives Institute**
  3. Significance of customers in Country S / How to attribute profits in the absence of comparables

*Open Discussion*

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#### V. Example 3

This session will address the issues raised regarding Example 3 of the DD.

*Introduction by a WP6 Delegate*

**Speakers:**

- **BDO**
  1. Most appropriate transfer pricing method to be applied in the example

- **Grant Thornton**
  2. Potential difference between the “arm’s length remuneration of the DAE” and the revenue minus the totals of items (1) (2) and (3).

- **Software Coalition**
  3. When and why the external purchase contracts should be allocated to the PE and what SPF's would cause any other relevant assets and risks to be allocated to the PE.

*Open Discussion*

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#### VI. Example 4

This session will address the issues raised regarding Example 4 of the DD [Introduction by a member of Working Party No. 6]

*Introduction by a WP6 Delegate*

**Speakers:**

- **Keidanren**
  1. Alternative scenario: the warehouse operated by an associated enterprise and staffed by its employees.

- **Giovannelli E Associati**
  2. Calculation of the profits as a single PE

*Open Discussion*

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#### Refreshment Break

15:45 - 16:15

#### VII. Approaches to Coordinate the Application of Article 7 and Article 9

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PUBLIC CONSULTATION ON THE REVISED GUIDANCE ON PROFIT ATTRIBUTION TO PERMANENT ESTABLISHMENTS
This session will address mechanisms to reduce additional compliance burden

*Introduction by a WP6 Delegate*

Speakers:

- **Studio Pirola Pennuto Zei & Associati**
  1. SellCo and DAPE as a single taxable person carrying on business in Country S.

- **Duff & Phelps**
  2. Single taxpayer approach

- **EY**
  3. Alternative approaches to deal with zero-profit PEs.

- **Japan Foreign Trade Council**
  4. Inconsistency between the conclusions of Article 5 and Article 7

*Open Discussion*

17:20 - 17:30 **CLOSING REMARKS**

Speakers:

- Co-Chair of Working Party No. 6
- BIAC
Revised Guidance on Profit Splits

6 November 2017
Selection of the TPSM as the most appropriate method, Unique and Valuable Contributions

Monday, 6 November 2017
Public Consultation on the Revised Guidance on the profit Splits

General Comments on the Discussion Draft

• The Discussion Draft offers reorganized and expanded explanations on selecting the most appropriate method, provides more examples, and addresses issues involving profit split factors. These efforts are highly appreciated.

• We welcome the statement that a lack of comparables alone is insufficient to warrant the use of the TPSM.

• On the other hand, the Discussion Draft, for example para 11, may also be read as more broadly endorsing the application of the TPSM.

• The final version of the guidance should therefore reiterate that the TPSM is applicable only in very limited circumstances.

Indicators that the TPSM may be appropriate

- Unique & Valuable Contributions
- Shared Assumption of Economically Significant Risks
- Highly Integrated Business Operations

• Valuable contributions should not be identified unless the contribution of one party to the transaction has generated considerable value independently.
Unique and Valuable Contributions

- The existence of unique and valuable contributions alone does not always guarantee that the TPSM is the most appropriate method. Cases exist that also require the shared assumption of economically significant risks.
- The economically significant risks are primarily assumed by Company A and neither Company B nor Company C would typically share in the assumption of those risks.
- We're concerned about the lack of detail regarding the "separate assumption of closely related economically significant risks".

OECD Public Consultation on the Revised Guidance on Profit splits

Catherine Harlow
Head of Transfer Pricing

November 2017

• Profit splits should be used only in limited circumstances and where the considered transaction is one that would be subject to a similar methodology between unrelated parties.
• We do not agree with the Guidance that the existence of "...unique and valuable contributions by each party..." is a clear indicator of the appropriateness of a profit split method.
• Applying the profit split method is too simplistic because it does not take into account:
  • The reality of how a multinational pharmaceutical company would typically operate
  • Unique and valuable contributions at different stages and different times in the value chain
  • How risk is borne and discharged over time
OECD Public Consultation on the Revised Guidance on Profit splits

- Pharmaceutical companies make some of the biggest and most risky decisions of any industry; each new drug ultimately requires multi-billion dollar investments.
- There are 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 comes to market let alone becomes profitable.
- With investments being more than a decade to play out, profound changes will occur during this time:
  - Companions’ innovations
  - Regulatory & commercial frameworks reshape the playing field
  - Therapeutic advancements create new fields altogether.
- There may be unique and valuable contributions at different stages of the value chain and at different times in the life-cycle of a pharmaceutical product. Intangibles created at the R&D stage of a product life cycle are created several years prior to commercialisation. In such a scenario where the parties make different contributions at different times, there is unlikely to be the same integration of risks to indicate that a profit split is appropriate.

Illustrative Pharmaceutical Global Value Chain
The main risk bearing activities are centrally controlled, funded and performed

<table>
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<tr>
<th>Years 1-10</th>
<th>Years 10-20</th>
<th>Years 20-30</th>
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<tr>
<td>R&amp;D spend $1B in country A on product Y</td>
<td>$2B profit on product Y with all sales arising in country B</td>
<td>$2B profit on product Z Unexpectedly all sales are in country C</td>
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<tr>
<td>$500M R&amp;D spend in country A on next generation product Z no spend on product Y</td>
<td>No R&amp;D spend</td>
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Questions
If product Y fails in Year 8, how will losses be shared between the countries?
If product Z is in later years successful in country C, how does the profit earned by C get shared?

OECD Public Consultation on the Revised Guidance on Profit splits

- Even if the profit split method was appropriate, there are practical difficulties with applying the profit split. The profit split method is complex for taxpayers to apply and for tax administrations to evaluate. Where a taxpayer does not use a profit split method in the first instance, it will be difficult to create some years after the event, the level of detailed analysis that would be required to support the outcome of a profit split method if later on required by the tax authorities.
- The profit split method is not helpful as a secondary method to validate transfer pricing in the pharmaceutical industry because there are a number of products at various stages in their life cycle for which it simply does not make sense to split profits. It would be unlikely that there would be agreement in a third party scenario as to how to share profits or losses with the significant dislocation in time between R&D expenditure and profits.
- One sided methods such as the TNMM has the advantage of being more practical and simpler to apply and requires fewer assumptions.
...Although most business operations undertaken by an MNE group are integrated to some degree, 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... (2017 OECD DD, para. 19; 2016 OECD DD, para. 21)

The 2017 Discussion Draft

- No reference to parallel (vs. sequential) integration (compared to 2016 OECD DD)
- Joint performance of functions, ownership of assets, assumption of risks (e.g. joint asset management services – example 7)
- High degree of inter-dependency (e.g. long term investments – para. 21)
- High degree of inter-relation and inter-dependency (e.g. contributions that are unique and valuable only in combination with the other party’s contribution – para. 22; e.g. complex web of intragroup transactions where the performance of each company heavily depends on the capacity of the other to provide the different components – example 10)
The transaction costs theory

- The business mode of MNE involves certain degrees of integration
- Only high degree of integration would render the application of TPSM plausible
- Taking into account the transaction costs theory, high degree of integration is featured with high external transaction costs
- The high external transaction costs are further characterized with high level of asset specificity, high level of transaction uncertainty, and high level of transaction frequency
- The presence of these elements might increase the usefulness of the TPSM
- Some examples might derive from experiences with raw materials and components in the extractive industry, tacit knowledge, distribution, and license agreements.

Conclusions

- Asset specificity
- Transaction uncertainty
- Transaction frequency

Contact details

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raffaele.petruzzi@wu.ac.at
www.wu.ac.at/taxlaw, www.wu.ac.at/dibt
Selection of a profit split method: High integration or inter-dependency alone should not be considered as an indicator

Caroline Silberztein, International Alliance for Principled Taxation
OECD Consultation, 6th November 2017

High integration alone does not make a profit split method appropriate:

Most MNE groups are highly integrated,
• Business models and supply chains are global
• Integration is 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.
Focus should be on whether the functions that are highly integrated are entrepreneurial ones i.e. involve unique and valuable contributions.
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 allocated residual profit through the use of a profit split method.

Global Trading of Financial Instruments example (2010 Report on the Attribution of Profit to Permanent Establishments, Part II, Section C)

1. Reward of capital and risk:
2. AL remuneration for Sales and marketing functions + Support, middle or back office (no profit split);
3. Trading and risk management => possible split of associated profit or loss in “integrated trading model” because:
   - “Each location has the capacity to perform the full range of trading and risk management functions necessary to conduct the business and thus performs an entrepreneurial role (assuming it also supplies its own capital).”
   - The difference from the separate enterprise model is that in the integrated trading model, the trading and risk management functions with respect to a particular third party transaction may be split between locations and the gross profit arising from that transaction may be recognised in any or all of the locations.
   - Trading or risk management in integrated form is unlikely to be found between independents and so it may not be possible to make reasonably accurate adjustments to make the data comparable.
   - Additionally, in the integrated trading model each location cannot act independently but must cooperate with the others in order to successfully enter into a transaction and subsequently manage the resulting risk.
Example 7 – Asset Management

- Asset Co's F/A/R (clientele, regulatory, strategic management, etc.)?
- Do Company A and Company B assume regulatory risk?
- Company A and Company B not entitled to share profits with Asset Co.
- Existing comparables for Company A and Company B's activities should not be dismissed if reliable. The fact that they may not provide information on how to split profits between Company A and Company B may be relevant to the application of the profit split method (appropriate as to its selection).

Example 10 – Automotive Industry, High Integration

- Technology IP & R&D?
- Brand? Marketing?
- Innovation?
- Global supply chain?

Each of Company A and Company B:
- manufactures vehicles
- has developed "unique and valuable" manufacturing processes
- distributes to final customers in its market

Company A and Company B "highly integrated"

- Company A and Company B are not entitled to share in the residual profit or loss associated with unique and valuable intangibles they do not contribute.
- Manufacturing and distribution activities are likely to be benchmarkable activities. Examples unclear as to why this would not be the case.
- The existence of a "complex web of transactions" is insufficient for a profit split method to be the most appropriate.
Business integration (freight forwarders)

Question 3: Additional examples of scenarios with a high level of integration of business operations, together with reasons for using a profit split method.

Johann H. Müller, Quantera Global, Denmark

From www.damco.com:

With a presence in over 100 countries, we employ more than 11,000 people worldwide. In 2016 we managed 659 thousand TEUs (twenty-foot equivalent units) of ocean freight and 190 thousand tons of air freight.
Collect freight
Locate shipping agent
Negotiate container space
Prepare export & customs papers
Deliver freight to vessel

Deliver freight
Decontainerise freight
Prevent detention & demurrage
Prepare import & customs papers
Collect freight from vessel

Is customer owner, principal?

Customer - China

Is customer owner, principal?

Customer - Europe

Order to use
Dispatching Entity - China

Order to use
Dispatching Entity - Europe

Thank You

Quantera Global, Denmark
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Selection of the PSM as the Most Appropriate Method

Objective factors that reflect integrated operations

- **MNEs operate as centrally-managed highly integrated unitary businesses**
- Constant pressure to contract-out activities if costs can be saved
- Many examples of MNEs contracting-out all kinds of functions
- Sometimes same function also done in-house (e.g. as a quality check)
- Performing activity in-house only justifiable by integration
- Integration creates benefits of synergy & generates 'residual' profits
- **Locations of risk, capital & intangibles are not objective**
- Transfer of 'ownership' to a related party/associated enterprise is fictitious
- These are core factors for a MNE, centrally managed & indivisible
- **The PSM should be designated the default method**
- Should be strengthened and systematised
- A pragmatic way to principles for where 'activities occur and value is created'
- Focus on physical less-mobile factors for clear and simple rules
- Could be easy to administer & provide certainty and predictability
ACCURATE DELINEATION OF A TRANSACTIONS
When One Party Assumes a Risk, Other Parties Contribute to Control

- Relevant Authorities
  - Paragraph 1.94 of Chapter I of the 2017 OECD TPG
    - Is the guidance the most on-point
  - Section D.1.2.1.5 of Chapter I of the 2017 OECD TPG
    - Used to allocate a risk either by a tax administration when the party contractually assuming a risk fails paragraph 1.94 and hence does not assume the risk, or
      - By a taxpayer when the party contractually assuming a risk and satisfying paragraph 1.94 elects to further allocate that risk to other parties that contribute to control of that risk under the last sentence of paragraph 1.94. This is the only relevant authority that uses the words “allocation of risk.”
  - Paragraph 1.105 of Chapter I of the 2017 OECD TPG
    - States that entitlement to ex-post upside and downside of risk realization is the consequence of being allocated a risk

ACCURATE DELINEATION OF A TRANSACTIONS
When One Party Assumes a Risk, Other Parties Contribute to Control (continued)

- Therefore
  - Application of Step 5 (Allocation of Risk) is required for a party contributing to the control of a risk but not assuming it to be entitled to ex-post upside and downside of risk realization.
    - Paragraph 1.94 (last sentence) is clear that Step 5 is not required when the party assuming the risk elects not to apply Step 5. Therefore, that party need not be considered a party contributing to the control of that risk.
    - The last sentence of paragraph 1.94 reads:
      "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 [must] not be considered." (Emphasis added)
    - The second sentence of paragraph 1.105 reads:
      "Usually, the compensation will derive from the consequences of being allocated a risk, and therefore that party will be entitled to receive the upside benefits and to incur the downside costs." (Emphasis added)
ACCURATE DELINEATION OF A TRANSACTIONS

When One Party Assumes a Risk, Other Parties Contribute to Control (continued)

• Does the last sentence of paragraph 1.105 introduce any ambiguity?
  − It does not. The last sentence of paragraph 1.105 reads:
    “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.”
  − The words “may be appropriate” should be interpreted consistently with paragraph 1.94 and Section D.12.1.5
    • It is appropriate when a taxpayer elects to apply Step 5 and further allocates the risk assumed by one party to allow parties that contribute to the control of risk (but do not assume it) to
    • It is appropriate when the party contractually assuming a risk fails paragraph 1.94, and a tax administration applies Step 5
    • In all other cases, it “is not appropriate” and the parties contributing to controlling a risk but not assuming it receive an arm’s length fee.

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‘Simple’ functions and non-identical comparables

- Integrated operations create feedback loops
  - Inappropriate to separate ‘high value’ and ‘simple’ functions within a group
  - Innovation is a continuous process
  - Runs through R&D-design-production-marketing-sales
  - Contributions should be reflected in concrete factors, e.g. payroll costs

- Lack of comparables, due not only to lack of data
  - Platform’s Toolkit: insufficient comparable data in 164 countries (2013)
  - Inexact comparables + ‘adjustments’ produce wide ranges
  - Limited evidence to support use of ‘adjustments’
  - These cannot be considered reliable (contrary to #14 of DD)

- Strengthened PSM is the only way to move towards objective allocations
  - Need for a new approach evident from work on Digitalisation
  - Work on Profit Split is last chance to move forward pragmatically

Shared Assumption of Risk, Shared Control of Risks

- Parties to transactions in intangible property (or other transactions involving unique and valuable contributions) may agree to contractual terms reflecting a variety of risk allocations. Common examples include:
  - A “lump sum” transfer of intangible rights assigns all future risk associated with future development and exploitation to the licensing party.
  - A variable royalty adjusted to target operating margin (return on sales) of the licensee assigns limited sales risk to the licensee, while the licensor assumes both sales and profit margin risk.
  - A royalty specified as a fixed percentage of sales shares risk associated with future sales between the licensor and the licensee, while risk associated with future profit margins are assigned to the licensing party.
  - A partnership in which the parties agree to share realized operating profits or losses shares all risks between the parties.

- Both the fixed percentage of sales royalty and the partnership involve shared assumption of risk. Only the partnership involves a split of actual profits.

- Any of the first three allocations might, or might not, be most appropriately analyzed based on a share of anticipated profits.
Arm’s length parties may not share control of all shared risks

Typically, allocations of risk between parties (such as a royalty or a shared percentage of sales) are affected by multiple factors which might be affected by one, both, or neither of the parties.

For example, a royalty set as a shared percentage of sales shares sales risks between the parties.

— Sales may be affected by technology risk, manufacturing risk and marketing risk.
— One party may largely control technology risk, and the other manufacturing and sales and marketing risk.
— These risks may not be highly, if at all, correlated: i.e., a party’s control over its technology risk does not depend on the other party’s success managing its sales risk. The technology owner’s sales and marketing risks in the royalty party are uncorrelated, and not correlated.
— Furthermore, determination of the separate impact of realization of the different risks on actual results is generally impossible if not impossible.

Therefore, analysis of control over risks in connection with risk attribution should generally be done at an aggregated level.

Paragraph 1.94 of the Transfer Pricing Guidelines properly states that shared risk control functions may be consistent with one-sided contractual allocations of risk.

Paragraph 1.105 properly indicates that the risk control functions performed by a party should be taken into account in determining arm’s length pricing. That accounting is determined in connection with selection of the most appropriate method, and could be done, inter alia, under a one-sided approach where appropriate comparables are found, and where risk control and risk sharing are appropriately reflected in the selected method.

Paragraph 1.105 should not be interpreted in conflict with paragraph 1.94.
Session V. Splits of actual and anticipated profits, Profits to be split
Public Consultation on PSM
6 November 2017

Split of actual or anticipated profits

The sharing of economically significant risks as the criteria for splitting the actual or the anticipated profits

Proposed guidance in the 2017 discussion draft

Sections C.2.2.3 and C.4.1

A PSM may be found to be the MAM where the assumption of one or more of the economically significant risks in relation to the delineated transaction are shared, or closely inter-related risks are assumed separately (e.g., highly integrated business operations or both parties make unique & valuable contributions) → split of actual profits, actual profits will reflect the playing out of the risks of each party (aligned with accurate delineation of the transaction).

Alternatively (e.g., unique and valuable contributions) anticipated profits split

To be determined on the basis of information known or foreseeable at the time the transactions were entered into.
Proposed guidance in the 2017 discussion draft

Example 9

A

Know-how
Enhanced value of TM and associated goodwill
Unique and valuable contributions
No HTVI

B

Been granted right to use Know-how and TM
Performs innovative marketing activities
Unique and valuable contributions

Scenario 1: A does not share risks of B: PSM based upon anticipated profits generated by B resulting from the combined contributions

Scenario 2: both parties agree to split actual profits and assume associated marketing risks: profits achieved from actual sales

PwC comments on splits of actual or anticipated profits

Confusing and difficult to understand: can you still share a risk?
Contrary to existing guidance (see also Chapter III, section C.3.3.1, 2017 OECD TPG indicating split on projected profits if ex ante approach; split on actual profits when other method chosen by taxpayer)
Criteria for using actual or anticipated profits: MNE members generally share risks to a certain extent, but 2017 guidance indicates allocation to part with ‘most control’; limiting sharing of risks
Artificial and counterproductive distinction
No automatic use of PSM in case risks are managed in more than one jurisdiction

PwC comments on splits of actual or anticipated profits

PSM is a transactional transfer pricing method
PSM is not
- Actual distribution of profits amongst MNE members
- Should not become a formulary apportionment

Example 9 needs additional facts and may lead to opposite conclusions
Referenced example 9 is not helpful as currently drafted

PwC suggests substantially redrafting or otherwise deleting the proposed guidance & example 9 of the 2017 Discussion Draft
“One-off transactions and splits of anticipated profits”

- Unrelated party Profit Split arrangements are normally part of an ongoing commercial relationship
  - Consequent possibility of periodic review of commercial terms
  - Balance of risk may influence whether profits to be split are anticipated or actual
- “One-off” transactions
  - Likely to be disposals/acquisitions of assets/companies
  - Likely to be a capital rather than a revenue transaction
  - Commercial negotiation may include potential adjustment, but very rarely based on profit
  - Adjustments negotiated to adjust consideration for specified events
- Same principle should apply to intra-group transactions:
  - The Arm’s Length Principle requires examination of what happens between unrelated parties in similar circumstances
“One-off transactions and splits of anticipated profits”

- Assumed that these are not transactions involving a “Hard to value Intangible”
  - Commensurate with income approach adopted in TPG should be applied only to defined hard to value intangibles
  - Default should not be to apply HTVI approach to other one-off transactions
- Long-term investment agreements/contracts: one-off transactions, or JV/partnership or ongoing commercial relationship?
- Arm’s length one-off transactions rarely adjust for profits
  - However, many have terms to adjust consideration in specified circumstances
  - Terms are set based on assumption that parties share sufficient information to arrive at an agreed consideration in advance of the deal

“Price adjustments in third party agreements”

- Adjustments based on:
  - Correction of errors or misrepresentation in disclosures: consideration reduction
  - Outcome of specified contingencies: consideration increase or decrease

Actual use of adjustments is not common,
- Terms will include a de minimis threshold to discourage minor adjustments
- Maximum consideration adjustment (positive or negative)
- Many transactions proceed without consideration adjustment
- Agreement typically specifies dispute resolution procedure and time limits for claims

“Extending the experience of arm’s length one-off transactions to intra-group transactions:”

- Third party one-off transactions assume no ongoing trading relationship
- For a one-off transaction, if arm’s length principles were applied, consideration would be based on current knowledge
- To support the anticipated proceeds, costs and balance of assets and liabilities, the parties would be expected to carry out some level of due diligence and have negotiated a sale and purchase agreement
- Adjustment to consideration/profit would only be expected in limited circumstances and be subject to a threshold and a cap of any adjustment
- Ex-post determination of profit on a transaction and adjustment of consideration based on profit would be very unusual
- Experience of one-off transactions between unrelated parties would indicate that, if any form of profit split were to be used, it would be of anticipated profits, based on documented current information
The spectrum of profit splits

- Profit split requires a split, and the application of that split to profits
- Third-party evidence is available (e.g., license disputes) as to how anticipated profit & actual profit are used
- Consider the following, which affect third party behaviour:
  - the form & timing of the transaction;
  - The degree of uncertainty as to future profits can affect the deal

Practical issues & Arm's Length behaviour

- Transfer Pricing: a valuation exercise often implemented as "one-way-street". MNEs trade at arm's length prices to avoid double taxation / MAP
  - Anticipated profits must be used to create agreement / license
- Third Party behaviour:
  - Set PS by reference to anticipated profit
  - Apply split ratio to actual profit unless impractical
  - Adjustments to ratio / split (if needed) are prospective only
An example: Unrelated Party

- Split ratio calculation; based on anticipated profits & sales to generate % fee
- % fee then applied to actual sales
- Split ratio Not renegotiated even if sales deviate from anticipated PROVIDED that margin is largely unchanged; but
- Renegotiated prospectively if margin is significantly different; OR if uncertainty is high at the outset, consider a “Stepped license”

Recommendations for TP Guidance

- Reflect third-party behaviour; anticipated profits often set Profit Split
- Acknowledge that Post- year end audit of the split using “actual” data can therefore be unfair (not arm’s length)?
- Direct audit to the reasonableness of anticipated profit data used in the calculation (see Ch. VI section D.4) and to the reasonableness of the period between reviews; but
- Changes to an agreement (in most cases) will be prospective only
Other profit splitting structure: some real life examples of profit splits

Dr. Julien Pellefigue

November 6, 2017

Following the arm's length principle makes it necessary to look when and how independent firms enter into profit splitting agreements

What does the ALP means?

• Considering the arm's length principle, a Profit Split between two subsidiaries A and B is appropriate if two independent firms, exactly similar to A and B, would enter into some kind of profit split agreement

The key question can thus be framed as follows: "what are the economic circumstances where two independent parties would organize their relationship through a contract with a profit split provision?" That "what kind of splitting methodology "would such parties use"?

Current draft of the TPG

• The current draft does not make any reference to market practices, neither does it rely on standard results of economics, whereas the profit split question has been thoroughly studied

• Following the ALP is not the same as "splitting the profit according to each party's contribution" or giving each party to a transaction its "fair share". Market is concerned by ex ante efficiency, not ex post equity. Relaying on the ALP can therefore very well end in a situation that is not ex post equitable, because that is the way the market work.

• Considering the arm's length principle, a Profit Split between two subsidiaries A and B is appropriate if two independent firms, exactly similar to A and B, would enter into some kind of profit split agreement

• The key question can thus be framed as follows: "what are the economic circumstances where two independent parties would organize their relationship through a contract with a profit split provision?" That "what kind of splitting methodology "would such parties use”?

Current TPG are far away from market practices

Circumstances where a PS is appropriate

• Unique and valuable contribution: Many firms supply a unique and valuable input to other firms at a fixed price. For the development of new knowledge, for instance, firm friendly handsets that were sold at a fixed price

• Highly integrated operations: Even in the most integrated supply chain, one party may be autonomous in nature, whereas the other party may be integrated in practice, in the sense that the profit is shared between the parties.

• Shared assumption of risks: In real life, profit split is sometimes chosen because it allows for a sharing of risk, not the other way around.

PS methodology

• Cost based (labour cost, headcount allocation, etc.). However, since identical profit parties are free to charge their services for a lower profit, it is often more convenient to use cost based methodology which is easy to understand, but also easy to manipulate

• Asset based (fixed cost, fixed asset allocation, fixed cost allocation, etc). However, since identical profit parties are free to charge there costs for a lower profit, it is often more convenient to use cost based methodology which is easy to understand, but also easy to manipulate.

• Incentives to perform something that is not ex ante contractible

• Difference in risk aversion between buyer and seller

• Profit participating contracts
Independent firms tend to enter into contracts with “profit participating” provisions rather than engage into profit splits.

### Why PS is rare?
- Independent firms are generally very reluctant to use ex post profit splits per se. One of the key reasons is that profit is not generated in a linear way and that independent firms, which have an incentive to reduce the profit pool to be split by devaluing more of the contract costs.
- When some form of profit split is appropriate, independent firms rather use payment terms that can be easily enforced, but which lead to some form of profit sharing.

### Alternative solutions
- Royalties based on turnover with tiered structure (the % of royalty increases based on the success of the project).
- Contracts with predetermined contingent payments made on specific milestones of the project (e.g., a payment of X M€ to buy a technology patent, with an additional milestone payment to be made to the seller when (and if) a prototype has been designed, another milestone payment at the time of the industrialization of the production, etc.). Contingent payments can also be decided if the licensee reaches a certain target profit or sales volume.
- Revenue sharing contracts, but each company keeps its costs.
- Supply contracts with a commitment from the buyer to buy a certain volume at a pre-determined price (potentially, with a decreasing price per volume).

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### Revised Guidance on Profit Splits

### REVISED GUIDANCE ON PROFIT SPLITS
THE MEASURE OF REVENUES/PROFITS TO BE SPLIT

1. Revenues
   - Less: direct selling cost (e.g. commissions)
2. Net revenues
   - Less: cost of goods sold or equivalent
3. Gross profit/income before fixed charges
4. Operating costs
5. Operating profit/EBIT
6. Interest
7. Profit before Tax

### Nature of Cost
- Fully variable
- Primarily variable
- Primarily fixed or semi-variable
REVISED GUIDANCE ON PROFIT SPLIT
THE MEASURE OF REVENUES/PROFITS TO BE SPLIT

Principles:
• Split according to Chapter 1 risk management/control principles
• Highly integrated joint delivery of services/goods involving two or more significant contributing locations – gateway to top of waterfall to consider at least a revenue split
• At this level there is a crossover with an adjusted comparables approach
• Consider example 7 para 100 – comparable available for services provided by A & B together but not comparables for their separate services
• Similar, but distinct, question as to whether, at each successive cost layer within the waterfall a highly integrated cost and joint risk/control profile exists
• If so then is conceivable there could be arms length cost sharing at this level - i.e. profit split at this level
• If not then there wouldn’t be - i.e. actual costs and risks at this level borne separately

REVISED GUIDANCE ON PROFIT SPLIT
THE MEASURE OF REVENUES/PROFITS TO BE SPLIT

Relevance of the variable/fixed cost distinction:
• Fully variable/direct transaction costs generally have same profile/fact pattern as revenues
• Thus if split revenues generally split net revenues – possibly costs of sales if similar profile
• Fixed costs often have a locational aspect
• Arms length sharing of location risk of other party’s cost base (e.g. FX/Natural) unlikely
• Non location specific risks (e.g. functional management related risks) for a given location are more likely to be managed locally in which case would not be shared
• Additional issues arise if attributable costs not discretely identifiable (e.g. intra group support centre for multiple locations)
• Variable/fixed cost distinction suggests appropriateness of profit split becomes less likely as move down waterfall of profit measures
• Arms length profit split at EBIT level rare - absent location specific de facto partnership

Risk and defining what profit should be split: net profit, gross profit, revenues
Bill Sample, Chair, USCIB Tax Committee
• Assuming the transactional profit split method is the most appropriate method, what profit should be split? Net profit (operating profit)? Gross profit? Revenues?
• A preliminary matter the profits to be split are limited to the profits related to the transaction that is the subject of the profit split. Routine profits and functions for which there are comparables should also be eliminated prior to splitting the remaining profits.
• Taxpayers should be able to use any reasonable, reliable measure of the profits to be split, so long as that measure reflects the accurate delineation of the transaction and is consistent with comparable methodologies used by unrelated taxpayers.
• The discussion draft provides it will generally be appropriate to split operating profits. The TPG should not prefer one measure of transactional profits over another; rather the measure of transactional profits to be split should depend on what unrelated parties would do. In addition, operating profits are undefined and may be difficult to determine on a case-by-case basis.

• The 2017 TPGs define gross profits from a business transaction as the amount computed by deducting from the gross receipts of the transaction the allocable purchases or expenses. Gross profit is not adjusted for increases or decreases in inventory or stock-in-trade, but without taking account of other expenses.
• Operating profits are undefined. It would be useful to add a definition to the glossary which states probably be gross profits less expenses other than interest (not excluding operating costs). In other words, gross profit is the amount a taxpayer would report as an operating cost for banks.
• Independent enterprises sometimes split revenues rather than profits. The final guidance should, therefore, permit the splitting of revenues by related parties.
• Of the three suggested levels of profits operating profits will be the most difficult to determine because it will require the greatest alignment of information. As the discussion draft notes the need to measure revenue and costs could require restating books and records on a common basis. This is a subjective exercise – what costs relate to the transaction and what do not? Companies do not keep books on a transactional basis. Therefore, the costs related to the transaction will have to be identified by the taxpayer . Operating profits will be more administratively difficult to determine than gross profits or revenues.

• Determining the proper level for splitting profits will depend on the delineation of the transaction. An important factor in delineating the transaction is who bears what risk?
• Market risk only – revenues?
• Market risk plus production risk and other risks associated with acquiring goods and services – gross profits?
• Market risk plus production risk plus intangibles risk and operations risk – operating profits?
TPSM not being the most appropriate method in some of the examples

Aude Delechat-Patel

Revised guidance on profit split

Careful choice of words

- “Unique and valuable” or “key”
- Clear definitions = objective interpretation and uniform application
- More comprehensive examples (e.g. examples where profit split would not be appropriate, numerical examples, specific facts…)

Outsourcing

- Profitable products comprised of several components
- Some components are outsourced
- Industry specific examples
Revised guidance on profit split

What about loss split?

• Sharing profits = sharing losses

• Risk awareness
  - Financial capacity to bear the risk
  - Management of the risk

• Where do we stop?

SATIS RES

Lump sum payments and sales royalties as scenarios of split of anticipated and actual profits

Alberto Pluviano

Practical example based on example 9 of the DD

• Describe the mechanics, practical implications, administration issues and simplification alternatives of a profit split model; and

• Identify concerns about split of anticipated vs. actual profits and implications of a lump sum vs. royalty approach.

• Analysis of a “Base case” scenario and of the results of two alternative scenarios: “Best Case” and “Worst Case”.

• Methodology:
  - Development of a detailed P&L (with simplifications) of Company A and Company B, compatible with the scenario described in example 9.
  - Calculation of anticipated revenue and operating costs over 5 years.
  - Definition and calculation of a profit split formula, transfer prices for goods, and royalty/lump sum for intangibles.
Assumptions

- Base Case: Revenue growth of 10% per year.
- Best Case: Revenue growth of 20% per year.
- Worst case: Revenue stable.
- NPV of the anticipated 5 years’ flows of operating revenue and operating costs/expenses.
- Profit split formula (simplified) based on intangibles’ value and residual driving costs.
- Transfer pricing of goods (not analyzed in details) includes routine profit.
- Lump sum/royalty includes residual profit/loss.

Summary of model results

<table>
<thead>
<tr>
<th>Profit Summary</th>
<th>Split of anticipated profits</th>
<th>Anticipated profit based Lump sum</th>
<th>Anticipated profit based Royalty</th>
<th>Split of actual profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>BASE CASE</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company A</td>
<td>60.7</td>
<td>58.1</td>
<td>72.2</td>
<td>78.5</td>
</tr>
<tr>
<td>Company B</td>
<td>18.8</td>
<td>44.2</td>
<td>31.3</td>
<td>25.9</td>
</tr>
<tr>
<td>Total Profit</td>
<td>79.6</td>
<td>104.5</td>
<td>104.5</td>
<td>104.5</td>
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<tr>
<td>Implied royalty %</td>
<td>21.9%</td>
<td>12.9%</td>
<td>24.8%</td>
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<tr>
<td>Implied lump sum</td>
<td>66.6</td>
<td>66.6</td>
<td>85.5</td>
<td></td>
</tr>
</tbody>
</table>

| ACTUAL - BEST CASE |                               |                                  |                                 |                        |
| Company A          | 60.7                          | 58.1                             | 72.2                            | 78.5                   |
| Company B          | 18.8                          | 44.2                             | 31.3                            | 25.9                   |
| Total Profit       | 79.6                          | 104.5                            | 104.5                           | 104.5                  |
| Implied royalty %  | 21.9%                        | 12.9%                            | 24.8%                           |                        |
| Implied lump sum   | 66.6                         | 66.6                             | 85.5                            |                        |

| BASE CASE          |                               |                                  |                                 |                        |
| Company A          | 60.7                          | 61.6                             | 50.4                            | 46.4                   |
| Company B          | 18.8                          | 13.3                             | 9.5                             | 13.5                   |
| Total Profit       | 79.6                          | 59.9                             | 59.9                            | 59.9                   |
| Implied royalty %  | 23.9%                        | 13.9%                            | 22.9%                           |                        |
| Implied lump sum   | 66.6                         | 66.6                             | 52.4                            |                        |

Proposals for possible edits to the DD

- Acknowledge that practical implementation will often lead to intermediate solutions between anticipated and actual profits.
- Redefine anticipated and actual profits as useful but “extreme” references.
- Recognize the significant differences between a lump sum and a sales-based royalty approach.
- Allow for reasonable simplifications (limit, where possible, the use of complex valuation techniques and ex-post adjustments).
- Encourage the use of ranges.
- Consider additional numerical tests on: other examples, impact of risks, residual losses, profit splitting factors.
Capital and headcount as splitting factors

- Capital should not be included as profit splitting factor.
- Profit splitting factors (allocation keys) must be real operational factors that are measurable and that reflect the actual activities of the various group members.
- This will ensure that profits of associated enterprises are aligned with the value of their contributions.
- MNEs raise capital through a central Treasury, backed by the credit of the group as a whole, allocating working capital as needed (and for tax advantages); hence it should not be included as a profit splitting factor.
Capital and headcount as splitting factors

- Labour is a key factor in value creation and should be included as a standard profit splitting factor for many MNE common business models:
  - Headcount
  - Payroll (adjusted for purchasing power parity)
  - What proportion? (e.g. 50-50 EU CCCTB proposal)
- Measurement period
  - While labour costs should normally be determined on an annual basis, R&D and related costs that have created meaningful assets with continuing or increasing value could be accumulated. That would allow the allocation to reflect the continuing and increasing value of intangibles by basing the allocation on the cumulative efforts that created them.

When Are Adjustments Needed?

- Timing Mismatch in Developing Valuable Contributions (e.g., R&D vs. marketing)
  - Factors such as current-period expenses, headcount, revenues, may not always be appropriate
  - Capitalized costs of developing intangibles may be preferred
  - Historic costs should be measured using then-current FX rates
  - Risk-weighted costs may be appropriate in some circumstances, especially for longer-lived intangibles
- Benchmarkable Activities and/or Transactions
  - Profit for benchmarkable (i.e., “routine”) activities should be excluded from the profit split
  - Profit for benchmarkable transactions (e.g., CUTs) should be excluded from the profit split

From PSM to Residual PSM

- Prior to Unrelated Parties
- Operating Profit
  - Country A
  - Country B
  - Manufacturing
  - R&D
  - Marketing & Sales
- Prior to Unrelated Parties
  - Entrepreneurial Profit
  - Country A
  - Country B
  - Manufacturing
  - R&D
  - Marketing & Sales
- Prior to Unrelated Parties
  - Functional Profit
  - Country A
  - Country B
  - Manufacturing
  - R&D
  - Marketing & Sales

- Prior to Unrelated Parties
  - Residual Profit Split
  - Country A
  - Country B
When Adjustments May or May NOT Be Needed?

Differences in Purchasing Power Parity ("PPP")

- Differences in PPP do not automatically imply a need for adjustment
- Assume that facts indicate that PSM is the best method to analyze a transaction between a "high-cost" affiliate and a "low-cost" affiliate
- Then, a "low-cost" affiliate may be entitled to non-routine return only when all of the following are true:
  - "Location rents" exist, and
  - The "low-cost" affiliate secured access to location rents, and
  - Price of the product (service) is determined in the market outside of the home country of the "low-cost" affiliate

Other Considerations

- Applicability of the PSM
  - Joint assumption of risks
  - Integrated operations
  - Unique value added by parties

- Available Alternatives
  - Evidence of arm's length remuneration of intangibles or activities

- Reliability
  - The most reliable measure of valuable contributions has to be selected
  - Only adjustments that increase reliability should be applied
Revised Guidance on Profit Attribution to Permanent Establishments

7 November 2017
General Scope, Direction, Objectives

The Need for a Holistic Approach to Functional Analysis

- **Objective**: to end BEPS due to MNE fragmentation of functions
  - Finding a sales PE by itself is not significant
  - Significant if associated enterprises also perform related functions
  - Sales + Marketing/Warehousing/Order Fulfilment/Customer Support
  - Hard to distinguish functions – between e.g. marketing/sales/support
  - Issue is value created by AEs as an ensemble in conjunction
    - Especially if e.g. a marketing AE found to constitute a sales PE
- **Cumulative importance of related functions**
  - E.g. data from marketing, sales, customer support feedback to platform design
- **Affects choice of most appropriate TP method**
  - Separate application of one-sided methods to related functions inappropriate
  - Combined activities may be seen to generate valuable intangibles
  - Apply Profit-Split to combined activities
Implications of Holistic Functional Analysis

- **Easier administration**
  - Sales PE alone (especially DAPE) could be treated as low-risk
  - Easier to prevent double taxation (DD #18)
  - Tax can be collected from “intermediary” AE (DD ## 21, 26, 31, 55)

- **Review Authorised OECD Approach**
  - Problems are mainly unintended consequences of AOA
  - Need to work in conjunction with UN Committee
  - Outcomes must suit all existing treaties

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OECD consultation on Attribution of Profits to PEs

Interaction between Article 7 and Article 9 – Order of priority

Prof. Dr. Robert J. Danon,
Director, Tax Policy Center, University of Lausanne
Partner, Danon & Salomé

Dr. Vikram Chand
Executive Director, International Tax Education,
Tax Policy Center, University of Lausanne

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Illustration of issue – Post BEPS

**Commissionaire**

Question: Under the AOA does the DAPE carry out any SPF that deserves remuneration under Art. 7?
Tax policy issues at stake

- BEPS Action 7 lowers PE threshold
- Source state gets to tax two taxpayers i.e. the DAE (art. 9) and the DAPE (art. 7)
- Order of priority between art. 9 and 7 matters because inter alia:
  - Uncoordinated implementation of art. 9 and 7 may lead to double taxation
  - Unnecessary administrative burden for NRE

Suggested approach

- Where DAE is a related party, art. 9 should apply before art. 7
  - Dual taxpayer approach should be revisited (particularly in light of the reinforced arm’s length standard under art. 9)
  - Arm’s length compensation to the DAE should extinguish tax liability of NRE
  - Unnecessary administrative burden on the NRE can be avoided
  - Recommendation: DAPE should be exempt from local filing requirements and penalties

- Where DAE is not a related party, art. 7 may be applied to the DAE
  - This is the case when the DAE is an employee of the NRE
  - Example 3 of the previous discussion draft needs to be reintroduced

Broader remarks and challenges

- Increased coordination between tax treaty (in the present instance BEPS Action 7) and transfer pricing aspects would in the future be welcome.

- Profit attribution raises significant challenges in the area of the digital economy: see in this respect our submission at:
Order of application suggested by paragraphs 112 (Part III) and 234 (Part I) of the 2010 Report

Paragraphs 112 and 234, 2010 AOA Report

Part I, Paragraph 234, 2010 AOA Report

[...] Issues arise as to whether there would remain any profits to be attributed to the DAPE after an AL reward has been given to the DA enterprise. [...] 

Part III, Paragraph 112, 2010 AOA Report

[...] Where, [...], it will first be necessary to apply the guidance in Section C under Art. 9 to establish the AL price of the transactions between the first enterprise and the agent enterprise (where the agent is an associated enterprise), and then to apply the guidance in Section D on Art. 7 to attribute an AL amount of profits to the DAPE. [...]

OECD public consultation on attribution of profits to PEs
PwC comments on the order of application

Is the order of analysis inconsequential?
See paras 234 (part I) and 112 (part III) AOA
Practical and pragmatic preference of Article 9 analysis before Article 7 analysis
No examples order of analysis has no impact on level of total profits to be taxed
Examples indicate Art 9 is applied before Art 7 as Art 7 is applied by considering AL outcome of DAE
Welcome clear preference on order or elaborate the examples to reflect the relevant impact on total profits in the source state and profits attributed to DAPE

Jurisdictions should apply consistent priority approach of Art 9 versus Art 7
Discretion of jurisdiction (tax authorities)
Claims certainty to taxpayers
Coherence?
How to solve (increased number of) disputes
Impact on corporate tax and collateral tax aspects

Alignment in particular with regard to risks
Six step approach under Art 9 versus SPF relevant to the assumption of risks: Overlaps, but guidance suggests also differences between the two approaches
Substance: conceptually no different analysis with regard to risk should be possible under art 9 or art 7
Risks: should only be attributed once, but will depend on priority order art 7 – art 9
If art 9 applied first: no additional risks (profits) allocated to DAPE
If art 7 applied first: profits reduced by profits allocated to DAE to avoid double allocation of risk
How in practice?
Thank you

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Public Consultation on the Revised Guidance on Profit Attribution to Permanent Establishments
OECD Conference Center, Paris, 7 November 2017

Analysis of SPF and Control Functions under the Second Step of the AOA Approach

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Managing Director
Institute for Austrian and International Tax Law
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The relevant questions

Step 1
Hypothesize the PE as separate and independent enterprise

Step 2
Remunerate the dealings by applying the OECD TPG

- SPF and control functions only relevant for purposes of the functional and factual analysis carried out under the first step of the AOA?
- SPF and control functions also relevant for the second step of the AOA?
SPFs and control functions only relevant for the first step of the AOA

- The functions ("relevant significant people functions") to be performed by the PE form the natural starting point of the analysis.
- In a next step, the assets are analysed (economic ownership).
- As for risks, the significant people functions relevant to the assumption of risks are those which require active decision-making with regard to the acceptance and/or management (subsequent to the transfer) of those risks.

SPFs and control functions also relevant for the second step of the AOA

- Only the transfer pricing methods are an addition to the analysis.
- Functional and factual analysis under the first step of the AOA is meant to hypothesize a PE as a separate and independent enterprise.
- This analysis already considers the functions, assets and risks.
- Actual conduct of the parties is the main trigger after the BEPS project (factual rational of Art 7 and Art 9).
- "Management of risk" (in the 2010 Report) ≠ "control over risk" (in the OECD TPG 2017)?

Conclusions

- The analysis of SPFs and control functions essentially carried out under the first step of the AOA.
- The basis for an aligned application of the ALP under Art 7 and Art 9 is primarily caused by this step.
- The analysis of "control over risk" under the second step of the AOA can be seen as the counterpart of "management over risk" under the first step of the AOA.
- Both concepts are based on the same factual rational.
- "Management over risk" and "control over risk" is eventually only subject to a difference in wording.
- In order to ensure an aligned application (or avoid misinterpretations), it is recommendable to align the wording of both concepts.
While there may be functions that would be considered both significant people functions for the attribution of risk for the purposes of the AOA and risk control functions for the purposes of Article 9, the conclusion cannot be drawn that these two concepts are aligned or can be used interchangeably for purposes of Article 7 and Article 9.
SPF vs. Risk Control Functions

**Deviation concepts?**

<table>
<thead>
<tr>
<th>SPF for the attribution of risks</th>
<th>Risk control functions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Require active decision-making with regard to:</td>
<td></td>
</tr>
<tr>
<td>(i) the acceptance and/or</td>
<td></td>
</tr>
<tr>
<td>(ii) the management (subsequent to the occurrence of the risk)</td>
<td></td>
</tr>
<tr>
<td>(i) make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function</td>
<td></td>
</tr>
<tr>
<td>(ii) make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function</td>
<td></td>
</tr>
<tr>
<td>(iii) mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation</td>
<td></td>
</tr>
</tbody>
</table>

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Interaction between Articles 5, 7 and 9

**Risk control functions attributed to the intermediary cannot be deemed to be performed 'on behalf of' a non-resident**

Article 5/Chapter 1 of the Guidelines generally:
- Allows risk mitigation to be performed 'on behalf of' another enterprise which retains 'control of risk'
- Does not allow control of risk itself to be delegated

Control of risk, appropriately attributed to the intermediary therefore cannot also be attributed to the head office or the DAPE.

Appropriate attribution of control of risk under Chapter 1 means:
- The party to which the risk is attributed must have the financial capacity to assume the risk
- The party to which the risk is attributed must actually perform the control of risk functions
- The arm's length principle must be respected within the relevant industry context, e.g. regulated businesses such as financial services it is important to recognize the impact of regulatory permissions and industry practices regarding the assumption of risk, 'on behalf of' independent enterprises

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Interaction of Articles 5, 7 and 9: control of risk

A dependent agent carries on two businesses:
- Its own business as an intermediary, for which Article 9 requires an arm's length reward
- The business of the non-resident enterprise, 'on behalf of' which it is acting; if it does not act 'on behalf of' the non-resident enterprise, Article 5 cannot apply to create a PE

Article 9/Chapter 1 of the Guidelines generally:
- Allows risk mitigation to be performed 'on behalf of' another enterprise which retains 'control of risk'
- Does not allow control of risk itself to be delegated

Control of risk, appropriately attributed to the intermediary therefore cannot also be attributed to the head office or the DAPE.

If appropriately attributed to the intermediary, control of risk cannot be 'on behalf of' a non-resident enterprise.

If not 'on behalf of' non-resident enterprise, cannot be attributed to head office or DAPE.

Appropriate attribution of control of risk under Chapter 1 means:
- The party to which the risk is attributed must have the financial capacity to assume the risk
- The party to which the risk is attributed must actually perform the control of risk functions
- The arm's length principle must be respected within the relevant industry context, e.g. for regulated businesses such as financial services it is important to recognize the impact of regulatory permissions and industry practices regarding the assumption of risk, 'on behalf of' independent enterprises.
Interaction between Articles 5, 7 and 9: consequences

- No risk of less than single taxation – Model Tax Convention allows host country to tax both parties
  - Article 5 gives host country taxing rights over non-resident enterprise’s profits
  - Article 9 gives host country taxing rights over arm’s length reward to the resident intermediary

- No risk of BEPS – Attribution of Profits Reports (2008/2010) and TP Guidelines align value creation with functions
  - Article 7: Attribution of Profits/DOI fully align assets, risk and capital with functions
  - Article 7: countries adopting article 7 without implementing DOI can still rely on separate enterprise principle in Article 7
  - Article 9/Chapter 1 of TP Guidelines recognize importance of contracts, but only to the extent contractual allocation of assets, risk and capital align with functions

Risk of double taxation

- Host country may attempt to tax the return to the same risk/assets in DAPE and intermediary
- Host country may tax the return to a risk/assets in DAPE or intermediary AND home country may attempt tax same return in the non-resident
- Host country and home country may both deny tax relief for losses e.g. host country denies tax relief in the intermediary as the transaction is legally on behalf of the non-resident, home country denies relief in the non-resident as the risks are economically controlled by the intermediary

Therefore – need for clarity and administrative simplification

- Administrative provision allowing the non-resident taxpayer to satisfy its obligations in respect of the deemed PE by including the income of the deemed PE on the tax return of the resident intermediary, rather than a separate PE filing, would significantly simplify compliance and help ensure that the host country is neither double taxing nor under-taxing the combination

Interaction between Articles 5, 7 and 9: consequences

Thank you
Examples 1 and 2: Characterization of the Dealing
Mary Bennett, International Alliance for Principled Taxation (IAPT)
OECD Consultation on PE Profit Attribution, 7 November 2017

Requirement to identify and characterize “dealings”

- “In fully hypothesising the PE, it is necessary to identify and determine the nature of its internal dealings with the rest of the enterprise of which it is a part” (2010 AOA ¶172)
- “internal dealings should have the same effect on the attribution of profits between the PE and other parts of the enterprise as would be the case for a comparable provision of services or goods (either by sale, licence or lease) between independent enterprises” (2010 AOA ¶173)
- “The dealings of the hypothesised separate and independent enterprise will be compared to transactions of independent enterprises performing the same or similar functions, using the same or similar assets, assuming the same or similar risks and possessing the same or similar economically relevant characteristics.” (2010 AOA ¶17)

Recognition and characterization of dealings depends on functional analysis

- In the case of a dependent agent PE (DAPE), the analysis focuses on whether the dependent agent enterprise’s (DAE’s) employees perform the significant people functions (SFPs) relevant to assuming risk or determining the economic ownership of assets (2010 AOA ¶232)
- In practice, the DAE may not perform those SFPs, so the attribution of assets, risks, and profits to the DAPE is reduced (2010 AOA ¶233)
- “There is no presumption that assets or risk should be attributed to the dependent agent PE.” (2010 AOA ¶245)
- E.g., DAPE may be attributed economic ownership of inventory if DAE staff perform SFPs relevant to assumption of inventory risk and to determining economic ownership of inventory; but not if head office performs those SFPs (2010 AOA ¶244)
Example 1 (Commissionnaire structure)

- Example assumes that where DAPE is created by commissionnaire activity (by SellCo as DAE), TradeCo’s head office is assumed to have sold widgets to DAPE which resells to buyers, using SellCo’s services.
- Consequence is treating DAPE’s profit attribution as starting with all revenue from sales to customers.
- Nothing in the Example’s facts allows that conclusion to be drawn.
- Should consider where are the people performing the SPFs relevant to determining where economic ownership of inventory should be allocated at time of customer sale, where the inventory and market risks, etc., are being assumed.
- If SellCo doesn’t perform those SPFs, DAPE may be doing no more than providing sales / marketing service to head office, and outsourcing that service to SellCo – DAPE’s profit would be based on that function (and expense).

Example 2 (Sale of advertising on a website)

- Example assumes that SiteCo’s DAPE which is created by marketing activities of SellCo has purchased advertising space from head office and resold it to customers, using SellCo’s marketing services.
- Result is to attribute all customer sales revenue to DAPE.
- There is nothing in Example to allow that conclusion to be drawn about dealing.
- Should consider where people are who perform SPFs regarding economic ownership of advertising space and assumption of distributor risks (e.g., who sets price and other terms and conditions of customer sales, who determines marketing budget, who determines amount of advertising space to be available for sale, etc.)
- If SellCo doesn’t perform those SPFs, DAPE may be doing no more than providing sales / marketing service to head office, and outsourcing that service to SellCo – DAPE’s profit would be based on that function (and expense).
• In addressing the need for additional guidance under Article 7, the Final Report on Action 7 said:

  • The work on Action 7 that was done with respect to attribution of profit issues focused on whether the existing rules of Art. 7 of the OECD Model Tax Convention would be appropriate for determining the profits that would be attributable to PEs resulting from the changes included in this report. The conclusion of that work’s that these changes do not require substantive modifications to the existing rules and guidance concerning the attribution of profits to a permanent establishment under Article 7 but that there is a need for additional guidance on how the rule of Article 7 would apply to PEs resulting from the changes in this report, in particular for PEs outside the financial sector. (Emphasis added.)

  • The highlighted language seems to require the new guidance to follow the existing AOA guidance and expand that guidance to cover the new PEs that would be created by the changes to Article 5, not to come up with new principles for applying the AOA.

  • Although not all OECD and inclusive framework countries follow the AOA, it is the most consistent way to apply the ALS and the TPG.

  • The analysis of the examples “is governed by the AOA contained in the 2010 version of Article 7.”

  • The 2010 version of the AOA is based upon the principle that the profits to be attributed to a PE are the profits that the PE would have earned at arm’s length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and through the other parts of the enterprise determined by applying the Guidelines by analogy. While the dealings are characterized, the nature of the PE needs to be determined. In some – but not all cases – the PE may be functioning as a distributor. In other cases, the proper characterization may be a contract service provider.

  • The examples repeat this language but thereafter ignore the steps necessary to implement this language in accordance with the 2010 version of the AOA.
The first step in applying the AOA is to hypothesizing the PE to be a separate and independent entity.

Because the PE and the enterprise are not legally separate entities, this must be done on the basis of functional analysis.

This may be confused because there are separate legal entities – Tradeco and Sellco – but there is no indication in the hypothesizing the PE if it becomes it's own entity that the legal entity of Tradeco is independent of the legal entity of Sellco. Under the 2010 AOA the PE is attributed those risks for which the significant functions relevant to the assumptions of the PE are performed by people in the PE and also attributed the economic return, where significant functions relevant to the economic ownership are performed by people in the PE.

None of this is analyzed in either example 1 or example 2.

There is no indication in the example of whether Tradeco or Sellco performs the functions relating to inventory risk. This should be one of the principal risks for a trading company, so deciding whether the risk resides within a significant risk or where it resides would be a significant factor. Because Tradeco is the PE, there is no indication whether Tradeco or Sellco designed the marketing campaign or developed brands. These factors would be relevant to determine whether Tradeco or Sellco designed the marketing campaign or developed brands. The examples assume Tradeco should be treated as distributor, despite this lack of analysis.

The "dealing" can only be determined once the functional analysis has taken place. So assuming that the "dealing" between Tradeco and Sellco is the purchase of inventory by the PE from Tradeco’s home office (and its resale to 3rd party purchaser) is without foundation because the functional analysis has not taken place.

The same is true in example 2. This example does not analyze who does what. The PE may enter into the sales contracts but Sellco’s home office may dictate the terms, for example, providing rate cards, which limit Sellco’s authority. A PE may still exist, but the level of Sellco’s authority when acting on behalf of the Sellco’s home office would be relevant to determining which whether Sellco or Sellco is performing functions which indicate assumption and control of risk. Example 2 may imply that the PE is considered to own the advertising space related to the website. There is no analysis, however, concerning who designs and maintains the website and whether that design is critical to the ability to sell advertising space.

As with example one, the "dealing" can only be determined once the functional analysis has taken place. If PE is only providing inventory in exchange for a price, PE is simply the contract service provider, rather than the seller of the advertising space.

OECD Public Consultation

Attribution of Profits to PEs – Examples 1 & 2

Benjamin Shreck

Tax Counsel, Tax Executives Institute, Inc.

2 November 2017
Significance of Customers in Country S; How to Attribute Profits in Absence of Comparables

- Questions raised in TEI response to June 15 Discussion Draft
- Questions indicate assumptions in Examples 1 & 2 are very broad and will not be useful guidance in more complex situations
- More detailed guidance is required for consistent application of the principles to many practical examples

Significance of Customers in Country S

- Is the fact that the customers are in Country S significant? Would the analysis be different if Sellco’s activities (in Country S) result in sales of advertising space by Siteco to advertisers in Country R and/or third countries, and the website users are in other countries?
  - If the customers are in Country S, would there be any additional profit attributed to the PE compared with a fact pattern where Sell Co received arm’s length remuneration? How does this compare with customers being wholly or partly in a different country? Is the answer either that there is no difference, or that residual profit related to sales to customers would or could be taxed in Country S, even if the customers were in a different country?

How to Attribute Profits in Absence of Comparables

- Examples have same methodology
  - Attributable profit = revenue in Country S, less: amount would have been received if trade was carried on with a 3rd party, less attributable costs
  - Effective resale minus principle
- Causes of absence of comparables:
  - Lack of local comparables or
  - Lack of any comparables?
- Local comparables addressed by use of regional or similar data?
  - If no comparable transactions, adoption of a profit split methodology not appropriate, so more guidance required on determination of resale-minus margin
How to Attribute Profits in Absence of Comparables

• Over-simplification of the example disguises the problem of the adoption of the AOA without specifically identifying the hypothetical separate entity and the nature of the transaction between the entities
• It would be much more helpful if the examples identified the hypothetical separate entity, characterized the dealings, and looked for comparables based on the Functions, Assets and Risks analysis

EXAMPLE 3
Most Appropriate Transfer Pricing Method

Profits attributable to PE of TradeCo are:
• Total payment TradeCo would have to pay to an unrelated supplier performing the same functions
• Less:
  - Arm’s length remuneration of BuyCo
  - Amounts paid to unrelated suppliers
  - Other expenses for the purposes of the PE
• This example relies on accurately determining a value for total payment
EXAMPLE 3
Most Appropriate Transfer Pricing Method

Issues
- No consideration of the most appropriate method
- Implication that a CUP is the most appropriate method

Chapter II, Part I of the OECD Transfer Pricing Guidelines
- Aim is to find the most appropriate method
- Consider traditional transaction methods and transactional profit methods

Discussion point
- Why should a different approach be taken to that outlined in the Transfer Pricing Guidelines for selecting the most appropriate method?

Profit attribution to permanent establishment

- Procurement Dependent Agent PE coexisting with a local subsidiary

OECD, November 2017
Chaïd Dali-Ali
Grant Thornton Société d’Avocats
Paris-France

Example 3: Procurement PE

Context

- TradeCo (Distributor)
- Revenues of goods
- Commission

- BuyCo (Procurement Agent)
- Selection and negotiations with suppliers

- Suppliers (Third parties)
- Sales of goods
- Customers (Third parties)
Example 3: Procurement PE

Assumptions made in the draft

• BuyCo is only involved in procurement activities in Country S on behalf of and in the name of TradeCo;
• BuyCo is not involved in TradeCo’s distribution activities and does not “have any entitlement to the amounts paid by TradeCo’s customers”;
• The Arm’s Length Compensation of BuyCo (“the form of the compensation is appropriate”) is a commission fee i.e. % of purchases made by TradeCo through its agent; AND
• Profits attributable to the PE “are those of an independent enterprise performing the same activities than BuyCo (on behalf of TradeCo)”, which would equal:
  • “Amount that TradeCo would have had to pay if it had purchased the goods from an unrelated supplier performing the same functions that BuyCo” (“PE revenue”), MINUS
    • (1) Amounts paid by TradeCo to unrelated suppliers;
    • (2) Other expenses incurred for the purposes of the PE; and
    • (3) The Arm’s length remuneration of BuyCo”.

Example 3: Procurement PE

Discussion

• From our perspective (i) this example, as it is, should not require the recognition of a PE, and (ii) the formula for computing the profit attributable to the PE, applied to the example as it is, is likely to lead to double counting and inconsistencies;

(i) A PE should not coexist with the established local procurement company

• The example clearly states that the pre-existing legal entity is only dedicated to procurement functions, meaning that it has no Significant People Functions that exceed this role and functional profile;
• As a result, and according to article 5.7 of the MTC, no PE should be characterized.
• In addition, this creates confusion and inconsistencies with respect to the proposed formula.

(ii) Issues related to the formula applied to this example as it is

The main concern relates to the definition of the PE revenue: is it the revenue of a Procurement Agent (“PE 1” very unlikely - or of a supplier (“PE 2” based on a CUP), or both in combination (“PE 3”), or others… ?

Reminder: BuyCo does not “have any entitlement to the amounts paid by TradeCo’s customers”

<table>
<thead>
<tr>
<th>AS IS</th>
<th>With a PE</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>PE 1</td>
</tr>
<tr>
<td>Revenue</td>
<td>200</td>
</tr>
<tr>
<td>Purchases (3)</td>
<td>500</td>
</tr>
<tr>
<td>Transportation (2)</td>
<td>20</td>
</tr>
<tr>
<td>Profits attributable to procurement (2)</td>
<td>2</td>
</tr>
<tr>
<td>Operating expenses (respectively)</td>
<td>30</td>
</tr>
<tr>
<td>Admin &amp; support to procurement (2)</td>
<td>2</td>
</tr>
<tr>
<td>Contributions to local etc</td>
<td>30</td>
</tr>
<tr>
<td>Operating profit (corresponding to line 11 for BuyCo)</td>
<td>80</td>
</tr>
<tr>
<td><strong>Attributable profits</strong></td>
<td>100</td>
</tr>
<tr>
<td><strong>BuyCo + PE profits</strong></td>
<td>100</td>
</tr>
</tbody>
</table>
When and why the external purchase contracts should be allocated to the PE and what SPFs would cause any other relevant assets and risks to be allocated to the PE

Significant People Functions

- Guidance on “significant people functions” probably is the technical area of the OD (and the OCA generally) which most needs elaboration
- SPF concept is central to the analytical framework, as it is relevant for:
  - Identifying those assets and risks attributable to the PE
  - Defining the “dealing” with respect to those assets / risks
  - Therefore selecting the appropriate TPM to apply by analogy
- Larger perspective
  - Same principles are relevant to attribution of sales contracts in Exs. 1 & 2
  - If same assets / risks are attributed to the DAE under Art. 9.9
    - No net income / loss could be attributed to the PE for those assets / risks
  - The facts and circumstances determine the extent to which the assets of the enterprise are used in the functions performed by the DAE personnel and the conditions under which the assets are used
- Guidance thus also needed on the difference between the two concepts

Application to External Purchase Contracts

- AOA guidance on assets
  - Assets generally are attributed to the PE if DAE personnel perform the SPF relevant to the determination of economic ownership of assets
  - The facts and circumstances determine the extent to which the assets of the enterprise are used in the functions performed by the DAE personnel and the conditions under which the assets are used
- AOA guidance on risks
  - The SPF relevant to the assumption of risks are those which require active decision-making with regard to the acceptance and/or management of those risks. The extent of the relevant decision making will depend on the nature of the risk involved.
- Possibly relevant SPF for assets (i.e. the contracts)
  - Should be a function performed by DAE personnel (not the head office or elsewhere) which creates the asset and is different than a normal procurement function
  - Concluding the contract?
  - Negotiating terms?
  - Qualifying suppliers?
  - All three?
  - Other functions?
### Application to External Purchase Contracts

- Possibly relevant SPF for risks (i.e., assumed through the purchase contracts)
  - Must involve active decision-making by DAE personnel (not by head office or elsewhere) regarding the assumption of the risk beyond a normal procurement function
  - Quality control?
  - Loss on defective widgets
  - Loss due to damage
  - Forex risk management?
  - Exchange loss
  - Decisions whether to prepay?
  - Time value of money cost

- Same SPF then identify the dealing based on assets / risks used through PE
  - Choose comparables and “most appropriate” transfer pricing method – e.g., TNMM
  - Amount attributed to the PE could be loss or zero
  - Administratively convenient reporting guidance needed

---

### Possible Results Based on SPF Identification

**Dealing 1: Buy-Sell**
- SPF Assets: external purchase contract allocated to PE
- SPF Risks: e.g., foreign exchange risk
- Dealing: purchase by PE and sale to head office at a price that reflects FX risk

**Dealing 2: Services**
- SPF Assets: external purchase contract allocated to head office
- SPF Risks: e.g., foreign exchange risk
- Dealing: service fee payable by head office to PE to compensate assumption of FX risk
General Comments on the Discussion Draft

• We appreciate the statement that any approach must ensure that there is no double taxation in a source country, and that the profits attributable to PE could be minimal or even zero in a case where an intermediary is assuming risks.

• Detailed guidance should be provided concerning the difference in the positions of Articles 7 and 9 with regard to risk.

• Single-taxpayer approach is the best way to go. An alternative option may be to regard a PE determination and its profit calculation as unnecessary in cases where its profits or revenue would not exceed a fixed amount.

• In any case, the final guidance should clearly recommend that simplified approach be adopted, thereby urging countries participating in the IF to take concerted actions.

Comments on Example 4

<table>
<thead>
<tr>
<th>Proofs attributable to PEs</th>
<th>OnlineCo</th>
<th>Merchandising and collection of information service</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warehouse PE</td>
<td>(1) amount</td>
<td>(1) amount</td>
</tr>
<tr>
<td>Office PE</td>
<td>(2) Employees’ compensation</td>
<td>(3) Expense allocated (or “dealing”)</td>
</tr>
<tr>
<td>Country R</td>
<td></td>
<td>Country S</td>
</tr>
</tbody>
</table>

“Constitute complementary functions that are part of a cohesive business operation”
Comments on Example 4

1. Possibility of Profit Calculation as a Single PE
   • While the activities at the warehouse and those at the office are viewed as part of a cohesive business operation, two PEs are determined to exist.
   • Consideration should be given to a simpler method that enables profit calculations as a single PE.

2. Alternative Scenario
   • Another example would be welcomed to clarify whether the conclusion differs if the warehouse is operated by an associated (or independent) enterprise and staffed by its employees.
   • Physical location of the inventory owned by a company in a resident country should not create a PE in a source country.
   • Even in a case where PE is deemed to exist, there should be no profit after paying arm’s length remuneration to the associated (or independent) enterprise.
Single PE vs two PEs

- If two locations are part of the same cohesive business, why should they form distinct PEs (see 2017 DD, para. 47) so that the calculation of profits is conducted separately (see 2017 DD, paras. 48-49)?

- Need for a conceptual/operative definition of “complementary, coherent and cohesive business operation” (mentioned in BEPS Action 7 Report, § 15, 2017 Update OECD MTC, art. 5(4.1); 2017 Draft Update OECD Commentary to art. 5 MTC, §§ 21, 79).

Single PE vs two PEs: compensation of profit and loss

Two PEs: some critical issues

- Each PE is treated as a taxpayer by the Tax Authorities of the source State.
- Higher administrative burden by the duplication of:
  - Tax Identification Number
  - Accounting framework
  - Tax returns (income, VAT, others)
  - Withholding agent compliance
  - Tax risk management procedures
  - Tax audits
- Extra G&A costs.
- Potential higher income tax burden if no tax consolidation may be arranged between PEs.
- Potential higher VAT burden if no VAT grouping may be arranged between PEs.
APPROACHES TO COORDINATE THE APPLICATION OF ARTICLE 7 AND ARTICLE 9

SellCo and DAPE as a single taxable person carrying on business in Country S

Determination of the arm’s length value of the intercompany transactions incurred between the associated enterprises under the transfer pricing principle (Article 9)

If a P.E. exists (i.e. all the conditions of Article 5 are met), the following use of Article 7 needs to determine the portion of profit to be attributed to the P.E. (or the hidden P.E.)

Main issue: Use the appropriate transfer pricing method to evaluate the intercompany transactions incurred between the associated companies, including, if necessary, adjustments.

Main issue: The subsequent application of Article 7 may allocate the profit to the P.E.; it should not affect the preliminary remuneration determined under Article 9 between the associated companies.
GROUP STRUCTURE BETWEEN COUNTRY R AND S: FACTS

Company resident in country R

Associated company resident in Country S

TradeCo, according to the tax treaty between Country R and S, has a PE in Country S

THE SINGLE TAX PAYER APPROACH: THE APPLICATION (1/2)

- A) Application of Article 9 on a "consolidated business basis" for the intercompany transactions
- B) Analysis of functions performed
- C) Analysis of risks assumed
- D) Choose the appropriate transfer pricing methodology to evaluate the arm’s length value of the transactions under the article 9
- E) Country R is entitled to tax TradeCo as involving by the transfer pricing analysis performed under article 9, deducting the commission to be recognized to the "deemed PE"
- F) On the other hand, Country S is entitled to tax the arm’s length remuneration of SellCo, including the profit distributed to the "deemed PE". Article 7 is applied in order to allocate the portion of the SellCo’s arm’s length profit to the "deemed PE"

THE SINGLE TAX PAYER APPROACH: THE APPLICATION (2/2)
Avoid double taxation.

Reduction of additional compliance burden.

Why the single taxpayer approach is the best method to use?

Appropriate documentation of the remuneration of the intercompany transactions.

Approaches to coordinate the application of Article 7 and Article 9

Single Taxpayer Approach

Andrew Cousins
Duff & Phelps, London

The “Single Taxpayer” approach

- The single taxpayer approach argues that in all circumstances the payment of an arm’s-length reward to the dependent agent enterprise fully extinguishes the profits attributable to the dependent agent PE.
- The AOA rejects the single taxpayer approach:
  - Primarily, on the grounds that risks can never be attributed to a dependent agent PE of a non-resident enterprise under the single taxpayer approach, because it follows legal form;
  - Secondly, because it disfavors the application of different approaches dependent on the type of PE concerned;
  - Thirdly, so as not to render the drafters’ text redundant.
- However, post-BEPS, following the changes to Chapter I of the TPG, these objections have already begun to appear unsustainable.
- Movement towards the single taxpayer approach will represent a major compliance and administrative benefit.
Differences between AOA and TPG

- The AOA aims at consistency with the arm’s length principle and should therefore theoretically tend towards commonality of outcome with the TPG.

- However, inconsistency of treatment between the AOA and the TPG exists, owing to:
  - The fact that, under the TPG, contracts form the starting point for allocation of risk;
  - Under the AOA, significant people functions are used to identify risk allocation.

- Consequently, in the case of a related party dependent agent, an Article 7 analysis using the AOA can produce a different outcome from an Article 9 analysis using the TPG, even though both are in theory based on the same principle.

- But even now, it is recognised that in many cases, where the allocation of the assumption of risks under the AOA and the TPG is in alignment, there is no additional profit to be attributed to the DAPE over and above the profit earned by the DAE.

Convergence of AOA and TPG

- Compared with the time when the AOA was written, the TPG have moved some distance away from contractual allocation of risk:
  - The divide between the application of the arm’s length principle under the AOA and the TPG has narrowed considerably.
  - The emphasis in the TPG on the actual conduct of the parties with respect to risk assumption is a move in the direction of significant people functions.

- The primary objection of the AOA to the single taxpayer approach has largely been rendered null and void, while the other objections fall away.

- It is time that the AOA was reviewed to bring its concepts into alignment with the TPG, such that they share a common application of the arm’s length principle.

- The validity of the single taxpayer approach will be the natural consequence, bringing with it significant benefits in reducing the compliance burden.

Public consultation on the Additional Guidance on the Attribution of Profits to Permanent Establishments
EY, Thomas Ebertz – 7 November 2017
Introduction

- Number of PEs and level of uncertainty will grow significantly.
- Increased compliance burden not limited to taxpayers only, but also creates additional resource constraints on tax administrations in return for little or no additional taxable profits.
- Increased existence of zero-profit PEs will create unintended consequences in the form of wage tax, VAT registrations/obligations, commercial registrations as well as other, unnecessary administrative duties for taxpayers.
- Some countries require full accounting set-up even for a dependent agent PE.

Preventing uncertainty and double taxation

- Develop clear rules on the attribution of profits
  - Perform article 9 analysis before article 7.
  - Emphasize importance of SPF, and don’t allocate any profits in absence of SPF.
- Treaty rules to stipulate no PE in case of zero-profit PEs
  - If not solved by further modification to Article 5, we urge the OECD to encourage tax administrations to address this by allowing an exemption for zero-profit PEs unilaterally through their domestic tax legislation.
- Avoid suggestion that sales should be recorded in books of deemed PE.

Coordinated application of article 7 and 9

- OECD should expressly state that tax administrations should never singularly apply either an Article 7 or an Article 9 analysis. Perform coordinated and parallel examination prior to proposing any tax adjustments to taxpayers.
- Taxpayers should be guaranteed access to all available dispute resolution mechanisms, and not be barred from dispute resolution for reasons such as a reversal of burden of proof or incorrect corporate income tax filing claims that may arise from disagreement in application of either Article 7 or Article 9.
Administrative simplification

► Discussion Draft paras 20 and 21 should be expanded and OECD should make firm recommendations urging countries to adopt mechanisms to reduce / eliminate the additional compliance burden and / or collection of taxes in their jurisdictions.

► Treaty or domestic exemption for zero-profit PEs.

► Allow existing resident taxpayer to specify or “elect” in its tax return that a PE of a non-resident entity has been created in its jurisdiction and that the related entity has assessed that no profit is attributable to the PE.
General Comments

• “[A]ny approach to the application of Articles 7 and 9 to cases of deemed PEs under Article 5(5) must ensure that there is no double taxation in the source country.”

⇒ It is evident that the significant lowering of the DAPE threshold by the Action 7 report would give an extra margin of interpretation in terms of the existence of DAPE.

⇒ The lack of clarity in the language of this new definition, coupled with the inherently complex nature of profit attribution would definitely increase the probability of double taxation.

Discrepancies between Article 7 & 9

• “the host country’s taxing rights are not necessarily exhausted by ensuring an arm’s length compensation” (Paragraph 19)

⇒ Taxpayers’ foremost interest and expectation from the OECD is to provide guidance that would lead to a correct understanding the situations where the application of Articles 7 and 9 are not in alignment

⇒ In absence of a clear delineation of what would give rise to “either positive, nil or negative” attribution of profits to DAPE after an arm’s length compensation, double taxation is inevitable

Call for administrative approaches to enhance simplification

• Re-consideration of single-taxpayer approach

⇒ Very few benefits for both taxpayers and tax authorities, when it seems difficult to show a clear rationale behind calculating additional attributable profits.