COMMENTS RECEIVED ON PUBLIC DISCUSSION DRAFT

BEPS ACTION 10: USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAINS

10 February 2015
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6 February 2015

By email to: transferpricing@oecd.org

Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
OECD

Dear Andrew,

**BEPS Actions 8, 9 and 10: Discussion draft on revisions to chapter 1 of the transfer pricing guidelines (including risk, recharacterisation and special measures)**

**BEPS Action 10: Discussion draft on the use of profit splits in the context of global value chains**

**General comments**

AFME\(^1\) and the BBA\(^2\) welcome the opportunity to respond to the OECD's discussion drafts entitled “BEPS Actions 8, 9 and 10: Discussion draft on revisions to chapter 1 of the transfer pricing guidelines (including risk, recharacterisation and special measures)” and “BEPS Action 10: Discussion draft on the use of profit splits in the context of global value chains”.

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\(^1\) The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society.

\(^2\) The BBA is the leading trade association for the UK banking sector with more than 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Our associate membership includes over 80 of the world’s leading financial and professional services organisations.
We wish to make clear that while AFME and the BBA have separate and distinct memberships, both organisations have decided to submit a single, combined response since our respective members share the same concerns with the OECD’s proposals in the discussion drafts.

We welcome that the OECD is consulting with business on its proposals. We believe that this approach is to the benefit of both policymakers and business and helps to avoid any unintended consequences arising from the OECD’s initial proposals. We believe that it is also valuable for the OECD to take account of the views of business on the practical aspects of operating the intended policy.

The relatively short time available to consider the discussion drafts – and the large number of other OECD discussion drafts recently open for consultation with short deadlines – poses a challenge for all businesses and the OECD secretariat. Should it be of assistance we would be pleased to meet with the OECD Secretariat to discuss these matters in greater detail or provide further information upon request.

**BEPS Actions 8, 9 and 10: Discussion draft on revisions to chapter 1 of the transfer pricing guidelines (including risk, recharacterisation and special measures) (the discussion draft)**

**The importance of regulatory capital and existing transfer pricing guidelines for banking and finance groups**

We note that the banking and financial services industry is subject to regulatory requirements, in particular with regard to capital, liquidity and leverage. We welcome the recognition in the discussion draft that the evolving regulatory environment in which banks and other financial institutions operate substantively differentiates them from other sectors for the purposes of action items 8 to 10.

Supervisory authorities have sought to ensure that the regulatory framework promotes financial stability, protects deposit holders and ensures the continuity of services to customers and businesses, in particular lending throughout the business cycle. This means that banks and other financial institutions are required to hold increased capital reserves against their assets and face limits on their ability to leverage. Critically, this also limits the ability of banks and other financial institutions to engage in activity which may cause concern in relation to BEPS.

The OECD has recently considered thoroughly the allocation of risk and capital within banking and financial services groups in developing the 22 July 2010 “Report on the attribution of profits to permanent establishments” (the 2010 report). We note that this report recognises the importance of Key Entrepreneurial Risk Taking (KERT) functions in a bank or financial institution (i.e., the creation of financial assets and management of
the risk associated with those assets). We believe that the 2010 report is widely regarded by both tax authorities and taxpayers as a reasonable and fair approach to taxing banking and finance businesses.

We would welcome clear recognition of the relevance of the 2010 report for the banking and financial services sector, and acknowledgement that it is consistent with the general approach outlined in the proposed revised Chapter 1, Section D of the Transfer Pricing Guidelines.

**Identifying commercial or financial relations**

We note that Part D.1 of the discussion draft provides new guidance for identifying the commercial and financial relations between associated enterprises. In particular, Paragraph 2 of the discussion draft states that the “process of identifying the commercial or financial relations between associated enterprises follows from examining contractual terms governing those relations together with the conduct of the parties. Establishing the conduct of the parties involves examination of all of the facts and circumstances surrounding how those enterprises interact with one another in their economic and commercial context to generate potential commercial value, how that interaction contributes to the rest of the value chain, and what the interaction involves in terms of the precise identification of the functions each party actually performs, the assets each party actually employs, and the risks each party actually assumes and manages.”

Whilst we believe that the process of identifying the commercial or financial relations between associated enterprises should focus on the *conduct* of the parties in addition to the contractual terms, we are concerned about a potential lack of consistency regarding the extent to which jurisdictions may take into consideration the conduct of the parties. We therefore welcome that Paragraphs 4 and 6 of the discussion draft include some examples suggesting how the conduct of the parties would be taken into account by tax authorities and we would encourage the OECD to include more examples. We would be happy to work with the OECD in due course in this regard.

As noted above, we would recommend acknowledgement of the established approach for banks and financial services. For the banking and financial services sector, we also recommend that the OECD guidance takes into account and stresses the importance of regulation as it affects both the contractual terms and conduct of the parties. The role of KERTs is directly relevant in this context and should be referred to in the OECD guidance.
**Financial capacity to bear risk**

We note that Paragraph 66 of the discussion draft provides that “Financial capacity to bear risk is a relevant but not determinative factor in considering whether a controlled party should be allocated a risk return. As stated in Chapter IX [of the July 2010 OECD transfer pricing guidelines], a high level of capitalisation by itself does not mean that the highly capitalised party carries risk (Paragraph 9.32). MNE groups, unless subject to capital adequacy regulations, can determine the capital structure of subsidiaries without explicit consideration of actual risk in that subsidiary.”

We note that Paragraph 66 of the discussion draft goes on to state that “For the same reason, a low level of capital in a controlled enterprise, should not prevent the allocation of risk to the company for transfer pricing purposes where such allocation is justified under the guidance of this Chapter”.

Again, we would note that the role of risk and capital has already been considered for the banking and financial services sector in the 2010 report. We believe that it would be helpful to cross refer to this work when developing any further proposals, in particular the interaction of the ability to assume risk and capital and the role of KERTs.

**Non-recognition**

We note that Paragraphs 83 to 93 of the discussion draft consider the issue of “non-recognition”, where transactions can be disregarded or recharacterised for transfer pricing purposes because the transactions do not have arm’s length attributes. Paragraph 86 of the discussion draft - in relation to the reason for the need for “non-recognition” – states that “except in certain regulated sectors, MNE groups have freedom to control their structures, including shareholding, capitalisation, and legal form.” We note that regulated banking and financial services groups do not have the freedom to structure their arrangements in the ways described in Paragraphs 85 to 87 as non-banking and financial services groups and we believe that this should be acknowledged explicitly in the guidance.

We note that Paragraph 93 of the discussion draft sets out the consequences of “non-recognition”. In particular, that the taxpayer’s structure may be replaced by an alternative structure that reflects the “fundamental economic attributes of arrangements between unrelated parties and that comports as closely as possible with the commercial reality of independent parties in similar circumstances”. We recommend that the OECD provides further guidance setting out how the alternative structure should be determined.
Special measures

Part 2 of the discussion draft presents five options for potential special measures to ensure that transfer pricing outcomes are in line with value creation. For options 2 to 5, the special measures seek to address issues arising from the “freedom that MNE groups have (except in certain regulated sectors) to control their structures, including the creation and capitalisation of companies”.

We think that it is correct to recognise that that the regulated environment for banks and financial services protects against such transactions, as we have briefly outlined in this consultation response. The further commentary on these aspects included in the AFME/BBA response on 6 February 2015 (attached for reference at Appendix 1) to the OECD’s 18 December 2014 discussion draft entitled “BEPS Action 4: Interest deduction and other financial payments” is also relevant.

For the reasons set out above, we suggest that if any of the options for special measures are developed further, care should be taken to ensure that they appropriately address the banking and financial services sector in a manner consistent with regulation and the 2010 report. In that regard, we believe that any general measure needs to take care not to cut across regulatory measures designed to promote financial stability and protect deposit holders.

We believe that any special measure should only be considered following the normal application of transfer pricing rules, which may well render the special measure unnecessary. We believe that the intention is for any special measure relating to capital to deal with a limited number of abusive situations and we would welcome this being explicitly stated. Any special measure which has a wider application is likely to also need a mechanism for eliminating double taxation. Our comments on the need for a corresponding adjustment included in the AFME/BBA response on 6 February 2015 (see Appendix 1) to the OECD’s 18 December 2014 discussion draft entitled “BEPS Action 4: Interest deduction and other financial payments” are relevant in this regard.

Paragraph 5 of Part 2 of the discussion draft acknowledges that “the situations addressed in this section have a close interaction with other actions under the BEPS action plan, including Action 3 on strengthening CFC rules and Action 4 on interest deductions”. We agree with that, and consider that measures to address over-capitalisation seem most naturally to be part of a CFC regime. If any of these options are developed further, future proposals will need to be coordinated with those developed under action items 3 (strengthening the CFC rules) and 4 (interest deductibility) to ensure that there are no duplicative special measures.
Consistency and dispute resolution procedures

We note that if the OECD does go ahead and develop the proposals associated with “non-recognition”, the “special measures”, or the focusing on the conduct between the parties with respect to identifying commercial or financial relations, it would be important to ensure that all jurisdictions adopt the proposals on a consistent basis to avoid double taxation and potential disputes between tax authorities. We would therefore encourage the OECD to provide as much clarity and guidance as possible. We would also stress the need for the development of appropriate dispute resolution mechanisms, currently being developed by the OECD under action item 14.

BEPS Action 10: Discussion draft on the use of profit splits in the context of global value chains

We also wish to take this opportunity to note the OECD’s proposals in its discussion draft entitled “BEPS Action 10: Discussion draft on the use of profit splits in the context of global value chains” (the discussion draft). The use of residual profit splits in the banking sector is well established, and has been the subject of considerable work at the OECD, including that included in the OECD’s 2010 report. Once again, we do not believe that the proposals in the discussion draft should interfere with the principles set out in the OECD’s 2010 report. We believe that the OECD’s output on action item 10 should therefore acknowledge the continuing relevance of the OECD’s 2010 report.

We are grateful for the opportunity to share our comments with the OECD on the discussion drafts and we would be happy to discuss any of the above in greater detail with the OECD and would be pleased to contribute further as the OECD’s work develops.

Yours sincerely,

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AFME

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BEPS Action 4 Discussion draft: Interest deductions and other financial payments

AFME\(^3\) and the BBA\(^4\) welcome the opportunity to respond to the OECD's discussion draft entitled: “BEPS action 4: Interest deductions and other financial payments” (the discussion draft). We wish to make clear that while AFME and the BBA have separate and distinct memberships, for the purposes of the discussion draft, both organisations have decided to submit a single, combined response since our respective members share the same concerns with respect to the proposals in the discussion draft.

We note that the relatively short time available to respond to the discussion draft – and the large number of other OECD discussion drafts currently open for comment – poses a challenge for all businesses and the OECD Secretariat. Should it be of assistance we would be pleased to meet with the OECD Secretariat to discuss these matters in greater detail or provide further information upon request.

Executive Summary

We support the OECD’s consultative approach on the development of these proposals. We believe that this will benefit both policymakers and business, by helping to reduce any unintended consequences arising from these proposals. We also believe that it is

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essential for the OECD to take account of the views of business on the practical aspects of operating the intended policy.

The discussion draft notes that measures based on gross interest expense would have distortive consequences. This is particularly relevant for the banking sector, where interest expense is effectively the equivalent of the cost of goods sold, and is closely linked to the cost of finance to the wider economy. We therefore agree that measures which consider net interest expense are a more accurate means of identifying and addressing BEPS concerns. We agree with the comment at Paragraph 209 which notes that because of the focus on net interest expense, banks will not be subject to a general limitation as they will be expected to generate net interest income. We would note, however, that the position of banks as net interest recipients should not be seen as indicative of base erosion in itself.

The banking sector - due to the evolving regulatory environment in which banks operate - is substantively different from other sectors for the purposes of this BEPS action. Banks are subject to strict regulatory requirements which, by a variety of measures, directly impact their capital structure, leverage and behaviour. We welcome the recognition of this distinction in the discussion draft.

Supervisory authorities and banks have sought to ensure that the regulatory framework promotes financial stability, protects deposit holders and ensures the continuity of services to customers and businesses, in particular lending throughout the business cycle. This means that banks are required to hold increased capital reserves against their assets and face limits on their ability to leverage. Critically, this also limits the ability of banks to engage in activity which may cause concern in relation to BEPS.

The discussion draft states at Paragraph 211 that consideration should be given to designing a rule which “limits a group’s net deductions on its regulatory capital to the interest expense paid on these instruments to third parties.” Paragraph 212 then states that targeted rules to address risks posed by specific transactions could be considered as an alternative. We would urge the OECD to first identify any remaining BEPS risks posed by banks. If such risks are determined to exist, we believe any measures taken to address them should be targeted rules that take fully into account and complement the evolving regulatory requirements banks face.

**Banking activity and the regulatory environment**

The business model of banks is built on borrowing from depositors or in the wholesale markets to provide lending to individuals, SMEs, larger corporates or governments at a margin over the cost of the funds to the bank. Banks may also buy or sell government debt and other securities to provide market liquidity to investors, and deploy their capital to enable their clients to hedge risk.

Regulation plays a critical role in determining how banks are able to carry out commercial activity to support the needs of their customers. Although banking has always been subject to significant regulation, the primary focus of policy makers since the financial crisis has been to improve the stability and resilience of the financial system, ensure deposit holders are adequately protected and support the continuity of
services to customers and businesses, in particular lending throughout the business cycle.

We believe that regulatory requirements on banks provide a significant restriction on their ability to undertake activity which may be considered to pose a BEPS risk from a number of perspectives.

i. Capital requirements

The key regulatory focus in recent years has been to strengthen the capital requirements placed on banks to reduce the probability of bank failures. Regulators have sought to ensure, via international standards such as Basel III, that banks have sufficient loss absorbing capital to withstand shocks to the financial system. This has led to a significant increase in the quantity and quality of banks’ capital. In Europe, these requirements apply to banks both at the group level and at the regulated subsidiary level, effectively requiring sufficient capital to be placed in customer facing operating entities.

In the context of BEPS, these capital requirements also act as a restriction on a bank’s ability to issue debt and push this down to subsidiaries as equity. This is because a bank subscribing for equity in a subsidiary is required to deduct that investment from its own capital when determining how much regulatory capital is eligible to be taken into account when calculating its capital adequacy. In other words, a bank which provides regulatory capital to a subsidiary reduces its own ability to undertake business, as its own capital base is reduced.

It is also worth highlighting that the capital requirements allow banks to meet a limited proportion of the minimum requirements through non-equity capital instruments. These instruments include Alternative Tier I capital (AT1), such as contingent convertible bonds, which have the characteristics of both debt and equity. However, we note that any BEPS risks posed by such instruments are specifically addressed by BEPS Action 2.

Paragraph 211 suggests the design of a group wide interest allocation rule which would limit a group’s total net deductions on its regulatory capital to the expense paid on these instruments to third parties. It is noted that regulatory capital provides core funding for a bank and an assumption that it plays a comparable role with debt in other sectors. We think that is a reasonable conclusion in the context of Action 4. The funds raised from regulatory capital are deployed in the business and generate profits in the course of the banks’ trade. Further, as noted above and unlike other sectors, banks’ ability to issue and redeem regulatory capital is subject to extensive and evolving regulation and regulatory approval.

ii. Large exposure limits

Banks are also subject to a regulatory large exposure limits. This rule limits any exposure, including those to a subsidiary, to 25% of capital net of any equity investment in subsidiaries and other undertakings. The large exposure constraint therefore places restrictions on banks’ ability to issue debt and push this down to subsidiaries as equity
as well as the use of intra-group loans from low taxed jurisdictions to high tax jurisdictions. In practice banks’ individual exposures do not come close to the 25% limit as this would give rise to concentration risk, which would prompt regulators to require banks to hold additional capital against that risk.

Some jurisdictions also impose domestic rules which further greatly limit BEPS activities for banks. For example, a US banking group would generally not be allowed to inject equity into an off-shore non-regulated entity.

iii. Commercial pressures

In addition to these regulatory pressures, banks’ activity is also influenced by their need to provide adequate returns for investors who have provided capital. Due to the nature of loss absorbing capital, investors expect greater returns than against other types of investment to reflect the potential risk of loss in the event of a default or write down. This creates a commercial pressure on banks to ensure they are not over capitalised and are earning sufficient return on their capital.

In addition to the regulatory constraints noted above, the ability of banks to borrow to fund equity investments is yet further constrained by external commercial pressures. This type of borrowing, or “double leverage”, is seen as a key consideration for investors and credit rating agencies when assessing the position of a bank. Double leverage is measured by inter alia calculating the ratio of equity issued to equity invested by a bank. If the ratio is considered excessive the holding company’s credit rating may be reduced to reflect the perceived reliance on discretionary dividends to fund the interest obligations of the holding company, or its potential inability to realise its assets and repay its debt. The commercial pressure to retain a high credit rating therefore acts as a market incentive for banks not to undertake this type of activity.

These commercial pressures apply directly to banks’ issuing entities (generally the parent or holding company) and this makes capital a valuable resource within a banking group. Once raised, the capital then has to be subscribed to the operating entities to meet local regulatory demands. In addition to the regulatory constraints, the focus on double leverage constrains a group’s ability to borrow to invest capital and means that capital needed by operating entities has to flow down from the issuers. Therefore there are strong commercial reasons for banks not to engage in activity which may pose a risk of BEPS.

Implications of regulatory requirements and commercial pressures for BEPS

These considerations, and the level of scrutiny employed by regulators and investors, mean that banks are over time unlikely to be significantly under or over capitalised, both externally and within the individual entities of a banking group. We believe that this significantly reduces the risk of potential BEPS activity being undertaken by banks through interest deductions and other financial payments.

Achieving BEPS through the use of interest deductions, which Action 4 addresses, requires the ability to freely structure borrowing, including the ability to terminate the borrowing easily. The adequacy and maintenance of a bank’s capital position is of
paramount importance and takes precedent over any discretion a bank might have to structure its borrowing in a manner which gives rise to potential BEPS concerns. Banks will also remain subject to significant regulatory scrutiny for the foreseeable future.

If there are specific BEPS concerns which the regulatory environment would permit and require further consideration, we believe these would be best addressed on a targeted basis with appropriate filters. For instance, we would only expect targeted rules to be contemplated when it has been clearly demonstrated that it would not be possible to address any concern using the arm’s length principle.

We would urge that any BEPS risks posed by banks be identified before determining if any further targeted measures are required. This will minimise the risk that any proposals would have unforeseen impact on groups’ regulatory positions and on the cost of finance to the wider economy. If such risks exist, we urge that any measures taken to address them be carefully targeted and take fully into account and support the evolving regulatory requirements banks face. We would be pleased to discuss this further with you.

Specific issues raised by the Discussion Draft

As noted above we fully support the net interest expense approach adopted in the discussion draft and believe that where BEPS risks are identified in the banking sector they should be only addressed by targeted measures.

As a general point we would note that the interest limitations introduced by many jurisdictions to date have provided measures which effectively exclude activity undertaken by banks, or banking groups, or otherwise ensure that the rules do not adversely affect the ordinary course funding of banks.

We would highlight how the approach taken by these jurisdictions recognises the policy drivers outlined elsewhere in this paper, not least the recognition that interest expense is the cost of sales for a bank and that such measures should operate without a detrimental effect on banks’ ability to lend and support economic activity. We believe that approach is appropriate and should continue to be a feature of any proposals or best practice suggested by the OECD.

Given the significant work that is being undertaken as part of the wider BEPS project, and the short time available to comment on the specific questions raised by the discussion draft, we would also make the following limited observations on the more general questions.

Group Wide Test

As business groups, such as the CBI, have noted the application of a group wide ratio on the basis of earnings or assets will inevitably lead to double taxation, unless that is directly addressed by a corresponding adjustment.

Whichever allocation factor is chosen (assets or earnings), their application will produce a difference between where net interest expense is incurred and the
jurisdictions to which the capacity to deduct the expense is allocated. The allocation factors in one jurisdiction in which a group operates will have an impact on every other jurisdiction in which the group is present.

Paragraph 80 notes “Groups may therefore seek to re-organise their intragroup financing to bring each entity’s ratio more in-line with that of the group, subject to any barriers preventing them from doing so”. In the context of banks this “self-help” approach would be particularly ineffective. The ability to locate borrowing to meet any tax ratio would firstly require the ability to predict the ratio for the year, which in itself is challenging for a risk-taking business. In addition to the substantive difficulties already identified by others, having predicted the location of the allocation, banks would also face regulatory barriers, as their ability to deploy and repay capital is subject to the approval of regulators who provide an additional level of oversight.

Fixed Ratio Test

As noted in Paragraph 158, fixed ratio tests have been developed and applied by a number of jurisdictions. When considering the merits of fixed ratio tests we would encourage the OECD to view this on a jurisdiction basis rather than an entity basis. If applicable, consideration should also be given to whether a higher ratio may need to be provided for banks in any proposals or suggested best practice given differences in bank funding compared to other businesses.

Combined Approach

The use of a combined approach has the capacity to resolve the difficulties of each model while still allowing BEPS risks to be addressed. Perhaps more significantly, it may also reduce the risk of double taxation presented by either approach in isolation. Conversely, we would be concerned if any combined approach were to in effect maintain the undesirable consequences of both approaches.

Careful consideration will therefore need to be given to ensure that any final rules are clear, predictable and do not create disproportionate compliance burdens for Tax Authorities and businesses.

Furthermore, if the OECD decides to adopt this approach it will also be important to ensure that any steps taken to address the banking sector are not invalidated by effectively introducing double hurdles.

Payments economically equivalent to interest.

The discussion draft identifies the difficulties that may arise from applying a best practice rule to items including those specified as payments economically equivalent to interest. We agree that there are likely to be practical issues in defining and extracting payments considered economically equivalent to interest when their treatment is likely to vary under different accounting standards.

One matter that could be problematic going forward is the intention to treat the equivalent of today’s finance leases and operating leases differently given the proposed
divergence of lessee accounting rules under IFRS and US GAAP. We note that the operating and finance lease terms will not be used but there will be a distinction on a similar basis.

The IFRS proposals would require lessees to treat all leases with periods over 12 months in the same way, reflecting a present value of the rentals in the balance sheet and charging a finance charge to the profit and loss account. There would be no distinction between different types of leases.

US GAAP would continue to distinguish between different types of lease and, broadly speaking, continue to charge the equivalent of operating lease rentals to the profit and loss account without separating out a finance charge.

The difference in accounting will either give inconsistent treatment between taxpayers using different GAAP if the finance charge in the accounts is used or practical difficulties for IFRS accounts users in splitting the accounts finance charge based on a split of lease type that is not relevant for the preparation of the accounts.

We would also suggest further consideration is required for the treatment of Sharia finance under any proposals.

**Double Taxation**

We believe that steps will be needed to ensure that the best practice approaches adopted by Action Plan 4 do not generate double taxation.

The discussion document accepts that the proposed approaches will deny deductions in excess of those needed solely to address BEPS. For instance, the suggestions at Part XII to allow for the carry forward of excessive deductions or capacity accept that there will be excessive restrictions.

Whilst we welcome any measures that prevent double taxation, we would urge the OECD to recommend more timely and comprehensive action to address the risk of double taxation. Any inability of corporates, including banks, to materially predict the tax treatment of debt will introduce uncertainty into investment and funding decisions.

We would therefore consider it of vital importance that the OECD sets out a mechanism which provides for clear and timely corresponding adjustments to be made where deductions are denied in any final proposals or best practice suggestions on the tax treatment of intra-group interest.

It is important to establish that a lender should not be taxed on intra-group interest income to the extent that the borrower is denied a deduction for the corresponding interest expense. In other words, there should be a coherent approach to the treatment of the lender and borrower to prevent double taxation, and this is particularly important given the proposals diverge from the arm's length principle.

**Interaction with Other Actions**
We recognise that the Action Plans are being produced under intense time pressure and that each is being developed separately. The need for a cohesive response to BEPS is critical if the Action Plans are to be successful. As the discussion draft notes, Action 4 potentially overlaps with a number of the other BEPS Actions. We would therefore ask the OECD to undertake a review of how the recommendations within all the action plans interact in order to ensure there is a consistent and clear approach to BEPS recommendations affecting the intra-group provision of debt finance.

Yours sincerely,

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February 06, 2015

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Re: BEPS Action 10
Comments on “Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains” dated 16 December 2014

Dear Mr. Hickman:

Introduction

Congratulations to you and your team for the very thoughtful discussion draft related to profit splits in the context of global value chains. We agree generally with the thrust of the draft but believe there are further enhancements that should be considered.

We are transfer pricing leaders with AlixPartners LLP, a leading global business advisory firm. We are the trusted advisors to corporate boards and management, law firms, investment banks, investors, and others who value objective advice, critical insight and actionable expertise.

The comments and opinions we offer here are our own based on our collective experience and judgment; they do not necessarily represent those of AlixPartners.

Comments

Our comments are divided into two parts. We first make certain general comments and then give our specific responses to certain questions raised in the draft.
General Comments

The OECD is right to be concerned about issues associated with one-sided methods such as TNMM and to be supportive of alternatives where appropriate. While a transactional profit split (TPS) is a double or multiple-sided method and often can handle the problems associated with a one-sided method, TPS has its own issues in application. In particular, selecting and evaluating appropriate profit split allocation keys or factors is a significant challenge. How the factors should be selected and evaluated, while a few descriptions are included in the draft, has never been comprehensively discussed and fully documented. We suggest that the evaluation and application of allocation factors be more clearly articulated in the interests of establishing a more reliable and less subjective process and results. It may be that a decision tree process, in which each potential factor is methodically analyzed and accepted or rejected and, if accepted, given a relative weight, might be a potential methodology.

Specific Comments

The comments below contain our responses to specific questions in the discussion draft.

1. **High integration of functions and risks (Scenario 1)**

We agree that it is very possible that a transactional profit split (TPS) can be reliable in a situation where a high integration of functions and risks is observed, but more detailed guidance is needed. It is somewhat questionable if “high integration” alone is a precondition for the application of TPS as the very issue of high integration is itself a subjective judgment. This scenario also requires subsequent guidance as to appropriate profit split factors. Just as a lack of appropriate comparables is a challenge for applying TNMM, a lack of appropriate profit split factors is a challenge for a TPS. Thus, if only to provide a list of examples, a discussion of potential profit split factors for Scenario 1 would be helpful.

We also do not necessarily agree that complex transactional structures per se warrant the application of a TPS. Either TNMM or TPS can be applied to test a bundle of transactions as long as such bundling makes sense in terms of functions and risks.

2. **Multisided Business Models (Scenario 2)**

When a multisided business model is involved, it is conceivable that the profitability of the entire value chain needs to be evaluated under alternative models, and not just according to a single “business model.” It is further likely that routine comparables will be extremely difficult to find in this situation. While TPS can be a good candidate for the best method, as in Scenario 1, finding
appropriate profit split factors to measure relative contributions to value creation is a challenge, and it would be very helpful to give detailed guidance on such factors.

3. **Unique and valuable contributions (Scenario 3)**

While “unique and valuable contributions” is a relatively well-defined concept, it still poses a significant challenge in application. We have seen many cases similar to this scenario where the measurement of the relative contribution to value creation by Company S from customer-facing intangibles is controversial. It is also not easy to evaluate the relative contribution to value creation by possession of a trademark, while R&D expenditures, capitalized where appropriate, can be a good proxy for contribution to value by the activities or associated intangibles.

Given the difficulty of quantifying the relative contribution, it sometimes may be useful to find local comparables which also have similar intangibles due to “unique” market-facing activities in each respective market.

Since this scenario represents one of the most common of the difficult situations faced by taxpayers, it is certainly valuable to give more concrete and quantifiable examples.

4. **Integration and sharing of the risks (Scenario 4)**

If the group decides to implement profit sharing of the rewards associated with jointly developed intangibles, it is expected that TPS would be the TPM used to test the results. However, the question is whether such an arrangement set by the affiliates, in terms of relative contributions and profit shares, is economically sensible. Therefore, each participant’s contribution should be analyzed before selecting and applying TPS.

5. **Fragmentation**

The fragmentation discussion appears to be quite similar to the discussion of integration. Where the global value chains are integrated, it is likely that fragmentation will be observed. Where the fragmented portion of the business is not material, taxpayers potentially can still use transactional routine comparables, but if it is material, it would be difficult to find comparables. The challenge again is how the profit split factors can be identified and quantified while accommodating the fragmentation.

6. **Lack of comparables (Scenario 5)**

Again, a seeming lack of comparables should be carefully evaluated and determined. One might still find useful comparables with more relaxed screening criteria, or improve the level of comparability with appropriate economic adjustments. Another factor to be evaluated is the absolute level and fluctuation of global value chain profitability. If the total profitability fluctuates significantly year by year, or total profitability is really high or low with readily available, if not very
exact, comparables data, one can imagine the difficulty of applying a one-sided method since doing so may attribute all the non-routine profitability or loss to the other party, which only can be justified if the tested party is really a routine player with limited functions and risks.

The example contained in paragraph 32 is a good one and the method described in the paragraph certainly can be useful if the local subsidiary is more than a routine functional player with limited functions and risks, while finding an appropriate profit split factor between affiliates is not feasible or reliable.

7. Aligning taxation with value creation (Scenario 6)

Value creation is a broad concept and representative profit split factors are of course not limited to the three value drivers described: production capacity, headcount, and value of production. This discussion needs to be expanded, preferably with quantitative analysis, to explain relative contribution to value creation. For example, specific expenditure items such as R&D and advertising might be meaningful factors. Instead of capacity, an appropriate depreciation amount may be a more meaningful profit split factor, and have a higher degree of correlation with profits.

The proper weighting of factors is also important. Weighting should be considered to improve the reliability of the profit split results and not just as a conceptual exercise. This point will be discussed below in Scenario 8.

It is helpful to introduce specific methods to quantitatively evaluate relative contributions through various methods such as RACI. Much more detailed discussion is needed.

While global value chains are surely “heterogeneous”, we think it is possible to develop a framework for profit split factors applicable to the vast majority of the cases, if one can integrate a sufficient number of examples and cases.

8. Hard-to-value intangibles

It is of course true that TPS is applicable to hard-to-value intangibles, but it may not be appropriate to value such intangibles by their cost of development. Like other TPS analyses, appropriate factors commensurate with the value of the intangibles should carefully be selected and analyzed. It is our experience that valuation methods might be more reliable if observed income, rather than cost, is used to derive the value. In addition, cross-referencing among different valuation methods, rather than relying on a single factor only, may be useful.

9. Dealing with ex ante/ ex post results (Scenario 8)

TPS can be a great tool for handling unexpected results. In order to support an arm’s length outcome for unexpected ex post results, a TPS arrangement must be sufficiently robust ex ante.
Provided it is reasonable, TPS is established ex ante and applied both ex ante and ex post, and ex post profit or loss split results can still be viewed as arm’s length.

It may also be appropriate to determine a royalty according to the profitability of the global value chain via TPS. This also requires that the model used to determine the royalty is not arbitrary but robust. Such a “variable” royalty is clearly helpful in intercompany pricing by absorbing the “shock” of intra year fluctuations of profitability and by avoiding end of year transfer pricing adjustments.

The idea of applying reported industry data about success rates for risk-weighting factors to derive weighted relative contributions for TPS, as indicated in Scenario 8 (para 49), should be carefully analyzed and implemented. First of all, it is not correct to automatically give higher values to the factors with low success rates due to apparent higher risk. The risk-return relationship needs to be carefully analyzed. Usually in the given value chain, the appropriate mix of each activity is competitively or conventionally determined. For example, a pharmaceutical company would not spend more resources for basic research on innovative products just because of higher risk. Put differently, higher risk does not necessarily mean higher return, only higher expected return. More careful analysis may produce more appropriate weights for different categories of intangibles.

10. Dealing with losses (Scenario 9)

Independent parties can agree on relatively complex mechanisms to share profit and loss from a joint business. They can agree not only on different arrangements for handling profit as opposed to loss, they also can agree on different arrangements depending on the level of profitability. The point is that these arrangements have to be made in advance and must still be consistent with how the functions and risks are shared. If a subsidiary is neither completely routine with very limited functions and risks nor a full entrepreneur, such an arrangement as described in para 32, where the profitability of the subsidiary fluctuates within a predetermined range but not outside, might be feasible. Such an arrangement effectively warrants different rules of profit/loss sharing depending on the profitability of the global value chain.

Thank you for your consideration of our comments. Of course, please feel free to contact us should you have any questions.
Regards,

Steven D. Harris  
Co-director, North American Transfer Pricing  
AlixPartners LLP

Nobuo Mori, Managing Director  
AlixPartners LLP
AOTCA Opinion Statement on the OECD 2014 Public Discussion
Draft on (BEPS Action10)
The Use of Profit Splits in the Context of Global Value Chains

Prepared by the AOTCA Technical Committee and
submitted to the OECD on 4 February 2015
AOTCA was founded in 1992 by 10 tax professionals’ bodies located in the Asian and Oceanic regions. It has expanded to embrace 20 leading organizations from 16 countries/regions.

The foundation of AOTCA was attributed to the existence of the Confédération Fiscale Européenne (CFE), the international organization for tax advisors in the European Communities with a long history of 49 years.

Over the years tax professionals doing businesses in the Asian and Oceanic regions had been strongly conscious of the necessity that the same international professional body as CFE would exist in the area.

Introduction

The following comments relate to the OECD’s Public Discussion Draft BEPS Action 10 on the Use of Profit Splits in the Context of Global Value Chains.

1. The greater part of the Discussion Draft seeks to obtain information and opinions on how Profit Split should be applied to various assumed factual situations. To provide useful comment requires expertise in the transfer pricing area which is not readily available to AOTCA.

2. As a general observation particularly for developing economies in the Asia Oceania region there are a number of issues that arise from the profit split approach.
   a. Lack of information about independent enterprises due to the small market which promotes a move to the profit split approach but
   b. The difficulties often encountered by developing economies, often due to lack of resources, minimum or no treaty networks, no exchange of information agreements etc. in accessing information about affiliates in other jurisdictions.

Accordingly:

1. The guidance provided by the OECD should emphasise that this is a method of last resort.
2. It can only be viable if all the relevant jurisdictions freely and openly share information and co-operate in reaching a mutually agreed position. Perhaps MAP should be mandatory.
3. Inevitably the use of profit split is likely to result in a dispute as each jurisdiction seeks to defend its profit split approach. Double tax is the inevitable result.
6 February 2015

OECD

Dear Sirs

Feedback on BEPS Public Discussion Draft -
BEPS Action 10: Discussion draft on the use of profit splits in the context of global value chains issued on 16 December 2014

The Association of Banks in Singapore (ABS) would like to thank the OECD for the opportunity to comment on the discussion draft on Action 10.

Background

ABS plays an active role in promoting and representing the interests of the banking community in Singapore and has a membership of 150 local, foreign banks and financial institutions. ABS also works closely with the authorities in support of the development and maintenance of a sound financial system in Singapore.

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

Feedback

We understand and recognise the objective of BEPS in establishing guidelines that meets the goal of preventing base erosion and profit shifting. However, it is critically important that the OECD achieves this objective through a workable and economical framework for industries, which above all else, is consistent with local legal and regulatory regimes imposed on industries such as financial institutions.

In this regard, we set forth below our members’ feedback based on their experience in the application of profit split method to the highly integrated transactions within the context of its varied, complex and regulated nature of its business.

Approach to application of profit split method

It is not possible to provide a prescriptive approach to the application of a profit split method to taxpayers and their business models, and we seek OECD’s reconsideration of its intention to re-write the guidance in this area based on the following reasons.

1. Members of the banking industry have a wide variety of business models in place, and profit split methods will apply in different ways to different business models. More particularly for banks, there is the regulatory context to consider (e.g. meeting conditions of a banking licence which might not permit the absorption of losses locally), which will have a bearing on local profit and loss expectations.

2. There can be a variance between value creation (giving rise to profits) vis-à-vis loss creation function, and the incidence of losses may require additional analysis to understand the nature of the loss (normal trading losses, operational losses or credit losses) and the cause of the loss. This can mean that it might not be appropriate to take the same, consistent approach to the splitting of losses as one would apply to profits.
3. Having said that, the OECD guidance should recognise that there is a need to take into account the practicalities of managing the transfer pricing treatment for large integrated trading books and should not require a transaction by transaction analysis each time a loss occurs. For instance, depending on the factual analysis undertaken, it may be acceptable if both losses and profits are split using a consistent approach over time. It would be useful for the OECD to acknowledge that this may be a possible approach for taxpayers to use, rather than prescribing one approach over the other.

We would appreciate your consideration of our feedback. Thank you.

Yours sincerely

Mrs Ong-Ang Ai Boon
Director
Dear Mr. Hickman,

BDI\(^1\) refers to the OECD Discussion Draft “Use of Profit Splits in the Context of Global Value Chains (BEPS Action 10)” issued on 16 December 2014. We would like to thank you for the possibility to provide our comments that allow us to engage with you on these important issues and have limited our comments to some general issues of the Draft.

1. Profit splits tend to imply higher risks of dispute due to their inherent subjectivity. We therefore welcome the efforts to provide further clarity on the application of profit split methodologies and to towards developing more objectivity in profit split factors. However, profit splits usually deal with unique and valuable contributions. They should, by their very nature, be analyzed taking into account their own specific features. Developing principles and more specific rules on how to deal with profit splits therefore seems to encounter various difficulties.

2. It is important to strike the balance between further guidance on transactional profit split methods aiming at a better alignment of value creation and profits in specific circumstances and the risk that the amendments to the profit split guidance could lead to the unilateral and arbitrary application of formulary approaches: Such an approach would lead to substantially more uncertainty and disagreement, and could have a damaging impact on cross-border trade and investment. Also, it will probably be difficult for countries to agree on the same allocation factors (and their weightings) given

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\(^1\) BDI (Federation of German Industries) is the umbrella organization of German industry and industry-related service providers. It speaks on behalf of 36 sector associations and represents over 100,000 large, medium-sized and small enterprises with more than eight million employees. A third of German gross domestic product (GDP) is generated by German industry and industry-related service.
the divergent interests of the tax authorities, which may lead to greater litigation and increased compliance burdens.

3. Therefore, the arm’s length principle must remain the basic principle in transfer pricing and the ‘most appropriate method’ approach under the arm’s length principle should be preserved. However, in individual situations where related party transactions conducted by group companies are not easily comparable to independent party transactions, flexible approaches such as the transactional profit split method, could serve to provide greater simplicity and certainty. They should be considered as a method of last resort, used only in limited circumstances, and should not be automatically applied in certain situations.

4. The profit split guidance should ensure, even in cases where perfect comparables are not easily available, that “residual” profit is not allocated to ‘non-unique’ contributions. Instead, non-unique contributions should be rewarded consistently with their value creation. An approach that would allocate residual profit to such non-unique contributions risks creating competitive distortions, and could be viewed as a violation of the principle of tax “neutrality”. The fact that functions are highly integrated should not bring to a different interpretation of their nature, even in cases where perfect comparables are not easily available.

5. In general, we believe that principles and rules should be developed in such a way that they are capable of flexible application to the full spectrum of business fact patterns. This approach would reflect the increasing diversity and flexibility of business models of our global economy. With regard to the outline of global value chains, it therefore does not seem useful to attribute a specific meaning to “global value chains”, due to their heterogeneity (as noted also in the OECD report on „Interconnected Economies“) and evolving nature.

Please do not hesitate to contact us if you have any questions.

Sincerely,

Berthold Welling
Dr. Karoline Kampermann
6 February 2015

Dear Mr. Hickman,

DISCUSSION DRAFT ON THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAINS

BDO welcomes the opportunity to comment on the OECD’s Discussion Draft on the use of profit splits in the context of global value chains issued on 16 December 2014.

We support the OECD’s efforts to develop rules to prevent BEPS by engaging in transactions that would not or would only rarely occur between third parties. We believe that additional guidance on the application of profit split methods in the context of global value chain functions would be helpful in addressing situations where other methods may not be immediately appropriate.

We recognize that the profit split is a useful tool that can increase transparency, certainty, and robustness. It is also important to weigh the practicalities and administrative costs for businesses in implementing transactional profit split methods. We present our responses and comments to questions given under various sections and scenarios below.

Value Chains

Given the high level of interdependence and integrated functions among the OEMs, the residual profit split method may be the most appropriate method, if sufficient information is available. In applying this method, it is important to ensure that the results of a profit split are more reliable than a one-sided method. The residual profit split method calls for selecting and using allocation factors based on functions, risks, assets, and contributions. This selection process is subjective in nature; thus, the results of the profit split analysis are highly sensitive to the selected factors and any weight assigned. Given these subjective factors, it is not obvious that the one-sided methods will be relatively less reliable than the transactional profit split method.

Whether the transactional profit split is more useful than other methods depends on the specific facts of the case and the relative reliability of the methods, given available data. The transactional profit split method may be more appropriate than other, “one-sided” methods in situations where each of the transacting parties make “valuable and unique” contributions, or in situations where the parties engage in highly integrated activities. While one-sided transfer pricing methods can feasibly be applied, the trade-offs between the imperfections, reliability, practicality, and cost of the one-sided and profit split methods must be carefully balanced.
In applying the profit split method, we recognize that it may be difficult to identify a reliable factor to split profits between the transacting parties. As such, guidance should be provided on:

1. How to unbundle functions in a supply chain with highly integrated functions?
2. How to reliably split profits between the transacting parties? What are considered reliable allocation keys to split profits in a supply chain?
3. How to compare and value the contribution of risk-bearing and non-risk bearing activities, respectively?
4. How to compare and value intangible creation relative to other activities?

**Multisided Business Models**

In Scenario 2, the use of transactional profit split methods may be less appropriate. The local subsidiaries may perform functions, such as promoting and localizing products in local markets, which can be benchmarked using a one-sided method. Based on the information provided, it should be possible to identify reliable comparables. Even with comparables that do not meet the high comparability standards of one-sided methods, the transactional profit split methods may not produce more reliable results in this scenario.

To determine whether the transactional profit split method is appropriate, the scenario should provide additional explanation and facts of the value-added, non-routine intangibles created by the subsidiaries through their promotional activities. It would be helpful to elaborate on the following:

1. An enhanced profile of the risk and other characteristics of the local subsidiaries;
2. Whether the local subsidiaries license IP from Company R;
3. Whether the local subsidiaries perform any development efforts other than making suggestions on new features for the technology; and
4. Other than promoting and localizing products in local markets, whether the local subsidiaries make unique and valuable contributions to the combined results of the Group.

**Unique and valuable contributions**

Chapter VI of the Guidance on the Transfer Pricing Aspects of Intangibles defines a “unique and valuable” intangible as one that is not comparable to that used by or available to parties to potentially comparable transactions, and one that is expected to yield greater future economic benefits than would be expected in the absence of the intangible. In the context of transactional profit split methods, “unique and valuable contributions” may be interpreted in a similar way as a contribution made by the transacting parties that is hard to benchmark, but yields a competitive advantage for the business. In the context of the profit split method, “unique and valuable contributions” must be defined in a quantifiable and measurable way so that allocation factors could be readily identified.

**Integration and sharing of risks**

In Scenario 4, the transactional profit split method is appropriate when information is available to reliably measure and quantify the shared risks and relative value of functions among the affiliated entities. However, the scenario does not provide enough guidance on whether B and C fund their own R&D spending. If this is not the case, the transactional profit split method may not be the most appropriate method.
In addition, it would be helpful to elaborate on the contractual terms of the profit sharing arrangement among Companies A, B, and C. Draft guidance deemphasizing the role of simply funding the creation of intangibles is still in brackets. Further clarity is needed on how to measure funding and contribution as a value driver in applying the profit split methods, which should align with the discussion draft on risk, recharacterisation and special measures released on December 19, 2014. In addition, the Scenario should illustrate why and how Company A, B, and C share risks in the MNE group.

**Lack of comparables**

Based on the information provided in Scenario 5, the profit split method does not appear to be superior to a one-sided method. Building a case for the profit split method in this Scenario would require new and different facts. It would be helpful to elaborate on the following aspects:

1. Provide examples on what risks are shared or unique and valuable contributions are provided by the distribution entities;
2. Whether the operating companies in the MNE group are independent/entrepreneurial entities or routine distributors;
3. For the regional business, each operating company fulfills orders in accordance with the terms agreed. Please clarify where revenues are recorded for these order fulfillments;
4. How transactional profit split methods can be applied to account for incremental value added by each operating company fulfilling orders in the regional business; and
5. Since transactional profit split methods require more qualitative considerations that may be subject to more challenges, how would the use of transactional profit split methods in this Scenario provide more reliable results than another method, such as the TNMM?

**Aligning taxation with value creation**

The Guidance might be modified to provide specific examples and details in identifying factors that would reflect value creation, such as providing a listing of commonly seen factors that reflect value creation by transaction type. Below is a possible non-exclusive example of such a list:

<table>
<thead>
<tr>
<th>Type of Transaction</th>
<th>Allocation Factor</th>
<th>Key Value Drivers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>Production capacity</td>
<td>Capital investment</td>
</tr>
<tr>
<td></td>
<td>Headcount</td>
<td>Key input of labor</td>
</tr>
<tr>
<td></td>
<td>Value of production</td>
<td>Contribution to actual output</td>
</tr>
<tr>
<td>Distribution</td>
<td>Product revenues/Unit of product sold</td>
<td>Contribution to sales effort</td>
</tr>
<tr>
<td></td>
<td>Headcount</td>
<td>Key input of sales force</td>
</tr>
<tr>
<td></td>
<td>Operating expenses as a percentage of sales</td>
<td>Operational efficiency</td>
</tr>
</tbody>
</table>
Furthermore, weighting dissimilar contributions is a challenging, subjective, and often unavoidable task. Further guidance on, for example, risk weighting, with practical examples would be useful. For example, in comparing R&D spending to distribution spending, one can weight spending by an objective measure of the likelihood of success. Examples of other possible weighting schemes and principles would also be useful. Lastly, the Discussion Draft should clarify the acceptable types of the allocation keys (e.g., quantitative factors, qualitative factors, or others).

While factors at the present term, such as bargaining power, options available and RACI-type analysis may not be the easiest to apply, information necessary to apply these facts may be gathered through conducting functional analyses. In addition to these types of factors, it may be viable to blend in factors based on historical data points if such information is available. Potential recommended approach could include deriving a trend between historical contributions (e.g., R&D or marketing spending, etc.) and value creation, such as using econometric analysis to compare historical R&D or marketing spending to profit growth, which may help to refine and improve the reliability of profits split factors.

Whether a framework can be developed to reliably conduct a multifactor profit split analysis depends on how many contributing parties and types of activities are involved in a global value chain. The more parties and types of activities there are, the more complex the global value chain is, and the more difficult it is to develop a reliable framework. Further, any lack of transparency of information and data throughout the value chain may impose difficulty in establishing a reliable framework.

**Hard-to-value intangibles**

The profit split method, as we understand, does not generally value intangibles directly, but rather allocates claims to the returns from the intangible. If we disregard relative claims between two entities, a transactional profit split using cash flow projections essentially uses an income method to value intangibles, with the relative split of value being a subsequent and separate calculation.

With regard to the warnings in 6.147-6.148, the use of historic intangible development cost, with appropriate attention to relative riskiness and differential useful lives, to split claims to future intangible returns, is well established under transfer pricing doctrine in the U.S.

**Dealing with ex ante / ex post results**

A transactional profit split method analyzes a transaction based on the “valuable and unique” contributions by each party, in order to align profits with value creation. This concept should still apply when dealing with uncertain outcomes, and results should be adjusted to align actual results with actual contributions. However, as noted in Chapter VI of the interim guidance, the cost of the contributions may be unrelated to the values of such contributions. Thus, when evaluating each party’s “valuable and unique” contributions, certain non-monetary contributions should also be considered (e.g., milestones/achievements, ideas, etc.).

In Scenario 7, the challenge of using a profit split method is that non-monetary contributions are difficult to measure and support. Therefore, guidance should specify the following:

1. Situations where a transactional profit split method is acceptable, and how to increase reliability when applying this method; and
2. How to deal with *ex post* adjustments. Since transactional profit split method analyses are typically performed after the fiscal year, it would be helpful to clarify how to apply adjustments retroactively between countries.
Use of the Transactional Profit Split Method to Calculate a Royalty

Using a transactional profit split method to set a price is a helpful and common practice. It simplifies and provides greater certainty on application of the method. However, if the share of development contribution between the two parties changes, or if actual financial results differ from projections used to determine the royalty rate, then the royalty rate should be re-evaluated based on revised facts and information.

It would be helpful if guidance can be provided to specify a safe harbor rule in this situation, and clarify the acceptable range of deviation between actual and anticipated results, which in practice could be useful. For example, in Scenario 8, if the royalty rate is calculated to be 10% based on contribution ratio of 80:20 by P and S, and projected profits of 100:

What is the acceptable deviation in the contribution ratio to continue the use of a 10% royalty rate (e.g., if the actual contribution ratio turns out to be 75:25 by P and S, would a 10% royalty rate still be acceptable)?

What is the acceptable deviation in the projections to continue the use of a 10% royalty rate (e.g., if actual profits turn out to be 120, would a 10% royalty rate still be acceptable)?

Dealing with losses

As illustrated in Scenario 9, if a difference in application of the factor correlates with profit and loss is demonstrated, it may be appropriate to adjust the profit splitting factor(s) when there is a combined loss. However, the adjusted profit split ratio should still align with the profile of assets used, functions performed, risks assumed and value contributed by the parties involved in the transaction. A switch from profit to loss should not result in a discontinuous change in how the parties share operating results.

Under the arm’s length principle, it is difficult to justify sharing combined profits among parties without sharing losses. It is possible that there could be exceptional cases, such as when the combined losses are primarily caused by one party in the transaction. If the combined losses stem from one party of the transaction, then the combined losses should be borne primarily by that party.

Other Considerations

The practical difficulties outlined in Paragraph 2.114 of the Guidelines are still relevant when applying the transactional profit split method. Difficulty in accessing information from foreign affiliates (especially when the tested party is a subsidiary in a group) is the biggest issue. The parent company in a group may be reluctant to share financial information with its subsidiary, even if the subsidiary contributes to the value creation of the group. Another commonly seen difficulty involves quantifying non-monetary contribution factors to split profits. While each of these issues impose challenges in applying the profit split method, most of them may be addressed through making certain assumptions based on the best available information.

Again, even when the transactional profit split method is appropriate, the practical challenges, complexity and subjective nature of the method must be considered carefully. Although there are weaknesses in a one-sided method when good comparables are unavailable, it is not obvious that the one-sided methods will be relatively less reliable than the transactional profit split method, given the subjective factors involved in applying the transactional profit split method.
It should also be emphasized that there is no hierarchy of methods between one-sided methods and transactional profit split methods. Selecting the most appropriate method should be based on the reliability of results each method yields in different situations. Extensive guidance is still needed on appropriate application of the transactional profit split method in complex situations. Currently, application of the profit split method requires greater subjective analysis in setting and defense, which creates uncertainty and poses an administrative burden for businesses.

**Conclusion**

We support the OECD’s efforts to provide clarity in the application of transactional profit split method under the context of highly integrated MNE groups operating within a global value chain.

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

For clarification of any aspect of our responses presented above please contact:

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BEPS MONITORING GROUP

Comments on BEPS Action 10: The Use of Profit Splits in the Context of Global Value Chains

This report is published by the BEPS Monitoring Group (BMG). The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This paper has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

This paper has been prepared by Jeffery Kadet and Sol Picciotto, with comments and input from Richard Murphy, Attiya Waris, Francis Weyzig, Yansheng Zhu and other members of the Group.

We welcome this opportunity to comment on the Discussion Draft, and would also be willing to speak at the public consultation on the subject.

ABSTRACT

The BMG welcomes this report from the OECD, which confirms that the time has arrived for expanded use of the profit split method, placed on a more regularised and systematic foundation. In our view there is a serious need to develop a simple-to-apply reliable approach to determining how profits will be apportioned amongst the members of a centrally managed multinational group. Specifically, we suggest that the Transfer Pricing Guidelines should include clear guidance stating concrete allocation keys and weightings for all business models now commonly being used. Anticipating the likely emergence of new business models, the Guidelines should also articulate the principles on which concrete allocation keys and weightings should be determined. Such simple and clear rules would be easier to administer, and greatly reduce conflicts both between tax authorities and companies, and among tax authorities. They would make an enormous step towards achieving the aim set by the G20 that multinationals should be taxed ‘where economic activities take place and value is created’.

1. General Remarks

A. Clarifying the Basis of the Profit Split Method

1. Transfer pricing rules are based on article 9 of tax treaties, which gives a power to adjust the accounts of associated enterprises according to the independent entity principle. Hence, they have become the major mechanism for apportioning the tax base of multinationals. Indeed, they have been made to bear far too much weight, for two key and interrelated reasons. The main reason is that article 9 has increasingly been interpreted to require entities which are affiliates of a multinational corporate group to be treated as if they were independent of each other. We believe that this is a misinterpretation, since the purpose of article 9 is to permit the adjustment of accounts of related entities to ensure an appropriate profit allocation. The independent entity criterion
for such adjustments specified in article 9 dates back to 1935, but since then both practical experience and the economic theory of the firm have shown that it is unworkable, since associated entities are not in fact independent parties and generally do not in any way behave like separate parties that are negotiating their relationship and transactions at arm’s length. Relatedly, the rules for attributing revenues and costs (and hence income) to different entities have become increasingly subjective, unclear and contested. Unsurprisingly, multinationals have themselves exacerbated the problems, by taking advantage of the separate entity concept to restructure by fragmenting their activities so that different functions are assigned to various entities in ways that minimise tax liability and achieve their BEPS objectives.

2. The mandate from the G20 for the BEPS project offers an opportunity to reorient the system, with the aim of ensuring that multinationals are taxed ‘where economic activities take place and value is created’. The new orientation means replacing the fiction of separate legal personality in those situations where it does not reflect economic substance with a holistic approach which treats corporate groups in accordance with the business reality that they are run as integrated enterprises. This would provide a much sounder foundation for rules to attribute both costs and revenues which could be simpler and easier to administer. It is heartening that some of the proposals resulting from the Action Plan have adopted this approach, notably those under Action 4 on interest deduction, and the simplified method for apportioning central service costs proposed under Action 10.

3. Regrettably, some of the proposals are confused and contradictory, mainly because they lack a clear and coherent orientation. This seems particularly the case in relation to transfer pricing rules. The continual evocation of the mantra of the arm’s length principle seems aimed at reassuring traditionalists that no significant changes are intended. At the same time, many of the proposals now put forward, in particular for revision of Chapter 1 of the Guidelines, strongly suggest moving away from the legal fictions of corporate personality and contracts between related entities, and the increased use of the profit split method.

4. This ambivalence goes back at least two decades, to the early 1990s when the OECD first confronted the central problem of the unsuitability of the comparable uncontrolled price (CUP) method due to lack of suitable comparables. Although this led to acceptance of profit-split, which entails apportionment of aggregate profits, it has been described as a ‘transactional’ method and based on the arm’s length principle. Worse, it has been treated simply as a fall-back, and no serious attempt has been made to formalise or systematise it, so that its application remains arbitrary, or merely a basis for bargaining.

5. We are therefore encouraged by the present consideration being given to the profit split method, and that the Discussion Draft on the Use of Profit Splits makes clear that this

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1 Proposals by the US to introduce a ‘comparable profit method’ in 1992 were strongly criticised by other OECD members, and a Task Force produced two reports on the proposals; the second report welcomed the introduction of a profit-split approach in the final US regulations, resulting in acceptance by the OECD of this method and its elaboration in the 1995 OECD Transfer Pricing Guidelines, somewhat revised in the 2010 Guidelines.
approach has a more important future. However, we consider that it should be made explicit that this method is not based on the separate entity concept. So far this is only hinted at in the reports. For example, present guidance in paragraph 2.108 of the Guidelines provides that the application of the profit split method must determine ‘the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions’. In contrast, paragraph 1 of this Discussion Draft begins by stating:

This document invites responses to questions that seek to gain insight about experiences and best practices in applying transactional profit splits, and views on how current guidance might be amended in order that transactional profit splits can assure that transfer pricing outcomes are in line with value creation. [Emphasis added.]

The term ‘transactional profit split’ is contradictory and confusing, and should not be used. It should be made explicit that profit split is a method of apportioning profits to ensure outcomes that are in line with the location of economic activities and value creation. This clarification should involve a more thorough revision of chapter 1 of the Transfer Pricing Guidelines, as we have recommended in our comments on the DD on Revisions to Chapter I of Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures).

6. To the extent that there is a guiding principle for the reforms proposed for transfer pricing rules, it is that profits should be attributed according to the functions performed, assets owned and risks borne by each entity. Unfortunately, this retains the fundamental ambivalence about how to treat the fictions of separate entities and contractual transfers within a corporate group. This can be seen perhaps most clearly in relation to the concept of ‘risk’. As we argue in greater detail in our separate submission on the proposals on Revisions to Chapter I of Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures), it should be clearly and explicitly recognised that any supposed transfer of risk within an integrated enterprise is fictitious and notional. To continue to accept the idea that risks can be borne by a particular affiliate is a recipe for encouraging elaborate BEPS motivated tax restructuring, and for continued conflicts between taxpayers and tax administrations, and between countries, over the inevitably subjective evaluations of risk and the appropriate return to risk. This cannot be what is meant by aligning taxation with the location of economic activities and value creation.

7. An explicit acknowledgment that profit split is a profit apportionment method should also be accompanied by an explanation in the Commentaries of the rationale for this approach. This is based on the understanding that for a MNC which operates on an integrated basis, attempting to treat its various affiliates as if they were independent makes no sense and is therefore unworkable in practice. In addition to the basic problem of lack of suitable comparables, the integrated nature of the activities of such a firm means that it is difficult or impossible to decide what proportion of the profits to attribute to particular functions, activities, or assets. To take a familiar example, that of a pharmaceutical company earning large profits from sales of proprietary medicines: it may be thought that these are mainly attributable to the laboratory research identifying the specific drugs concerned; but such discoveries only have value following an extensive
and expensive process of development, trials and regulatory approvals; and the resulting revenues also depend to a great extent on marketing efforts, on which far more can be spent than on the primary research. A profit apportionment method such as profit split avoids these problems by allocating profit using allocation keys which reflect the real economic presence of the firm in the countries concerned, usually based on employees, level of expenses, and revenues.

**B. The Need for simplified methods**

1. A second general point should be made before beginning our specific comments below. The feedback from developing countries on the BEPS project has stressed the importance for them of formulating solutions that are simple and easy to administer. This should indeed be a concern for all tax administrations, which everywhere are being expected to do more with fewer resources. The discussions of risk in Section D of Chapter I and of Intangibles in Chapter VI of the Transfer Pricing Guidelines provide an excellent illustration of the differing platforms from which MNCs and interested tax authorities are operating. The discussion makes clear the need for a detailed analysis that includes the various legal effects of the form of intangible property concerned, the various commercial and legal effects of any contractual terms concerning those intangibles, and the functions performed, assets owned and risk assumed by the various parties. Each MNC that has implemented BEPS structuring has a relative army of in-house legal, tax, and other specialty personnel whose jobs it is to understand and protect the MNC’s interests. Most MNCs also engage outside counsel, tax advisors, economic analysts, and other specialists as well. On the other hand, the tax authorities in this world, especially in developing countries, have far fewer resources. This inequality of resources is a major disadvantage of transfer pricing methods which rely on detailed ‘facts and circumstances’ examination and ‘functions, assets and risks’ analysis of each corporate value chain. Under this approach it is difficult for tax authorities to challenge a company’s structures and policies, if they are fully explained and documented, without applying equivalent resources to analysing those structures and policies. It may be noted that recent reporting has indicated that even the United States tax authorities have hired outside counsel to help them with an ongoing transfer pricing review of Microsoft at a cost in the millions of dollars. No tax authority can afford to apply such resources to ensure a detailed audit of every multinational within its jurisdiction. This approach benefits only the large tax advisory firms who offer services of transfer pricing analysis and documentation, and the consultants who have made transfer pricing regulation a big business.

2. In our view a key answer to this problem in the short-term context of the 2015 BEPS deliverables is to significantly expand the use of the profit split method and to provide formulary guidance for concrete and objective, easy-to-compute allocation keys that makes it easy to administer by tax authorities in all countries. This may well involve a trade-off between the fine-tuning of the transfer pricing result in each specific case with simplicity of application. However, the present overwhelming need is to develop a system that will really work in practice. Fine-tuning should be limited to exceptional cases where large sums are involved, which may often need to be dealt with on an ad hoc basis, e.g. through Advance Price Agreements.
3. We endorse and support the formulations stating the goals of good tax policy in the Action 1 2014 Deliverable, *Addressing the Tax Challenges of the Digital Economy*, Section 2.1. Those listed are neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. Without undue sarcasm, it should be pointed out that these goals do not include creating a mentally challenging exercise that is fun for professional accountants and lawyers to pursue. On the other hand, a method which could be simple to understand and apply would be a profit split method that uses concrete allocation keys. This eliminates Solomon-like subjective decision making for both taxpayers and tax authorities alike, and would meet a number of these tax policy goals.

- **Neutrality**
  Since concrete allocation keys that focus on objective factors such as personnel, expense levels, revenue, customers, etc. will all be independent of the form of business activity used by any MNC, neutrality will be achieved. MNCs can choose their form of business organization based on business and legal objectives, independent of tax considerations. This should also result in fewer of the convoluted structures that so many MNCs now use to pursue their BEPS objectives.

- **Efficiency**
  Compliance costs to business and administration costs for governments will clearly be minimized.

- **Certainty and Simplicity**
  The use of concrete allocation keys clearly creates certainty and simplicity in comparison to seriously subjective analyses of relative risk and relative value of intangibles.

  The Action 1 2014 Deliverable in Section 2.1 also notes: ‘Complexity also favours aggressive tax planning, which may trigger deadweight losses for the economy’.

- **Effectiveness and Fairness**
  The resource imbalance between wealthy taxpayer MNC groups and tax authorities, many of which are seriously underfunded, will be reduced whilst smaller taxpayer entities will have a greater chance of achieving fair outcomes compared to the wealthy MNCs.

We could continue the above listing and note how this simpler-to-apply profit split method also contributes to flexibility. However, enough has been said.

2. **Specific Comments**

A. Scenario 1, Question 4:

*What guidance should be provided to address the appropriate application of transactional profit split methods to deal with these aspects of value chains?*
1. First, a general comment regarding the background facts of this Scenario. A royalty is being paid to the non-EU parent of the group. The facts stipulate that aside from this royalty, ‘the European operation of the group is largely independent of the parent.’ Para 10 goes on to say:

In this scenario one-sided methods can reliably be used to determine arm’s length pricing for the royalty and for the contract manufacturing and distribution services.

If we look at many of the successful profit shifting groups, the convoluted intra-group structures and royalty streams that they create for group-developed IP, manufacturing, and distribution are integral parts of the profit shifting mechanisms. Further, IP in particular is typically unique such that there are normally no comparable unrelated party transactions that would allow a true arm’s length royalty to be determined. Hence, we strongly suggest that future example guidance for ‘value chain’ situations assume as background that the IP development is a part of the activities to which the profit-split method is to be applied. As for contract manufacturing and distribution services, we suggest that at least one example similarly include such activities and indicate as background a situation where the manufacturing and/or distribution functions are unique and are appropriately a part of the combined income subject to the profit split method.

2. Now to our specific response to Question 4. There are two aspects of this. First of course is how to measure the profits to be split. Second is how to split the combined profits amongst the associated companies.

3. In regard to the second aspect regarding how to split the combined profits, a particularly relevant point is that **certain factors are pretty much all 100% within the control of group management**. These include intra-group factors such as:

- Capital structuring of subsidiaries, both concerning the specific categories and types of shares or securities issued as well as the specific ownership of each group member by one or more other group members,
- Form of organization of each group member as a corporation, LLC, partnership, branch or other available form of organization,
- Financings both between associated companies and from third parties where pledges or guarantees have been made by associated companies,
- Contractual sharing of risk, e.g. which associated company will bear risk of inventory obsolescence, customer credit risk, etc., and
- IP-related agreements including, for example, R&D and software service contracts, cost sharing agreements, licenses and transfers.

A value chain will of course be based on many legitimate business and investment decisions regarding where to conduct R&D and software development, what R&D to conduct and what software to develop, what products to produce and how and where to produce them and later market them, where to inventory them, whether regional warehousing is required and if so where to place it, what internet presence is necessary and what personnel will be responsible to maintain it, etc. All of these business and
investment decisions will determine the real third-party facing functions, assets, and risks that the group conducts, owns and assumes throughout the value chain. These functions, assets and risks are reflected in the financial statements that purport to inform the public of the financial position and operating results of the group. Those financial statements eliminate all intra-group dealings and capital ownership since they are all internal and have no “reality” to the external world.

4. Where the profit split method is the most appropriate method, then all internal intra-group factors must be ignored with only the real third-party facing functions, assets, and risks being considered in the transfer pricing analysis. Such an analysis would take into account operational factors such as employees and their real responsibilities, revenue and customers, operational tangible assets, R&D functions, design functions, manufacturing, sales functions, expense levels, etc. It would ignore the effects of all intra-group agreements and capital ownership that shift revenue, expenses, and risk amongst the group members. This is absolutely necessary to achieve the goals of BEPS Action 9 on Risks and Capital, which states its aims in part as: ‘to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital’. This guidance must be incorporated into Section C.3 of Chapter II, Part III of the Guidelines.

B. Scenario 2, Question 5:

Can transactional profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how?

We recommend the use for this Scenario 2 business model of two equally weighted allocation keys as follows:

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

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

  This key would include categories of expenses such as:

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

C. Scenario 3, Question 7:

Does the way in which “unique and valuable” is defined for intangibles assist in defining the term “unique and valuable contributions” in relation to the transactional profit split method?

1. Yes, it will assist in analyzing specific situations in relation to deciding whether the profit split method is the most appropriate transfer pricing method to apply.

2. In considering this determination of the most appropriate transfer pricing method to apply, it is more than fair to say that taxpayers will know their own intangibles and contributions intimately. On the other hand, tax authorities in all countries, whether developed or developing, will be at a disadvantage in understanding both a taxpayer’s specific situation regarding intangibles and contributions and those of other players in the taxpayer’s industry or trade segment. We suggest, therefore, that Paragraph 6.17 (or some other appropriate paragraph) include the following language: ‘In the event that any tax authority believes that any associated company holds unique and valuable intangibles or provides unique and valuable contributions, the burden of proof to establish the contrary will be on the applicable taxpayer.’

D. Scenario 3, Question 9:

Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm’s length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?

1. In this situation for Scenario 3, we recommend the use of three allocation keys to be applied to the combined profits of Companies P and S with the indicated weighting as follows:

   - Sales (weighted at 25%)
     The inclusion of sales as one of the allocation keys reflects the importance of each market and its customers to the global business of Companies P and S. The country of sale should be determined by the location of the customer and not the legal terms of the sales contract. (See concluding comment in this section concerning this sales allocation key.)

   - Marketing and Distribution Expenses (weighted at 25%)
     Para 2.138 of Transfer Pricing Guidelines provides, in part:
     An allocation key based on expenses may be appropriate where it is possible to identify a strong correlation between relative expenses incurred and relative value added. For example, marketing expenses may be an appropriate key for distributors-marketers if advertising generates material
marketing intangibles, e.g. in consumer goods where the value of marketing intangibles is affected by advertising.

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

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

Advertising expenses (allocated by market that advertising targets)

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

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

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

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

This key would include categories of expenses such as:

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

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

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

2. Note that there is no allocation key for property or inventory. Regarding property (including rented and leased property), we believe that the value and extent of facilities will most typically be reflected by the labour retained by each group member. This reliance on labour also avoids all the difficult property valuation issues that inevitably arise if property is included as a direct allocation key. If depreciation (book or tax) were to be used, the many varying methods, lives, and inconsistent treatments make these too subjective and subject to potential abuse. Regarding inventory, the sales allocation key measures the importance of the source market and suggests that inventory and inventory transportation costs could be duplicative, to some extent.

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

4. An alternative approach would be to eliminate the ‘sales’ allocation key and then equally weight the remaining two keys. This would leave the ‘sales’ key to be used only in cases where there has been a meaningful creation of value due to participation of local users and consumers. If the ‘sales’ key were eliminated, then consideration should be given to including a key for the value of inventory allocated by location where maintained.

E. Scenario 4, Question 11:

In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks?

1. Within any group of associated companies, the assignment of the rewards of business success and the assumptions of business risk amongst the group members are totally within the control of the group’s management. They typically exercise this control through inter-affiliate contracts that are specifically structured to provide what they
perceive as the best tax result for the group. These contracts and agreements are in no way documents resulting from arm’s length negotiations between unrelated persons.

2. Given the serious and effective use that this control and the contractual mechanism has provided to multinational groups, we believe that business opportunity and risk cannot be an allocation key or otherwise be used in the process of applying the profit split method. Rather, the actual physical aspects of the conduct of business (location of employees, property, customers, etc.) must be the factors on which the profit split method is based. When this is done, factors such as personnel numbers and personnel costs will reflect the relative business benefits and risks that are spread amongst the countries in which the group operates. Such an allocation key approach will also be administratively much easier to apply than a person-by-person analysis and weighing of the exact relative management functions performed by each executive with often overlapping responsibilities.

F. Scenario 4, Question 12:

*Would a one-sided method produce more reliable results?*

A one-sided method would be totally inappropriate in Scenario 4. To be at all appropriate, a one-sided method assumes that the measured side will be performing activities that carry very little, if any, business opportunity or business risk. The facts specify that: ‘Companies A, B and C each control and perform their own research, development and production processes’.

G. Scenario 4, Question 13:

*What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?*

The facts of Scenario 4 are sufficient. Nothing further needs to be elaborated to establish the need for use of the profit split method. The integrated nature of the group’s business of developing and selling medical equipment products using proprietary IP developed by each of the three identified group members makes this clear.

H. Fragmentation

*General Comments*

1. While we agree that there can be legitimate business and legal reasons why a multinational group might choose to organise certain of its activities and functions under distinct affiliates, we believe that the vast bulk of what can be described as fragmentation is motivated principally to achieve a better tax answer rather than to accomplish any important business or legal objective. The extent of the recent Luxembourg tax ruling leaks clearly demonstrates this. Fragmentation is an accepted and regularly conducted part of the tax planning/tax avoidance toolkit practiced by virtually all multinationals and definitely by all of their legal and tax advisors.

2. In our view, therefore, it is essential for the success of the BEPS project to make clear the necessity of moving away from the presumption of acceptance of the separate entity existence of associated enterprises. Without this recognition,
fragmentation would be sure to continue as an important tax planning/tax avoidance tool. For this reason our submission on Action 7 concerning PE Status recommends a reconsideration of article 5(7) of the Model Convention. Such a reversal of the presumption would much reduce the need for detailed analysis of corporate structures to decide whether and to what extent a particular affiliate or sub-group should be regarded as not part of the integrated business. Such an analysis requires a tax authority to identify all relevant group entities within any fragmented structure and truly understand their respective roles and the contractual and financial flows between them. Under current rules, it is only in this way that a tax authority can determine, for example:

- If each player’s separate existence should be respected (i.e., whether non-recognition or re-characterization should be considered),
- Whether any player’s activities cause it to have an unregistered branch (i.e. permanent establishment) that exists under current domestic rules or an applicable treaty or in the future under any expanded PE definition that emerges from the BEPS,
- The appropriate characterization for tax purposes of the various contractual relationships and financial flows, and
- Whether a transfer pricing review is appropriate for any such financial flows as appropriately characterized.

Typically, the MNC and its advisors will be well aware of the big picture and objectives of the planning as well as all the created entities and what functions, assets and risks each will conduct, own or assume, and will illustrate these for themselves in charts and diagrams. However, under current rules most tax authorities would never see these charts and diagrams. Under normal circumstances, the tax authorities in source countries, and often in home countries as well, will never be aware that careful and concise fragmentation planning has even occurred. All these tax authorities will see is what the MNC intends for them to see. This reality is at the heart of fragmentation planning: show the relevant tax authorities what you want them to see and no more. Since they are not aware of what they can’t see, tax authorities cannot ask appropriate questions that will allow them to carry out their functions and collect legally due taxes.

3. This situation should be transformed if the proposals under Action 13 on Country by Country Reporting and Transfer Pricing Documentation can be successfully implemented on a worldwide basis. The combination of the Country by Country Report and the Transfer Pricing Master File, which in our view should be directly and automatically supplied to all countries where the MNC may have a taxable presence, should give all tax authorities both an overview of the firm as a whole, and the detailed information on legal and ownership structure and geographical location. In addition, the new Local File will include much relevant information including a local organization chart, information on material controlled transactions, and copies of material intercompany agreements concluded by local group entities.

4. However, even where information on all participants in a fragmentation plan are included these three reports, the reports will not set out in any easily understandable
manner the fragmentation planning that an MNC has undertaken. There will be no nicely prepared charts and diagrams showing for each fragmentation planning the participating group entities and the contractual relationships and financial flows amongst them. In short, as the tax authorities in both MNC home countries and source countries view the three reports, there will be no obvious indication of the existence of fragmentation planning focused on their respective countries.

5. Fragmentation planning isolates various functions, assets, and risks so that they will appear unconnected with various source countries to which they truly relate. Hence, in many if not most cases, group entities involved in fragmentation planning will not be included in the ‘local files’ of the countries to which significant portions of their operations relate. In addition, contractual relationships and payment flows will often be structured so that no source country entity is a direct counterparty. Where this is the case, the applicable ‘local files’ are unlikely to include any information suggesting even the existence of such group entities involved in fragmentation.

6. Hence, we suggest that the BEPS project in considering fragmentation, for both the transfer pricing rules as well as other special measures, provide clear guidance for both MNC home and source countries including:

- How to recognize the possible existence of fragmentation planning,
- The various implications regarding potential non-recognition and re-characterization of entities, contractual relationships and financial flows,
- The potential application of permanent establishment, CFC, and other applicable taxation mechanisms to counteract BEPS behaviour, and
- The application of the profit split method to MNC group entities involve in fragmentation planning.

I. Question 14:

Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how?

Guidance similar to what is provided above in our responses to Questions 5 and 9 should be given regarding allocation keys that should be used for varying types of MNC group transactions for which the profit split method is appropriate.

J. Question 15:

Can transactional profit split methods be used to provide reliable arm’s length transfer pricing solutions for fragmented functions? If so how? Can other methods address the issue of fragmentation, and, if so, how?

1. The profit split method is normally the most appropriate one to be used in such cases. MNCs have total control to fragment by creating whatever organization chart they believe will result in the lowest effective tax rate on a worldwide basis. The following, which is from Part I, Para 85 of the BEPS Action 8, 9 and 10: Discussion Draft on Revisions to Chapter I, clearly acknowledges this total control:
‘Attributes of non-arm’s length arrangements can be facilitated by the ability of MNE groups to create multiple separate group companies, and to determine which companies own which assets, carry out which activities, assume which risks under contracts, and engage in transactions with one another accordingly, in the knowledge that the consequences of the allocation of assets, function, and risks to separate legal entities is overridden by control.’

2. Recognizing this total control to fragment functions, risks and assets, the best way to truly align value and profits is with profit split methods. These methods are the only ones that truly counteract and nullify the carefully crafted BEPS fragmentation planning that MNCs have so successfully conducted over the past several decades.

K. Question 16:

*What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?*

No comments.

L. Aligning Taxation with Value Creation:

*General Comments*

1. We are very much encouraged by the suggestion in this section for the use of more concrete allocation keys. We believe that this is a very positive approach that will greatly simplify administration of transfer pricing and reduce potential conflicts. In particular, we especially applaud the approach of focusing on concrete factors such as production capacity, headcount, and value of production and ignoring the soft and subjective areas such as intangibles and risk. Perhaps ‘ignoring’ is not the best word to use since the reality is that abstract and hence nebulous factors like intangibles and risk will normally be adequately reflected by these more concrete factors. Hence, they are not being ignored; rather, they are being accounted for in a very much more concrete and practical manner.

2. Earlier within this submission in the responses to Questions 5 and 9, we set out several similar approaches to the use of concrete allocation keys. We strongly suggest that the Guidelines should include clear guidance stating concrete allocation keys and weightings for all business models now commonly being used. Anticipating the likely emergence of new business models, the Guidelines should also articulate the principles on which concrete allocation keys and weightings should be determined.

3. In support of this simplified approach, it is clear that any allocation of profits of a complicated corporate structure that results from the current approach based on a detailed assessment of functions, assets and risks will by its inherently subjective nature only result in a very wide range of possible profit allocations. The use of simple-to-apply concrete allocation keys that are appropriate for the particular business model used will result in profit allocations that will virtually always fall within this wide range. Adoption of such an approach will ensure a reduction in BEPS behaviour, greatly enhance the ability of tax authorities to actually administer and collect taxes, and reduce conflicts both between tax authorities and taxpayers and among tax authorities.
M. Question 22:

*In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?*

1. As explained above, guidance should be modified to provide concrete allocation keys and weightings for each business model now being used and the principles on which concrete allocation keys and weightings should be determined for new business models that appear in the future.

2. For example, where an MNC uses a business model of developing, maintaining, and exploiting an internet platform that provides free service to customers and charges advertisers and others for access to that customer base, then the following concrete equally weighted allocation keys could be used:

- The number of customers using the MNC’s services in each country, and
- Operating expenses including all research and development, website maintenance, sales, marketing, distribution, management, support functions, etc.

Additional details are included in our response to Question 5 above, which concerns Scenario 2.

See also our response to Question 9 above, which concerns Scenario 3. This involves a business model where a manufacturer and its distributor subsidiary each hold important self-developed intangible property. The following concrete allocation keys could be used with the indicated weighting. There are additional details and discussion on this in our response to Question 9 above.

- Sales (weighted at 25%)
- Marketing and Distribution Expenses (weighted at 25%)
- Expenses Other than Marketing and Distribution Expenses (weighted at 50%)

N. Question 23:

*What guidance is needed on weighting of factors?*

As indicated above, the guidance to be provided on the weighting of allocation keys for each type of business model should be specific set percentages. We strongly recommend including specific set percentages such as those included in our responses to Questions 5, 9, and 22 because that will provide administrative simplicity and many fewer disputes. The only cost would be a little less specificity, and given the subjectivity of any theoretical arguments on the relative weighting of the allocation factors, this ‘cost’ is indeed very low.

O. Question 24:

*How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for
example approaches based on concepts of bargaining power, options realistically available, or a RACI-type analysis of responsibilities and decision making)?

As indicated above, we strongly support the use of concrete approaches that will ease the transfer pricing process and reduce conflicts. We do not have practical experience with RACI-type analysis. If this is an approach that can be made with relative objectivity, then we fully support its use as an allocation key. If on the other hand it carries only slightly less subjectivity that dealing with Solomon-like judgments on issues of relative risk and the value of differing intangibles, then we recommend that RACI analysis not be used as an allocation key. Rather, easily measurable and objective keys such as personnel headcount and total compensation costs should be used. The latter of these two (total compensation costs) would normally be used within the analysis of any business model that involves relative risk and intangibles since compensation costs will reflect the higher paid personnel who typically make business risk and intangible decisions.

P. Question 25:

Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an MNC operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate?

1. It is certainly possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an MNC operates an integrated global value chain. As explained in more detail in our response to Question 9 above, the following allocation keys and weighting would provide a simple and easy-to-apply approach to allocating profits under the profit split method for an integrated global value chain model. There are considerable additional details and discussion on this in our response to Question 9 above.

   - Sales (weighted at 25%)
   - Marketing and Distribution Expenses (weighted at 25%)
   - Expenses Other than Marketing and Distribution Expenses (weighted at 50%)

2. Again, as noted in the above general comments, such a simplified approach will normally result in a profit allocation that is within the very wide range of outcomes that would result from a theoretically correct and terribly subjective assessment of functions, assets, and risks. The reduction in BEPS behaviour, the ability of tax authorities to actually administer and collect taxes, and the reduction in conflicts will be very much worth any reduction in specificity of the process itself.

Q. Hard-to-Value Intangibles

General Comments

1. We believe that using the profit split method on a mandatory basis and with concrete allocation keys will be the best approach to discouraging BEPS behaviour with respect to the transfer of partially developed intangibles.
2. BEPS tax avoidance planning often involves the transfer of partially developed intangibles to a low or zero-taxed associated enterprise. Commonly, these transferee enterprises have few if any operations of their own or capability to either conduct or even oversee the completion of the intangible project. In such cases, the application of a profit split method using appropriate concrete allocation keys for the particular business model would apportion profit to the associated enterprises where real activities take place and little, if any, within the low or zero-taxed associated enterprise that nominally owns the intangibles. Because in such situations the transferor usually continues to be involved in R&D efforts and maintenance/enhancement following the transfer of the partially developed intangible project as well as its exploitation, the transferor’s real activities will be reflected in the various concrete allocation keys. As long as the profit split method is consistently applied throughout the life of the intangible’s development and subsequent exploitation, taxation will align with value creation.

3. Assume next that the transferee, whether taxed within its countries of operation at normal rates or at low or zero rates, is an associated enterprise that truly carries on its own activities through its own competent and capable personnel so that the transferor is no longer involved (and therefore would not have activities picked up by the applicable concrete allocation keys). In this situation, an approach such as the special measure suggested in Part II, Option 1 of the BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter 1 would be appropriate to apply. We applaud the suggestion of this Option 1 and believe that it is a necessary addition to the Transfer Pricing Guidelines.

R. Question 26:

*What specific aspects of transactional profit split approaches may be particularly relevant in determining arm’s length outcomes for transactions involving hard-to-value intangibles?*

No further comments in addition to the above general comments.

S. Scenario 7, Question 27:

*How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?*

1. The focus of this scenario and question is on dealing with *ex ante/ex post* result differences. A first important point is that the two associated enterprises have common ownership and common control. Is this common ownership and control 100%? This will typically be the case in most MNC situations. Assume for this initial discussion that there is no significant level of minority ownership.

2. Even though two associated enterprises have 100% common ownership and control, there can be legitimate reasons why they might make an agreement such as described in Scenario 7. For example, they could have completely separate managements and operations that are each judged for employee compensation and bonus purposes based on the relevant company’s operating results. This of course is fine as it presumably helps the common owner motivate and compensate appropriately the personnel of each company. While the common owner chooses to organize its affairs in this multiple management group manner, this owner alone will ultimately bear the economic costs of the taxation of
the two associated enterprises. Our overall tax policy goal is to see that the overall tax costs are fair to both this owner and the relevant countries in which these two associated enterprises operate. As further tax policy goals, the approach used to determine the profits of each company must be easily administrable and not an undue burden to either the companies or the tax authorities.

3. The transfer pricing method to be used must consider the tax policy goals discussed in Section 1B above (i.e. fairness, ease of administration, etc.) as well as the factual uncertainty regarding whether one or both of the companies might incur cost overruns that will affect economic outcome. In this case, the simplicity and ease of using a profit split method with concrete allocation keys on an ex post results basis is compelling. The owner is free to organize his activities as he chooses, but this much simpler approach to determining the portion of profit to be reflected in each enterprise will in fact better align taxation with value creation. Whether a cost overrun was caused by some unforeseen circumstances or merely from a bad initial cost estimate will not be a concern to the tax authorities. The work was still required and contributed value to the eventual profits that are earned by the two enterprises from the sale of the one product.

4. Now assume a situation where there is a significant minority interest in one of the two associated enterprises. In this case, there is a real economic issue regarding the bearing of taxes by the two enterprises. Despite this real economic issue, we believe that the above approach to using a profit split method with concrete allocation keys on an ex post basis is the more appropriate approach to adopt in order to best achieve the desired tax policy goals. The controlling owner and the significant minority interest have the choice, if they desire, to agree on how they will allocate tax costs amongst group members.

T. Scenario 8, Question 28:

Is the application of a transactional profit split method to calculate the royalty in Scenario 8, or in other circumstances to set a price, helpful? What are the advantages and disadvantages?

Yes, we believe that this is a helpful approach, but only in combination with the implementation of the special measure for ‘hard-to-value intangibles’ suggested in Part II, Option 1 of the BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter 1. This special measure would provide for a contingent adjustment mechanism that would have the economic effect of continuing the 80/20 sharing relationship that has been determined under the facts of Scenario 8 if actual sales divert from anticipated sales.

U. Scenario 9, Question 29:

In what circumstances might it be appropriate under the arm’s length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss?

1. As has been indicated throughout this response, we strongly recommend applying the profit split method in a simple-to-administer fashion that involves the use of concrete allocation keys. We have also suggested above that the Guidelines should include specified concrete allocation keys and weightings for all business models now commonly being used. In order to provide guidance for the new business models that will be
developed in the future, the Guidelines should articulate the principles on which concrete allocation keys and weightings should be determined.

2. We believe that it is very appropriate to vary the allocation keys and their relative weighting in gain and loss situations where called for in any particular business model. Hence, for any such business model (e.g. the one used by the global trading organization in Scenario 9) that has a common and logical special treatment for losses, the guidance we have suggested for the use of concrete allocation keys and their relative weighting should be appropriate.

V. Scenario 9, Question 30:

Are there circumstances under the arm’s length principle where parties which would share combined profits, would not be expected to take any share of combined losses?

We have no specific comments on this. However, if there are one or more common business models in use where this makes sense, we have no objections to such specific guidance being included in the Guidelines. As noted earlier, we have suggested that the Guidelines be expanded to include stated concrete allocation keys and weightings for all business models now commonly being. Such a treatment where there are combined losses could be included in this guidance.

W. Question 31:

Paragraph 2.114 of the Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?

1. Certainly, these practical difficulties will remain. But additions can be made to the Guidelines that will lessen these difficulties. We will briefly discuss each of the issues raised in Question 31.

2. The first issue is:

[Associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates.

We do not doubt that this may sometimes be true in reality. To minimize this in the future, we strongly suggest that the Guidelines reiterate in appropriate places (such as within the detailed profit split method guidance) what was recently included regarding penalties in paragraph 42 of the Action 13: 2014 Deliverable Guidance on Transfer Pricing Documentation and Country-by-Country Reporting. This paragraph reads, in part:

‘Moreover, an assertion by a local entity that other group members are responsible for transfer pricing compliance is not a sufficient reason for that entity to fail to provide required documentation, nor should such an assertion prevent the imposition of documentation-related penalties for failure to comply with documentation rules where the necessary information is not forthcoming.’

3. Associated companies are associated because there is a high percentage of common ownership. The common owner or owners have control and must take these obligations
seriously. If not, then local tax authorities should have the authority to make adjustments and impose penalties with the burden of proof regarding changes to be on the shoulders of the applicable taxpayers. This should cause the owners to respond to their obligations more readily.

4. The second issue is:

[I]t may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies.

In the case of MNCs, they are annually making necessary material adjustments from local accounting so that their consolidated accounts are reported for financial statement purposes on a consistent basis. Despite this, of course, there could be potential adjustments that might be material from a local country perspective but which are not material from a consolidated perspective so that no adjustments for such items are made.

5. Despite MNCs choosing not to make some or all of these adjustments for financial statement purposes, they still must go through a serious review process to look for potential adjustments and to document them. Even if they decide in the end that those adjustments are not material enough to make, they have records of these potential adjustments. With this in mind, MNC claims of difficulty in obtaining common basis combined revenue and costs should be ignored. We recommend that the Guidelines make perfectly clear that the burden of producing combined revenue and costs data is on the relevant associated enterprises and that penalties to enforce this are appropriate. MNCs have themselves chosen the form in which they operate and producing proper combined income or loss information on which the profit split method can be applied is on their shoulders.

6. In a longer time-frame it would be desirable, in order to further systematise and regularise the application of the profit split method, to develop harmonised tax accounting standards. In virtually all countries, tax authorities require significant adjustment to financial accounts to make them suitable for tax purposes. This includes significant adjustments to key concepts such as the recognition of income. Hence, although MNCs already produce consolidated financial accounts on a group-wide basis, these can only provide an approximate basis for defining aggregate profits for tax purposes. We recognise that there are not sufficient resources or time in the BEPS project to do significant work on this issue. However, considerable work has been done, and is continuing, in the framework of the EU’s project for a Common Consolidated Tax Base, to establish a harmonised tax base definition. We recommend that the current work on profit split, which has rightly focused on other aspects such as appropriate allocation keys, should be followed up by work on tax base definition, which could build on the CCCTB proposals.

7. The third issue is:

[W]hen the transactional profit split method is applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the
transactions and to allocate costs between the transactions and the associated enterprises' other activities.

The principal issue is one of consistency in calculation. We believe it fair to say that MNCs must maintain accounting systems that allow them to easily identify direct expenses applicable to their various categories of income. Hence, there should be no difficulty identifying such expenses.

8. It is reasonable that different group members might apply differing approaches and bases for allocating indirect expenses that are not directly allocable to any category of income. If this is the case, then it would be fine for the combined profit or loss to be calculated on a consistent basis only recognizing revenue and direct expenses. We suggest that the Guidelines provide guidance for such flexibility in the absence of any unusual situation where one or more group members have material indirect expenses relative to other relevant members that would make combined profits or losses on this basis inappropriate.

X. Question 32:

Finally, what further points would respondents wish to make about the application of transactional profit split methods not covered by previous questions?

No specific comments. We would just like to say that we appreciate greatly and strongly support the current focus on an expanded use of the profit split method. With greater use of the concrete allocation keys and set weighting for different business models that we suggest herein, we believe that the BEPS Project’s objectives and the use of the profit split method will be more achievable for all countries. In our view, such a simplified profit split method would be far easier to administer especially in developing countries than the other transfer pricing methods which require ad hoc evaluations of facts and circumstances, and a pointless search for comparables which do not exist. It should also establish a more stable and predictable framework for business, and ensure that taxes are paid ‘where economic activities take place and value is created’.
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February 6, 2015

Ref: OECD DISCUSSION DRAFT: THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAINS

Dear Andrew,

BIAC thanks the OECD for the opportunity to provide comments on its three Discussion Drafts covering elements of Actions 8, 9 and 10 of the Base Erosion and Profit Shifting (BEPS) Action Plan issued on 16 & 18 December 2014 (the Discussion Drafts). We acknowledge and thank you for the huge amount of effort that you and others have put into these drafts.

There is no doubt that transfer pricing issues, along with deductible payments, lie at the heart of the BEPS project. Governments have expressed concerns about aggressive structures in certain contexts, lack of clear (or any) guidance in others, and the perceived inability of the fact-driven arm’s length standard to deal with new situations in still others. BIAC agrees that all of these areas should be examined, and that the legitimate concerns of governments fully and swiftly addressed. However, BIAC also believes that the arm’s length standard, properly applied by both taxpayers and governments, still offers the best prospect of classifying transactions according to “real-world” economics, and equitably and consensually dividing income between countries based on economic activity. If this is not clearly articulated, however, then we will see a further acceleration in a worrying trend already apparent in the transfer pricing audit practices of several countries, where a broad interpretation of “BEPS principles” is used to justify new unilateral theories, and the automatic application of non-arm’s length approaches in routine situations.

So, elements of the proposed guidance in currently unclear areas such as risk or commodity transactions are greatly to be welcomed – but such guidance should build upon established concepts rather than upon new ones (such as, for example, “moral hazard”). Likewise, profit splits may well be appropriate in certain difficult cases – but the default position, nevertheless, should be application of the arm’s length standard, with profit splits only being applied where the default position cannot be. Recharacterisation, or “special measures”, which recast a contract or other legal arrangements from the form agreed by the parties into a new and different form, may be justified in egregious cases – but only when other alternatives, most particularly, the proper application of intercompany pricing principles, have been tried and failed. While it may sometimes be more time-consuming to run through a full functional analysis, than to move swiftly to a recharacterisation, such a functional analysis (the elements of which are broadly agreed and widely understood) not only provides more commercial certainty for taxpayers, but also benefits
governments because there will be fewer instances of double taxation as different countries seek to apply different rules with no commonly-agreed standards.

Finally, and as noted in my comments on Action 14, particularly if dispute resolution is not improved, then business may return to a more adversarial relationship with tax authorities and, especially in the complex area of Transfer Pricing, seek new ways to mitigate double taxation in the face of risk from ad hoc recharacterisations, and non-arm’s length practices. A return to this type of cat and mouse game would be to neither the advantage of governments nor the vast majority of responsible, unaggressive taxpayers.

In each of our three sets of comments, we give much more detail on where we think the new proposals will eliminate BEPS-related issues, and/or provide new and helpful guidance. Likewise, in our comments we also present what we hope are constructive alternatives, where we disagree with proposals made in the three Discussion Drafts. To reiterate, however, while we acknowledge weaknesses and gaps in the current rules, and are supportive of moves to rectify both, we also strongly advocate that the arm’s length standard, and the legal form adopted by taxpayers, remain the starting point – if not always the ending point – for dealing with the matters raised in Actions 8-10.

We very much hope that you find our comments useful, and we look forward to working with you on these important issues over the next several months.

Sincerely,

Will Morris
Chair
BIAC Tax Committee
INTRODUCTION

1. **BIAC believes that the ‘most appropriate method’ approach, under the arm’s length principle (“ALP”) should be preserved**, and that the profit split should not be automatically applied in situations where one-sided methods can provide a reliable result. **We believe that the profit split approach should also not be seen as necessary to “corroborate” other arm’s length methods of pricing.**

2. **BIAC also believes that the splitting of residual (profits or losses) vs. a global profit split approach represents a more appropriate framework**, because it takes into account one-sided methods to price routine or ‘benchmarkable’ transactions before residual profit or losses are split between unique contributions.

3. Although we recognize that the diversity of the non-financial sector renders the exercise more complex, **BIAC would welcome a similar approach to the guidelines the OECD has issued for financial institutions, as it would clearly draw the line between the concepts of residual profit split, profit splits and formulary apportionment.**

4. This document is organized in four sections:
   i. An introductory discussion about the conceptual framework in relation to Global Value Chains (“GVCs”);
   ii. Comments on the conceptual background of the Transactional Profit Split (“TPS”) Method;
   iii. A summary of responses from BIAC members to a BEPS Transfer Pricing questionnaire conducted in late 2014; and
   iv. Specific comments in relation to questions included in the Discussion Draft.

GLOBAL VALUE CHAINS

5. When businesses implement profit splits, a “residual profit split approach” is preferred, whereby group companies first define and delineate routine functions and an appropriate return for such functions, and then allocate the residual profit to group companies based on a functional analysis. This approach has been used by financial institutions for many years.

6. In the case of financial institutions, the OECD has developed articulated guidelines, and we understand that work has provided financial institutions with some guidance on how to apply the profit split method within group companies.

7. Although we recognize that the diversity of the non-financial sector renders the exercise more complex, **BIAC would welcome a similar approach to provide guidance beyond the financial services sector, as it would clearly draw the line between residual profit split approaches, profit splits and formulary apportionment.**

8. **BIAC observes that the global economy is characterized by a growing number of players, interacting in an increasing number of ways, resulting in complex networks and relationships that create value in different ways. These complex interactions result in a huge spectrum of fact patterns across Multinational Enterprises (“MNEs”), where products are made, services are provided, and intellectual property is created.**
9. These networks and relationships create opportunities for MNEs to structure their value chains in new and innovative ways. As a result, greater choice is afforded between assigning (or outsourcing) activities to related or unrelated parties.

10. We observe that MNEs no longer only outsource back-office tasks, and that strategic core tasks within the value chain may also be outsourced such as R&D and production activities. For example, an MNE may sell ICT products where production may (partially or entirely) be outsourced to a third party contract manufacturer. This can be the case, even where the MNE’s reputation and commercial success are significantly dependent on the quality of its products.

11. BIAC is concerned that the OECD appears to be focusing its analysis of transfer pricing in relation to GVCs on the basis of a paradigm where all MNEs operate as a single economic entity on a fully integrated basis. Although this may be true for some MNEs, it is not the case for all. In this regard, we believe that principles and rules should be developed in such a way that they are capable of flexible application to a wide range of business fact patterns through further practical guidance. This approach would reflect the increasing diversity and flexibility of business models that we see in our global economy, taking into account the fact patterns that are underpinned by legal agreements and the conduct of the parties. BIAC believes that each case should be analyzed on its own merits, and on the basis of commonly applicable principles. This would allow revised guidelines to be adapted to a rapidly changing world.

**PROFIT SPLIT METHODOLOGY**

12. The profit split method is generally used where the other OECD methods are not appropriate, particularly for transactions involving hard to value intangibles or unique and valuable contributions from various parties. We believe that this should continue to be the case, as the other methods (i.e. the Traditional Transaction Methods and the TNMM) still often offer the most appropriate and practical way to benchmark and analyze transactions. Compared to such other methods, profit splits are generally more subjective in nature and can lead to more burdensome and costly examinations, more disputes and, importantly, more double taxation. Here again, we would welcome some clarity on what profit splits cover.

13. Indeed, BIAC believes that the splitting of residual (profits or losses) represents a more appropriate framework, because it takes into account one-sided methods to transfer price routine or benchmarkable transactions before residual profit or losses are split between unique contributions.

14. As highlighted in paragraph 2.118 of the OECD Transfer Pricing Guidelines, there are a number of possible approaches for estimating the division of profits. Although BIAC is not suggesting a preference for a particular approach, we do consider that the fundamental distinction between unique and non-unique contributions should be maintained and supported by unequivocal wording.

15. BIAC believes that the profit split guidance should ensure, even in cases where perfect comparables cannot be found, that “residual” profit is not allocated to ‘non-unique’ contributions. An approach that would allocate residual profit to such non-unique contributions risks creating competitive distortions, and could be viewed as a violation of the principle of tax “neutrality”.

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16. BIAC is particularly concerned about the risk that the amendments to the profit split guidance could be seen as direct encouragement of the use of the profit split method over other methods and, ultimately, could lead to the unilateral and arbitrary application of formulary approaches by taxing authorities: such an approach would lead to substantially more disputes requiring resolution, creating further uncertainty and disagreement and making the successful output of action 14 an imperative.

BIAC SURVEY

17. In late 2014, BIAC conducted a survey of its members to ask questions in relation to several of the BEPS Transfer Pricing Actions. Within a section on intangibles one question related to specifically to profit splits:

“What would be the implications of broader adoption of multi-factor profit split methodologies – could this be an appropriate solution where comparables cannot be found?”

18. Many respondents expressed concern in relation to the fact that the multi-factor profit split methodology (in relation to intangibles) carries a high degree of uncertainty, subjectivity and complexity.

19. It was also observed that it would be difficult for countries to agree on the same bundle of allocation factors (and their weightings) given the divergent interests of the tax authorities, which may lead to greater litigation and increased compliance burdens.

20. Overall, the majority of respondents were of the opinion that the Profit Split should be considered a method to be used in the rather exceptional and limited circumstances, where no simpler methods are appropriate.

SPECIFIC QUESTIONS

21. In this response, BIAC has not provided specific comments on the individual examples set out in the Discussion Draft. BIAC believes that, other than in cases where two or more parties make a unique and valuable contribution, the choice of the most appropriate method should depend on whether comparables can be identified, and whether reliable adjustments (if necessary) to those comparables can be made. Even in relation to complex, integrated or fragmented activities, other, less administratively burdensome one-sided methods may provide an equally reliable or, in some cases, a more appropriate outcome.

BIAC has therefore focused its comments on the conceptual issues raised by the examples, and by the related questions included in the Discussion Draft.

Value chains (ref. questions 3 and 4)

22. For the reason identified above, BIAC believes that the ‘most appropriate method’ approach, under the arm’s length principle (“ALP”) should be preserved, and that the profit split (or even the residual profit split) should not be automatically applied in situations where one-sided methods can provide a reliable result. In addition, taking into account the substantial transfer pricing compliance burdens already faced by MNEs, BIAC believes that the principle of testing the simplest transaction should be retained and should be sufficient as such. Favoring profit splits, and two sided analyses will increase the complexity of transfer pricing, and will likely result in further disputes, creating double taxation. Transfer Pricing not being
an exact science, tax authorities will disagree with the sharing of profits and losses, if they test one-sided transactions under the ALP principle with a global profit split approach.

23. Overall, BIAC considers that it would not be helpful to attribute a specific meaning to “GVCs”, due to the variety and evolving nature of GVCs models.

**Multisided Business Models**

24. BIAC considers that the transfer pricing analysis of multisided business models should not be different from the analysis applicable to other types of businesses.

25. It should also be observed that multisided business models are likely to also be adopted by start-up or small businesses, which may look for independent suppliers if they need support in other Countries, rather than developing their own multinational structure. Under such a model, the independent suppliers may receive a routine remuneration than a share of the profit.

**Unique and valuable contributions (ref. question 7)**

26. BIAC considers helpful the definition at paragraph 6.17 contained in the 2014 Report “Guidance on the Transfer Pricing Aspects of Intangibles,” and encourages the OECD to retain this definition as a key reference for its guidance on the attribution of profit within a transfer pricing analysis. The fact that functions are highly integrated should not bring to a different interpretation of their nature. Non-unique contributions should be rewarded consistently with their value creation, even in cases where perfect comparables are not easily available.

**Integration and sharing of risks (ref. questions 11 and 12)**

27. In many cases, risk can be addressed as a comparability factor through appropriate adjustments to one-sided methods. For example, if a risk is shared, the first consideration should be whether the shared risk would materially impact the price of the transaction at arm’s length: if not, the “sharing” dimension should not be further considered in the pricing; if yes, a possible approach could be the one discussed at paragraph 32.

28. There will naturally be situations where risk bearing represents a unique contribution (or is even the essence of the transaction). In such cases, a profit split method may be appropriate, and risk should then be compensated through an appropriate share of residual profit (or loss). The profit split method can be an appropriate and reliable method in cases of multiple unique and valuable contributions.

29. Similar concepts must also apply to the sharing of risks and take account of material risks that MNEs choose to manage and measure which ultimately would have a detrimental effect on their business model if unmanaged: if a particular type of risk could normally be addressed with a comparability adjustment (when the tested transaction differs from comparables for that specific risk), the fact of being shared within a GVC should not automatically result in the sharing of residual profit to that particular risk.

**Fragmentation and lack of comparables (ref. question 15, 17, 18 and 20)**

30. As a general principle, BIAC considers that non-unique contributions should not receive a higher compensation as a mechanic consequence of being integrated or fragmented or due
to the lack of perfect comparables, especially where this would give a dramatically different result to that obtained by using a one-sided method.

31. BIAC believes that the tentative methodology described at paragraph 32 of the Discussion Draft could provide a potential practical solution, but we strongly disagree with the idea that a lack of comparables could result in a quasi-profit sharing mechanism (unless the intention is to apply a profit split approach that only tests the residual profit allocation). A lack of comparables is often due to an absence of information on existing firms in publically available databases, and therefore, should not be treated as an indicator of an entity having a unique, value adding function. Profit sharing mechanisms should be acceptable only if consistent with the ALP.

32. On the other hand, the methodology described at paragraph 32 of the Discussion Draft could be modified to develop a practical solution for cases where perfect comparables are not available. For example, in the case described at paragraph 32, once a range of operating margins of 4-10% has been established on the basis of a one-sided method, the analysis should remain conceptually based on a one-sided approach and seek refinement of the positioning within the range on the basis of an approximate assessment of the functions, assets and risks of the tested entities in relation to the comparables. Where a one-sided method can reliably be used to price the transaction, there should be no need to corroborate the result through the application of a profit split.

33. In case of fragmented functions representing non-unique contributions and for which a one-sided approach would be conceptually more suitable, the methodology could allow for the refinement of the allocation of profit to each entity while maintaining the one-sided nature of the approach in cases where the quality of comparables is not sufficient to directly apply the range of comparables results to the tested transaction.

34. BIAC considers that such a methodology could be explored in order to provide greater simplicity and certainty: in particular, it would be very important to preserve the concept that a range of acceptable results must be determined, rather than specific data-points.

35. BIAC suggests that further practical guidance would be welcomed to improve the use of one-sided methodologies when only non-perfect comparables exist. BIAC notes that slightly imperfect comparables may be more accurate in some cases than the application of a (potentially) largely subjective profit split.

Aligning taxation with value creation (ref. questions 22 and 23)

36. BIAC is concerned that profit splits tend to imply higher risks of dispute due to their inherent subjectivity. BIAC therefore welcomes the efforts towards developing more objectivity in profit split factors. However, it is difficult to imagine how more specific rules could be developed, considering that profit splits usually deal with unique and valuable contributions, which, by their nature, should be analyzed on the basis of their own specific features.

37. The absence of detailed practical guidance as to the use of profit splits can make the assessment of the most appropriate methodology difficult. Developing further guidance on a consensus basis could assist governments and taxpayers reaching a more consistent and common understanding of when this method is most appropriately applied. We note that the subjectivity associated with a profit split methodology introduces an increased element
of uncertainty into the filing of tax returns, particularly where the opinions on the weight and significance of different allocation criteria may vary between tax authorities and taxpayers.

38. Considering the difficulty of this subject, BIAC confirms its availability to analyze and provide input on practical proposals developed by the OECD.

**Approaches based on concepts of bargaining power, options realistically available, RACI-type analysis (ref. question 24)**

39. Any general rule based on these concepts would likely lead to formulary apportionment (prevailing on arm’s length conditions of the specific case). BIAC is therefore not in favor of establishing new guidelines referring to these concepts, although certain methodologies may be helpful in individual cases.

**Hard to value intangibles and dealing with ex-ante / ex-post results (ref. questions 26 and 27)**

40. One common feature across a large number of businesses is the desire for relative certainty in results. Consistently, it should be recognized that in many arm’s length transactions, parties prefer a fixed price or a fixed profit element, when compared to ex-post adjustments that could bring additional profits or unexpected losses. In addition, in many third party relationships, ex-post adjustments would not be possible.

41. Clearly, there are situations where independent parties will be willing to review and share the results on an ex-post basis. However, these are likely to represent a minority of cases. BIAC therefore recommends a principled approach, respectful of the ALP, that would not lead to pre-conceived assumptions that results should be adjusted ex-post.

**Dealing with losses (ref. questions 29 and 30)**

42. BIAC believes that any robust profit split methodology should be developed in such a way that can generally deal equally well with the generation of profits and losses.

43. Cases where losses may not be shared or shared in a different way appear to be marginal and exceptional: focusing the analysis of how to split losses in exceptional cases instead of standard cases could increase the risk of challenge by Tax Authorities.

**Practical difficulties (ref. question 31)**

44. Paragraph 2.114 of the existing Transfer Pricing Guidelines provides a good summary of important practical difficulties faced in the application of the transactional profit split method. Given that the paragraph only provides a summarized description, and that some of the difficulties identified can present substantial challenges, we believe the guidance should be expanded to provide taxpayers with important context to enable the assessment of the most appropriate method given the facts and circumstances at hand. We have taken this opportunity to describe some important practical difficulties that are encountered in dealing with the profit split method.

45. We believe that the following three steps provide a useful framework for analyzing the entire process of applying a profit split method:
a. Conceptual profit split: defining how the (residual) profit should be split in a specific case;

b. Method development: the desired split of profits must be converted into a pricing methodology applicable to specific transactions which must be capable of generating the target split of profit or at least a good approximation to be complemented with periodic adjustments (if adjustments are anticipated, this phase will also include the definition of how they can be implemented); and

c. Implementation: specific functions in one or more entities within the MNE will be responsible for setting and updating prices of transactions, invoicing them, monitoring them and administering adjustments if required.

Step “a” is largely discussed in the other sections of this document. We therefore focus our comments on the practical difficulties associated with steps b and c.

46. Method development (b):

Gross profit splits: A first issue (also common to phase a) relates to the fact that, in certain cases it may be that the only appropriate or practicable option is to split gross profit, rather than operating profit. Although this issue is analyzed in paragraph 2.131 of the Transfer Pricing Guidelines, in practice tax authorities often challenge the application of the method to gross profit. We would therefore welcome more detailed guidance on this point.

Accounting systems: A common practical difficulty relates to the need to use common denominators in terms of accounting standards and accounting systems to derive the data necessary to calculate the profit split and set the prices of transactions.

Disallowable expenses: Another serious issue is represented by the different approaches taken by tax authorities on the deductibility of certain expenses. We would welcome clear guidance to establish that when applying a profit-split method on an international basis, “common” rules should be accepted instead of local rules and regulations with respect to the deductibility of certain expenses. A more “selective” approach preferring domestic rules undermine the viability of the profit split concept.

Customs: Generally speaking a profit split is not an acceptable method for customs valuation purposes – meaning that transactions have to be redefined and revalued for corporate income tax and customs purposes. This naturally creates substantial administrative burden. This issue would be magnified if profit splits are to be adopted more widely. A review of the profit split method should incorporate an analysis of its practical compatibility with other taxes.

Data availability: MNEs often face challenges in reliably gathering the substantial variety and volume of data necessary to accurately develop the method (e.g. aligning different IT systems or accurately converting different currencies, etc.).

47. Implementation difficulties (c):

The administration of a profit split model generally requires ad-hoc processes to be created and the cooperation of different functions and entities within a MNE. Ensuring proper staffing, education, timeliness and quality controls is often difficult. These issues are often compounded by the fact that the profit split method requires more regular refinements and
updates than other transactional methods. Even year-end adjustments, which might be seen as an ‘easy fix’ can be very complex - periodic adjustments can create significant challenges in their calculation, invoicing, accounting and related obligations (including indirect taxes and customs).

**Conclusions on practical difficulties**

48. In conclusion, the issues described above will become more prevalent if profit splits are to be applied more often. These burdens will be most severely felt by smaller taxpayers that may not have the necessary resources or expertise to effectively or appropriately deal with them. However, larger MNEs also can struggle to successfully deal with the substantial challenges that profit splits create.

49. Finally, we are concerned that a focus on sharing of ‘profit’ alone may lead to a gradual shift away from the fundamental principle that transfer pricing should apply to transactions. Even in the application of the TNMM, taxpayers have experience of audits focusing on the ‘bottom line’ profit without regard to specific transactions. This deprives the taxpayer of the fundamental means to resolving the resulting double taxation. We encourage the OECD to consider re-emphasizing the transactional aspects of the profit split method. More generally, we suggest that the OECD also keeps as a clear objective that any development in the guidelines on profit splits should not reduce a taxpayer’s ability to achieve an effective solution to double taxation issues; this point is particularly important in relation to non-OECD member Countries participating to the BEPS project on an equal footing, as well as other Countries supporting the project.
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Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

Dear Mr. Hickman,

We appreciate the opportunity to provide our comments regarding the Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains.

For an export oriented family owned business, globalisation is not new, but the pace of integration of national economies and markets has substantially accelerated in recent years. Combined with an ever-increasing importance of managing tax risks and of developing, protecting and exploiting intellectual property, this development has an important impact on the way cross-border activities take place. From our experience the use of profit splits for the remuneration of intangibles has already increased and we expect that it will play a further increasing role. Therefore, the focus of the Working Party No. 6 (WP 6) of the Committee on Fiscal Affairs (CFA) of the OECD to clarify the focus on the circumstances in which the application of a transactional profit split method may be appropriate as well as the ways in which the factors used to split the profits can align profits and value creation are highly appreciated.

From our experience with discussions of the local field auditor in several jurisdictions the most important aspect of the use of a transactional profit split method is to clearly define the circumstances in which the application of a transactional profit split method is likely to be appropriate. And even more important to clearly exclude situations where the application of a transactional profit split method is not acceptable. Currently it seems that some tax authorities try to apply the profit split method as a default method to increase tax revenues.

An essential first step in this process is to accurately delineate the transactions, which in turn relies heavily on an analysis of the functions performed by the parties, taking into account the assets used and risks assumed, as well as the other economically relevant characteristics of the transaction. Importantly, a thorough functional analysis cannot be performed in isolation: the broader context of the MNE group’s business operations will often be essential to understanding the functions, assets and risks of the parties to a transaction, and their contribution to value creation. From our view it should be clearly stated, that the application of a profit split method can only be appropriate, if there is a split of entrepreneurial functions und risks in the MNE group.
Value chains (page 3)

Globalisation has resulted in a shift from country-specific operating models to global models based on matrix management organisations and integrated supply chains that centralise several functions at a regional or global level. A fierce competition is the flip side of the coin “globalisation”, which makes it necessary for MNEs to be as efficient and productive as ever possible in the game “survival of the fittest”. It is therefore crucial to avoid any double taxation. In that respect the application of a profit split should be thus, that it is acceptable to both (or all) parties involved. This might imply that it is only a tool for APAs or MAPs. Inherently it requires some negotiation between the parties involved. We do not think that the application of a profit split method can be standardised to such an extent, that it can be applied like a benchmarking exercise.

Regarding Paragraph 5 of the discussion draft we would like to suggest an amendment to the following sentence: “In specific situations the functional analysis may show that the use of profit split methods or valuation techniques (e.g. discounted cash flow method) is appropriate.” From our experience the use of profit split methods, as currently applied in the transfer pricing world, has nothing in common with valuation techniques such as the discounted cash flow method or a discounted earnings method. We would therefore highly appreciate, if the transfer pricing guidelines would not give the impression that a profit split is an alternative method to a discounted cash flow method. In addition we would like to point out that in business valuation the profit split method is applied as a residual profit split method for intangibles, especially for customer relationships. In that respect it is a default method with a poor reputation.

Unique and valuable contributions (page 6)

The Guidelines note that transactional profit split methods may be the most appropriate method in cases where both parties make “unique and valuable contributions” to a transaction, in particular, where both parties contribute unique intangibles.

7. Does the way in which “unique and valuable” is defined for intangibles assist in defining the term “unique and valuable contribution” in relation to the transactional profit split method?

We fully support the notion that a profit split method may be the most appropriate method in cases, where both parties contribute unique intangibles. From our perspective the way in which “unique and valuable” is defined for intangibles is helpful and sufficient in defining “unique and valuable contribution”.

8. What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method?

9. Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm’s length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?

10. What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3?

No additional aspects need to be elaborated. In the context of Scenario 3 the so called “incremental cash flow method” should be applied. This method has been presented in one of the consultation meetings of the WP 6 on Transfer Pricing Aspects of Intangibles. In fact, this method uses a profit
split based on consumer research data. It could be readily applied in any circumstances where unique and valuable intangibles such as brands, customer relationships and patents are involved.

Integration and sharing of risks (page 7)

Where MNE’s business operations are highly integrated, strategic risks may be jointly managed and controlled by more than one enterprise in the group, creating a strong interdependence of key functions and risks between the parties.

11. In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks?

As stated above, a profit split should only be applied, where entrepreneurial functions and risks are shared between the parties. It is therefore important, that each party controls and performs its own research, development and production processes.

12. Would a one-sided method produce more reliable results?

No.

13. What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?

No further elaboration needed.

Fragmentation (page 8)

Related to this, the interim guidance on Chapter VI contained in Guidance on Transfer Pricing Aspects of Intangibles mentions the potential for using transactional profit split methods in cases where one party holds the legal ownership of intangibles while another performs important functions relating to the development, enhancement, maintenance, protection and exploitation of those intangibles, and another party provides funding (see paragraph 6.57-6.58 and examples 17 and 18).

14. Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so how?

Yes, it should be amended, as such situations occur. Specifically against the background, that the legal ownership based on a registration of an intangible is the more valid the older the registration is. Therefore, companies normally try to avoid a change of registration. Reference could be made to a so called “score card method”, where the different factors are weighted.

15. Can transactional profit split methods be used to provide reliable arm’s length transfer pricing solutions for fragmented functions? If so how? Can other methods address the issue of fragmentation, and if so, how?

Again, we would like to recommend the so called “incremental cash flow method”. Within this method a score card approach can be applied to price the fragmented functions.
16. What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?

No additional elaboration necessary.

**Aligning taxation with value creation (page 10)**

In practice, transactional profit split methods are typically applied using one or more allocation keys or factors to split the profits, based on the outcome of a functional analysis that determines how value is created in the MNE group. As the Guidelines note, it is important that factors are used in an economically valid way that approximates the division of profits that would have been agreed at arm’s length. (See paragraph 2.108)

22. In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?

23. What guidance is needed on weighting of factors?

24. How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for example approaches based on concepts of bargaining power, options realistically available, or a RACI-type analysis of responsibilities and decision making; Responsible, Accountable, Consulted and Informed for each task in a business process, project).

25. Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an MNE operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate?

As stated above, we do not think, that a standardisation to the requested extent is possible and desirable. Aligning the profit split with the value creation depends too much on the facts and circumstances of the case. That is why we also believe that it is mainly a tool for APAs or MAPs.

**Hard-to-value intangibles (page 12)**

The interim guidance on Chapter VI suggests that transactional profit split methods may, in some cases, be applied to the valuation of partially developed intangibles. It goes on to caution that, in such cases, using transactional profit split approaches based on the cost of the contributions made by the parties may be unreliable as there may be little relationship between such costs and the value of the contributions (paragraph 6.147-6.148).

26. What specific aspects of transactional profit split approaches may be particularly relevant in determining arm’s length outcomes for transactions involving hard-to-value intangibles?

Limited to the extent of early stage developments, where it is not yet predictable, whether the development will be successful at all, e.g. in the pharmaceutical industry, we support the suggestion to use transactional profit split approaches based on the cost of the contributions made by the parties.
Dealing with ex ante / ex post results (page 12)

Transactional profit split approaches have been suggested as a way to address significant differences between ex ante and ex post result, and may provide an appropriate way to deal with unanticipated events where strategic risks are effectively shared between associated enterprises.

27. How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?

The reason for differences between ex ante and ex post can be twofold. A lack of accuracy in the planning process can be one reason and a true unpredictable market development can be the other reason. According to the complexity of MNEs, deviations in the planned results are not rare. It might also be that the different risk aversion of the parties involved lead to different planning assumptions and therefore to variations in planned results. In applying the profit split method careful consideration should be given to that fact, to avoid an unintended allocation of risks and profits. If the unpredictable market development occurs the result should be attributed according to the originally agreed profit split.

28. Is the application of a transactional profit split method to calculate the royalty in Scenario 8 or in other circumstances to set a price, helpful? What are the advantages and disadvantages?

If the royalty is calculated on the expected profit from the expected sales and then converted into a royalty rate on those sales as suggested in scenario 8, P should be able to benefit from a positive development of sales and vice versa. If the royalty rate itself is not changeable, the accuracy of the planning figures (profit and sales) determines whether the ex post result is still arm’s length. The conversion into a fixed royalty rate based on flexible sales always limits the consideration of ex post deviations to one factor, i.e. sales.

Dealing with losses (page 13)

The Guidelines note that references to “profits” in the guidance should be taken as applying equally to losses (para. 2.108). The guidance also states that generally the factors used to split profits should be applied consistently, including during loss years (para. 2.117), unless independent parties would have agreed otherwise.

29. In what circumstances might it be appropriate under the arm’s length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss?

If the losses occur, due to normal business development, such as price fluctuation or shift in demand, a variation of splitting factors does not seem sensible. On the other hand, if there is a specific risk attached to the location of one party or if one party, does not show the same accuracy in its behaviour or planning, a third party would negotiate a variation of splitting factors or refrain from the transaction.

30. Are there circumstances under the arm’s length principle where parties which would share combined profits, would not be expected to take any share of combined losses?

For an investor risk and return should match. If the profit potential is very low or the share of the profit is minor, any loss taking might not be acceptable.
31. Paragraph 2.114 of the Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?

The pointers remain relevant. That is why we would recommend applying the transactional profit split method only in two circumstances:

- When unique and valuable intangibles are involved,
- As a tool in APAs and MAPs.

32. Finally, what further points would respondents wish to make about the application of transactional profit split methods not covered by previous questions?

The method should be renamed profit-and-loss split.

An additional perspective

In the introduction of the White Paper on Transfer Pricing Documentation, the WP 6 also takes reference to Action 13 “Re-examine transfer pricing documentation” of the Action Plan on Base Erosion and Profit Shifting (BEPS): “Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE’s provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.”

In Action 13 of the BEPS Action plan the OECD does not only consider the perspective of the tax authorities but also acknowledges the necessity of MNEs to achieve risk assurance, to avoid double taxation as well as penalty protection.

Against this background we would like to stress, that we are very much concerned, that the required information in the Country-by-Country Reporting will lead to a total profit split request by certain countries, which is not based on a transactional approach. We therefore recommend rethinking the current information request. The required transparency will not be beneficial, but will lead to a dispute flood.

We hope our comments and suggestions are helpful to foster the further discussion.

Please do not hesitate to contact us, if we can be of any further assistance.

Kind regards

Brose Fahrzeugteile GmbH & Co. KG

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6 February 2015

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Comments on the OECD Public Discussion Draft on the use of profit splits in the context of global value chains - 16 December 2014 – 6 February 2015

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

BUSINESSEUROPE is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft on the Use of profit splits in the context of global value chains - 1 December 2014 – 6 February 2015 (hereinafter referred to as the Draft).

General Comments

BUSINESSEUROPE welcomes the OECD’s work on the use of profit splits in the context of global value chains.

In the current economic environment many MNEs are conceived as integrated businesses; relevant implications arise from this scheme as related party transactions conducted by group companies will not always be perfectly comparable to those conducted by independent parties. Although no clear answer can be provided by either Tax Administrations or international organizations for every situation and the priority of the arm’s length principle is one of the fundamentals of transfer pricing, flexible approaches should be further analyzed in this regard.

Under this scenario, the limited functionality of one-sided transfer pricing methods has already been acknowledged by Tax Administrations, international organizations and taxpayers, being therefore needed further guidance to address functionality constraints within the use of one-sided methods or alternative approaches such as transactional profit split methods, which may prove extremely useful in the context of highly integrated or global intercompany relationships.
Nevertheless, it should be noted that the application of the profit split should be (as the application of any other of the transfer pricing methods accepted by the OECD) properly supported in every situation, proving that it is the most appropriate methodology to test the arm's length nature of the remunerations agreed, given the facts and circumstances of the case. Thus, the application of the profit split should be based on a thorough functional analysis (functions, assets and risks) in order to determine the contributions of each party and the corresponding allocation of profits.

As a general rule, MNEs do not operate on a fully integrated basis. In fact, in practice, only a little proportion of the related party transactions are of such an integrated nature that only an aggregated analysis is possible and therefore, the use of the profit split is quite limited. However, there are some situations in which it is not possible to use traditional methods or the Transactional Net Margin Method. In these situations both taxpayers and Tax Authorities should be aware of the need to objectivize the application of the profit split, given its technical complexity and the reality of the business conducted. Absent of objectivizing the application of the profit split method and overcoming the hurdles of complexity, may lead to distinct application of the profit split method by tax authorities, hence increasing the risk of double taxation. Therefore, the use of the profit split methodology may be limited to scenarios where traditional transfer pricing methodologies do not provide reliable arm's length pricing.

If selected, Profit split methods should be applied transaction by transaction and not at a general level which will otherwise lead to a formulary apportionment approach. If this were the case, there would be a certain risk to see tax Administrations tempted by this trend to have a global approach, what could be easier for them to apply.

**Questions**

1. **Can transactional profit split methods be used to provide a transfer pricing solution to this scenario? If so, how?**

If highly integrated, yes, once the routine functions conducted by contract manufacturers and distributors are properly remunerated, together with the license of IP, the residual profit achieved by the Group could be shared among the three OEMs using appropriate criteria.

2. **What aspects of Scenario 1 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?**

A thorough functional analysis (functions, assets and risks) in order to determine de contributions of each OEM together with a detailed overview of the value chain; this will allow to determine whether the profit split method would be the most appropriate to share profits among Group members.
3. **Is the application of a transactional profit split method more useful than other methods for dealing with particular aspects of value chains, such as highly integrated functions, and the sharing of risks?**

In certain situations where contributions made by each group entity are highly integrated and it is not possible to segregate the contributions of the entities and find comparables, then yes.

4. **What guidance should be provided to address the appropriate application of transactional profit split methods to deal with these aspects of value chains?**

BUSINESSEUROPE would appreciate any efforts by the OECD on detailing those factual situations in which the use of profit split is appropriate: what the "significant integration" means, which allocation keys are recommended to share profits, etc.

5. **Can transactional profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how?**

Same as answered to Question 1. For those activities very specific and integrated where no reliable comparables could be found, the use of the profit split method could be advisable.

6. **What aspects of Scenario 2 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?**

Detailed functional analysis; it is crucial to determine where value is created along the value chain, which companies are responsible for value creation and to what extent.

7. **Does the way in which "unique and valuable" is defined for intangibles assist in defining the term "unique and valuable contributions" in relation to the transactional profit split method?**

Yes. However, further guidance would be helpful to clarify these concepts.

8. **What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method?**

As mentioned before, the overview of the whole value chain together with a complete functional analysis in order to determine whether the contributions made by each party are "unique and valuable" or routine and whether comparable transactions exist. If the contributions are found "unique and valuable" the most appropriate criteria to split profits according to such contributions.
9. Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm's length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?

For example, if the profit split method is found to be the most appropriate method, the overall profit achieved by the Group in connection with these transactions could be shared among the parties involved in the transactions using a residual profit split methodology; that would involve first, remunerating the routine activities (in the case of Company S, the distribution and marketing functions conducted) and once they are covered for all entities, the residual profit could be allocated to Company S (under the assumption that it is the only company performing "unique and valuable" functions.

10. What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3?

Advantages: proper allocation of profit among Group members according to value creation if the profit split methodology can be reliably applied.

Disadvantages: technical complexity.

11. In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks?

After conducting a comparability analysis, the risks assumed by each company should be determined. Afterwards, the application of the profit split method could be appropriate.

However, this question should be analyzed together with comments raised on action 9 on risk and capital.

12. Would a one-sided method produce more reliable results?

It depends on the circumstances. As long as the contribution of the Group companies are highly integrated and can be considered as "unique and valuable", the profit split method could be adequate. On the contrary, if contributions of entities can be segregated and comparables exist, one-sided methods to determine the arm's length profitability of each company/activity on a single tested-party basis would be adequate and preferable due to less complexity.

13. What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?
As mentioned before, the overview of the whole value chain together with a complete functional analysis in order to determine the real nature of the contributions made by each party.

14. **Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how?**

Any guidance provided related to the use of profit split methodology should be consistent and coherent with that of intangibles as part of a complete system.

15. **Can transactional profit split methods be used to provide reliable arm’s length transfer pricing solutions for fragmented functions? If so how? Can other methods address the issue of fragmentation, and, if so, how?**

Yes, the use of the profit split may provide reliable results in the context of fragmented functions. In order to allocate adequately profit to each entity it is important to review in detail the functions and risks assumed by each entity so that remuneration is assigned in accordance with value creation. Alternatively, also one sided methods may provide reliable results in the case of reliable comparables as independent enterprises may operate under similar circumstances.

16. **What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?**

It is necessary to develop under what premises fragmentation is appropriate and when the use of one-sided methods is preferable.

17. **How can comparables be found and applied in scenario 5? What method is likely to be appropriate for determining an arm’s length remuneration for the activities of the group companies?**

An analysis of the value chain together with a complete functional analysis will determine the most appropriate method. If after performing a functional analysis it is concluded that a one sided method is the most appropriate method, comparables will need to be identified using databases. Should the profit split be the most appropriate methodology, total profit achieved by the companies could be shared taking into account a reasonable allocation key, such as the turnover generated by each company over the total turnover generated by the Group. Alternatively, total profit can also be split using a residual approach by first remunerating routine distribution activities using external comparables (benchmark of independent distributors) and then sharing the residual profit according to the contribution made by each party.

18. **How can comparables be found and applied in scenario 3 (or to any other relevant scenario in this discussion draft)?**
The use of external comparable (external databases) would be, among others, appropriate to remunerate routine activities when the residual profit split is used.

19. **What aspects of scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?**

As mentioned before, the overview of the whole value chain together with a complete functional analysis in order to determine the real nature of the contributions made by each party.

20. **In what circumstances, if any, might an approach described in the last sentence of paragraph 32 be appropriate?**

We don't have comments in this regard.

21. **More generally, in what circumstances would a transactional profit split approach be useful in supporting the application of other transfer pricing methods, and what guidance would be useful to develop for the supporting use of such approaches?**

We don't have comments on this.

22. **In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?**

This question should be analyzed on a case-by-case basis. Additional guidance on what factors would better reflect value creation would be very useful when using profit split methods. However, it is difficult to find common features for specific industries as they will mostly depend on the functional analysis and the contributions made by each party to value creation in each specific transaction. Nevertheless, listing examples could serve as guidance.

23. **What guidance is needed on weighting of factors?**

How to weight allocation criteria is a critical step when applying profit split methodologies. Developments in this regard might be very valuable for taxpayers in order to implement these methodologies such as what to value most, how to weight different factors, etc.

24. **How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for example approaches based on concepts of bargaining power,
options realistically available, or a RACI-type analysis of responsibilities and decision making)?

Alternative approaches can be very useful when traditional ones are not appropriate. Especially when dealing with highly integrated activities where, as mentioned before, it is very difficult to find independent comparables, additional explanations provided may provide further clarification on the arm's length nature of the remuneration agreed by the Group companies. Therefore, Tax Authorities should be open to these approaches as they will help taxpayers to prove the rationality of the transfer pricing policies adopted.

25. Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an MNE operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate?

A multifactor profit split analysis would be appropriate to test the arm's length nature of the remunerations agreed among Group companies when the activities conducted are very integrated. Under this scenario, the use of several factors would allow to align the value creation with the profit achieved by each party. The selection of the factors to use and their weight should be determined considering the facts and circumstances of each case, so that they reflect the function, risk and asset profile of the companies involved.

26. What specific aspects of transactional profit split approaches may be particularly relevant in determining arm's length outcomes for transactions involving hard-to-value intangibles?

In these situations a thorough functional analysis of the contributions made by each Group entity becomes even more important in order to determine to what extent they are entitled to perceive the potential profits generated by the developed IP.

Given the difficulties to use one-sided methods to value certain intangibles, transactional profit split methodologies could be appropriate when there are different entities performing relevant functions in connection with the development enhancement, maintenance, protection and exploitation of those intangibles.

However, this question should be analyzed together with comments raised on action 8.

27. How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?

In these situations it would be possible to use residual profit split methodologies in order to ensure a proper remuneration of the entities involved in the transactions under analysis. Once routine functions are remunerated, the residual profit/loss is shared among the Group entities according to their respective contributions. It is therefore
needed a deep analysis on how to value the contributions made of each party, considering not only functions or costs, but also risks borne; further guidance on how to measure and weight risks for the purposes of sharing profit/losses would be very useful.

28. *Is the application of a transactional profit split method to calculate the royalty in Scenario 8, or in other circumstances to set a price, helpful? What are the advantages and disadvantages?*

The use of the profit split could be useful when the IP licensed is very specific and comparable are hard to find. Also when both parties have been engaged in developing, enhancing or maintaining such IP and therefore a fixed royalty rate on sales is not considered to reflect the arm’s length contribution of the licensee.

However, this question should be analyzed together with comments raised on action 8.

29. *In what circumstances might it be appropriate under the arm’s length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss?*

It should be carefully supported that different factors are used depending on whether the Group makes profits or losses in order to avoid subjectivity and any behaviours that would not be acceptable between independent parties. Proper explanation should be prepared in order to demonstrate that entities involved in the intercompany transactions under analysis would be entitled to different return as their contributions would vary depending on the final result (i.e. profit / losses).

30. *Are there circumstances under the arm’s length principle where parties which would share combined profits, would not be expected to take any share of combined losses?*

It is difficult to think of such situation in a relationship between independent parties. In principle, only when it could be solidly proved that the entity contribution is not related to the generation of losses, it could be argued that such entity should not take part of them; on the contrary, if all the entities are considered as entrepreneurs (assuming key functions/risk in the value creation), all of them should be ready to share either profit or losses.

31. *Paragraph 2.114 of the Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?*

Indeed, practical difficulties highlighted in paragraph 2.114 still remain relevant and it is generally acknowledged that the application of the profit split method is of technical complexity. Nevertheless, in some cases it is the only approach that provides
consistent results in line with the arm's length principle being thus necessary to facilitate its use by the MNEs. In this regard, simple approaches should be admissible in connection with the factors used or the weight given to each of them, so that the practical implementation of the method does not become very difficult to manage for taxpayers. More sophisticated models should be kept for those Groups where information needed to split profit/losses is easily available through its internal systems.

In light of the above, detailed guidelines on the definition of profit would be advisable since MNEs are complex and often encompass many different businesses. It is therefore necessary to segregate and to allocate costs till the bottom line. In this regard, the use of management accounts should probably be favored as a starting point to avoid MNEs to put in place a new set of information to answer to the tax Administration requests.

32. Finally, what further points would respondents wish to make about the application of transactional profit split methods not covered by previous questions?

Any guidance provided by the OECD in connection with the practical application of this methodology (e.g. definition of profit, factors to share profit/losses, how to weight them, etc.) would help taxpayers to implement it with more certainty as this method is very useful for testing the arm's length nature of certain transactions.

Since value chain might change over time, any developments on the need to update the allocation of profits would also be useful.

Consequently, we urge the OECD to carefully consider these aspects in the process ahead.

BUSINESSEUROPE would be willing to engage in a constructive dialogue with the OECD on use of profit splits in the context of global value chains.

On behalf of the BUSINESSEUROPE Tax Policy Group

Yours sincerely,

[Signature]

James Watson
Director
Economics Department
Dear Mr. Hickman:

RE: BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

The Canadian Bankers Association\(^1\) (CBA) welcomes the opportunity to provide a submission on the OECD’s Public Discussion Draft on BEPS, Action 10 on Profit Splits in the Context of Global Value Chains (the “Discussion Draft”) released December 16, 2014. We bring the perspective of an industry characterized both by intense competition in Canada and the active involvement of our banks internationally.

Very generally, the Discussion Draft examines the circumstances in which the application of a transactional profit split method is likely to be appropriate, and the ways in which the factors used to split profits can align profits and value creation in the context of global value chains. The CBA is committed to contributing constructively to the BEPS project, in the expectation that the final outcome will deliver fair, certain, predictable, sustainable and principled rules that taxpayers can easily apply and tax authorities can easily administer.

Guidance

The OECD has previously provided detailed guidance to financial institutions on attributing profits to Permanent Establishments (“PEs”) within a multinational banking group. Article 7 of the OECD Model Tax Convention on Income and on Capital ("Model Tax Convention") sets out the arm’s length principle to determine profits attributed to PEs. The 2010 Report on the Attribution of Profits to Permanent Establishments (the "PE Report") is the OECD’s guidance on the interpretation of Article 7. Included in the PE Report is detailed guidance for Banks, Global Trading on Financial Instruments and Insurance Companies which can be used for determining profit splits for global value chains in

\(^1\) The Canadian Bankers Association works on behalf of 60 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. [www.cba.ca](http://www.cba.ca).
the banking context. In our view, any further guidance for banking enterprises for determining profit splits should be consistent with the existing detailed guidance set out in the PE Report. To do otherwise will increase uncertainty for taxpayers and could result in an increased number of disputes with and between global tax authorities.

Moreover, many aspects of the guidance that was provided by the OECD in the PE Report can also be applied equally to the application of the transactional profit split method for global value chains in the context of Article 9 of the Model Tax Convention. For example, the concept of “key entrepreneurial risk-taking functions” ("KERT-functions") that is used in the PE Report should be used to provide guidance for the “people functions” which are referred to in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators (the "OECD Guidelines").

In our view, any further guidance should be also clear on the principles to be taken into account in the profit split analysis, e.g., determining what unique and valuable contributions are, what is considered routine versus non-routine services and how these concepts differ. The OECD guidance should also confirm that in the event that where other methods cannot be applied, then only the residual profit split method is appropriate. Specific examples should also be avoided in further guidance since tax administrations may be tempted to apply such examples to situations to which the examples are not relevant, resulting in an increase in tax controversy and disputes.

**Losses**

The PE Report (page 146, paragraphs 190 to 195) provides guidance where a profit split results in a trading loss. We do agree that there is likely a correlation between profit and compensation; however, there is less or limited correlation between losses and compensation. Where a profit split could result in a trading loss, the KERT functions performed by each party should be analyzed as well as the profit split agreement to determine apportionment.

It is important to note that, as compared to splitting profits, there are different and less certain factors to be taken into account when sharing losses. Any further guidance should be clear on the principles that should be taken into account for sharing of losses as different interpretations by tax administrations can be harmful to taxpayers and result in an increase in tax controversy and disputes. In addition, it is important that tax administrations accept that profit split methods could result in sharing of losses between jurisdictions in order to decrease taxpayer uncertainty and avoid an increase in tax controversy.

The banking and financial industry is highly regulated. Regulatory requirements may in certain circumstances prevent financial institutions from sharing losses (as noted in paragraph 195 on page 147 of the PE Report). Further guidance should be clear on the principles that should be taken into account in order to address the impact of regulatory requirements on profit splitting or loss sharing methodologies, as different interpretations by tax administrations regarding profit or loss attributable to a PE in a particular jurisdiction will ultimately result in an increase in tax controversy and disputes for taxpayers.

**Centralized Services and Costs**

Further guidance from the OECD should clearly address how to account for head office and other centralized services within a multi-national enterprise when applying a transactional profit split method. In our view, it is appropriate if such costs are first allocated amongst the parties based on services being provided and the benefits being received before any remaining profit is allocated amongst the group. Without clear guidance, the allocation of head office costs can lead to an increase in tax controversy.
Safe Harbours and Controversy

We recommend that any further guidance include clear safe harbours to minimize tax controversy, including factors used to split profits, the weighting of these factors, and industry safe harbours.

Applying profit splits is a very subjective exercise and the burden to taxpayers increases if tax administrations do not agree with the profit split methodology. In most cases, in order to ensure certainty and minimize double taxation a multilateral Advance Pricing Agreement will have to be entered into and this increases the administrative burden of taxpayers. Clearer guidance and additional safe harbours could reduce this burden on taxpayers.

Guidance should be clear on the principles of a change in the value chain as different interpretations by tax administrations will result in an increase in tax controversy. As industries change, profit split methods in that industry will also need to change to reflect different value creation.

Administrative Burden

In our view it is important that the use profit split methodology does not create an additional burden for taxpayers with respect to keeping additional books and records. Further guidance should be provided on the type of information tax administrations can request on profit split methods to minimize the additional administrative burden on taxpayers.

We appreciate the opportunity to provide these comments on the Discussion Draft. We would appreciate responding to questions and provide any further information that can be useful as the OECD continues its work in this important area.

Sincerely,

[Signature]

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2 There are only a few instances where there is binding arbitration under mutual agreement procedures.
CBI RESPONSE TO THE OECD PUBLIC DISCUSSION DRAFT ON BEPS ACTION 10: THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAINS

1. The CBI is pleased to comment on the OECD’s Public Discussion Draft on Action 10: The use of profit splits in the context of global value chains.

2. As the UK’s leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

3. The CBI continues to support the BEPS programme to update international tax rules to reflect modern business practice, tackle abusive tax structures and target the incidence of double non-taxation. However, we are concerned that if complexity and uncertainty are not avoided, the outcome will be an increase of double taxation and resulting legal disputes, which could have a substantial and negative impact on cross border trade and investment, but also on tax administrations with limited resources.

Overview

4. The CBI welcomes the attempt by the OECD to clarify both when profit split methods should be used and how profit splits should be implemented.

5. The CBI believes that profit split methods should only be used in clearly defined limited circumstances where no simpler methods are appropriate. Tax payers should have upfront clarity on what method should apply.

6. The general business experience of the use of profit split methods has been problematic. Some tax authorities force their use rather than engaging with the taxpayer in order to better identify appropriate comparables for the application of another OECD recognised method. The full global value chain of an MNE is very rarely understood by tax authorities. This often leads to simplistic calculations which do not reflect the actual fact pattern, in terms of assets, functions and risks. It is very difficult for many countries to agree on the same allocation factors. Without co-ordination and agreement across all countries, the inevitable result will be increased disputes, greater compliance burdens and ultimately double taxation. Therefore significantly more guidance on how to implement a profit split, and what impact that has on other tax rules needs to be introduced.

7. The exception to this is in relation to banking and financial services, where the OECD’s 2010 “Report on the attribution of profits to permanent establishments” was the result of a thorough consideration, and
the resulting approach is generally well understood by taxpayers and tax authorities. We believe the OECD’s current work on profit splits should acknowledge the 2010 Report remains the relevant approach for banking and financial services.

8. We would also welcome more guidance on how adjustments can be made to comparables, so that the majority of transactions in the global value chain can be dealt with under “the most appropriate method” rather than defaulting to a profit split. This would help to increase the use of the more acceptable methods and reduce the application of profit split methods.

9. This discussion draft makes suggestions that move towards some form of formulary apportionment. This would disrupt the existing international consensus – including the OECD’s own position – that the arm’s length principle should remain the accepted basis for transfer pricing methodologies and therefore we would not welcome any further guidance on the use of these methods.

Detailed Comments

10. In this response, due to the detailed analysis that would be required for each example, the CBI has not responded to each of the specific questions raised in the discussion draft. We have therefore limited our comments to the conceptual issues raised by the examples.

11. The CBI has reviewed the response prepared by BIAC. The BIAC response provides an analysis in respect of the proposals and the CBI supports the conclusions reached in that paper. We have however noted points of specific interest to British business, and where possible, provided further examples from our members.

Value Chains

12. The CBI supports the current approach under the arm’s length principle as the “most appropriate method”. This should mean that profit splits are not automatically applied in certain situations. Except where two or more parties make unique and valuable contributions, the choice of the most appropriate method should depend on whether comparables can be found, and whether reliable adjustments to those comparables can be made if necessary. These simpler methods may also be more relevant and less burdensome for more complex business structures.

13. Functions which are highly integrated should not be accorded a different interpretation to their nature.

Multisided business models

14. The CBI considers that the same analysis should be applied to multisided business models as is applicable to other types of business. No special rules for the application of a profit split method should be required.

Scope

Unique and valuable contributions

15. The CBI considers that the wording in paragraph 6.17 of the transfer pricing guidelines as amended for the 2014 report “Guidance on the Transfer Pricing Aspects of Intangibles” is helpful and that concept should be maintained for the purpose of profit splits.

Integration and sharing of risks

16. As outlined above, we do not believe that specific rules should apply for integration and that the most appropriate method should be applied.

17. We have submitted representations in respect of the OECD discussion draft on the proposed revisions to Chapter 1 – including details of the treatment of risks. We would note that there are a number of scenarios where companies solely transfer the risk to third parties (e.g. insurance or the use of derivatives in financial markets). Therefore there may be a number of situations where a one-sided
method may produce reliable results.

**Fragmentation**

18. There are a number of commercial reasons why fragmentation occurs and each situation should be analysed on its own merits. In principle, non-unique contributions should be treated consistently and should not vary merely as a result of fragmentation, integration or a lack of comparables.

19. Profit splits should only be used if consistent with the arm’s length principle. The methodology outlined at the end of paragraph 32 of the discussion draft could potentially be refined to offer a practical solution if, once a range has been established, positioning in the range can be changed based on a review of the functions, assets and risks of the tested entities.

**Lack of comparables**

20. As clearly outlined in paragraph 82 of the discussion draft on the revisions to Chapter 1, we welcome the clear wording which confirms that “the mere fact that transactions may not have been seen between independent third parties, does not mean that it does not have characteristics of an arm’s length arrangement”. We believe greater emphasis should be placed in this paper on this same theme and there should be a recognition that even where there are no comparables, applying a profit split does not automatically provide a more accurate answer.

21. There could be a number of situations where an adjustment is made to one-sided comparables which then provide a more objective and accurate answer to a subjective profit split methodology. We would welcome further work to be carried out and more detailed guidance on when adjustments to one-sided methods can and should be used in preference to moving into profit splits.

**Aligning taxation with value creation**

22. The CBI supports the objective of the BEPS Action Plan that taxation is aligned with substance. However, the experience of our members regarding profit split is that it invariably leads to greater disputes and potential for double taxation, due to the inherent subjectivity. We would therefore welcome any move towards achieving more objectivity within profit splits. However, we remain sceptical that this can be achieved, given that the focus of profit splits should remain on unique and valuable contributions. By definition, these need to be evaluated based on their own specific features given they are different to anything else.

23. Any general rules based on bargaining power, options realistically available or a RACI analysis which would lead to any form of formulary apportionment would not be welcome and would disrupt the existing international consensus – including the OECD’s own position – that the arm’s length principle should remain the accepted basis for transfer pricing methodologies. We would therefore not welcome further guidance on the use of these methods.

**Hard to value intangibles and dealing with ex ante/ex post results**

24. As outlined in our response to the discussion draft on the revisions to Chapter 1, the use of earn-out clauses in commercial transactions relating to the sale of intangibles is overstated. In the significant majority of cases, the seller is looking to divest of all future risk, whilst the purchaser would be looking to reward the taking on of the full risk in future.

25. It is unclear how future results can be measured given that intangibles will continue to be subject to development and unforeseen changes may occur (from new technologies, to force majeure natural disasters).

26. It is our view, that only in situations where it is clear that the transaction has not been supported by contemporaneous documentation to support future projections with factors known at the time of the sale, should actual future results be taken into account. To use future results as part of a profit split would be a move away from the arm’s length principle.
Dealing with losses

27. The CBI believes that any robust transfer pricing methodology should be capable of dealing equally with losses as it does profits.

28. The main exception is where an entity has been formed (such as a captive insurer) to specifically take on risk for losses for which an arm’s length premium should be paid.

Difficulties in preparing and implementing a profit split

29. To illustrate the practical difficulties facing business, we have prepared a mini-case study. We then look at the issues facing business both from an internal perspective, and also when dealing with tax authorities.

Case Study - Preparing a profit split for a complex value chain where multiple entrepreneurs are contributing to value creation

30. In a complex value chain, establishing how to split operating profits requires a mapping exercise to identify who creates what value where. This can be achieved by performing a detailed process map, followed by valuing each process and then allocating each process value to the parties that contribute to that process. The example we use here is where 2 entrepreneurs are identified. One (X-co) responsible for managing the supply process and the other (Y-co) responsible for all marketing & sales related activities in a territory where by the transaction to price is the supply of finished products supplied by X-co to Y-co

31. Process descriptions are as such not standard in industry and each MNE will have designed its own organization matrix with accountabilities and responsibilities. Such mapping must therefore be based on / rely upon internal information of the MNE.

32. Each business furthermore will use its own set of value drivers for running its business: e.g. what are the critical success factors for running the operation, what are the related risks. Some of those are common for industry, others will be specific for an MNE or specific to a region. Those drivers are relevant for determining what value a process is generating. An assessment therefore is to be made of what driver is more valuable and what process is depending on what driver.

33. Having so mapped the value per process, via a detailed contribution matrix one needs to determine what X-co and Y-co contributes to what process: who is responsible/accountable, who is performing the leg work on a process, who is the decision maker, who provides input (e.g. via a RACI).

34. To convert that functional matrix in a number to be applied in the profit split, one needs to set how much e.g. work contributes to a process, how much responsibility is taken for the decision etc. For example, in a RACI, having Responsibility for a process may imply 40% of the value is to be attributed to that contributor, Accountability 30%, Consulted 20% and Informed 10%. This needs to be assessed per transaction under review.

35. By bringing the process value map and the contribution matrix together one can then see what X-co and Y-co contribute to a process as a percentage of value that serves as the percentage for the profit split.

36. Where possible, one should focus on a residual profit split approach. However, it will not always be possible to carve out benchmarkable transactions from a process analysis. For example, where CUPs are available for intellectual property it will be possible to exclude those from the exercise. However,
for a manufacturing site eliminating their involvement from processes and contributions may be more difficult or impossible since a manufacturing site may contribute to multiple processes (e.g. strategy, buying, planning) where it will be hard to breakdown the whole process in to such a detail to carve the manufacturing site’s contribution. A practical solution could then be to allocate that full process and value to the relevant entrepreneur in the chain (X-co) and have X-co compensate the manufacturing site based on the benchmark for manufacturing sites, out of the profit allocated to it via the profit split.

37. Method wise now a profit split has been established with a percentage for each entrepreneur. However the transaction under review is a supply of goods. Therefore, the prices per transactions should be set in a way that X-co collects via the transfer price per finished product, the profit it is entitled to according to the profit split methodology respecting indirect tax requirements as well as legal requirements: prices reflecting proper value for the goods supplied and transfer prices not higher than the price for which Y-co can sell into the market. As an example: Where X-co and Y-co would run multiple goods flows in various product segments, profit margins will differ per product category. Applying a mechanic based on allocating an average profit element to each product may then result in transfer price for the low margin product exceeding the sales price to the market. In number of jurisdictions this is not allowed and therefore the pricing mechanic needs to be adjusted to take the profit margin generating factor into account.

Practical difficulties

38. We have outlined below a number of practical issues for companies attempting to apply the profit split method:

i. The process value map as described is in general not available or used in businesses: it needs to be built for tax/transfer pricing purposes only.

ii. Building the process and value map is time consuming:
   o it requires explanations as to what the tax team is trying to achieve to get the relevant input from people (why the processes need to be mapped, why particular value drivers have been selected etc).
   o it requires consensus from all those contributing to the processes on what value drivers to use and what relevant contributions are made
   o it requires input from a significant number of senior and non-senior people in the business to ensure a un-biased view
   o the outcome needs to be validated and approved by various departments
   o no external data is available to corroborate at process level

iii. Organizational change in MNEs is continuous, both in terms of process as well as contributors. Changes happen gradually throughout the year. A practical view therefore needs to be taken as to when the profit split allocation should be amended. To do so, the mapping needs to be updated, including all the validations listed above with multiple departments, senior management etc.

iv. Due to market conditions, focus by the business on value drivers may change and/or the relative value of the drivers may change (e.g. in a declining market supply chain related value drivers may increase in relative importance). This implies that a profit allocation to one of the entrepreneurs may change without any change in who contributes to a process.

v. Converting the methodology to a transfer price for goods is a cumbersome exercise and requires constant monitoring and adjusting to land the operating profit close to the profit split as set under the methodology. This is because prices must be set at the moment of supply to comply with Indirect Tax requirements. At that moment X-co and Y-co may not yet have full visibility of all related costs: e.g. in a situation where material prices are volatile and forecasting of sales is difficult, the actual results will differ from the assumed costs when setting the prices in the IT-system (e.g. an average forecasted cost may be used and fixed costs allocated to finished products may have taken place based on an annual forecast). A cumbersome process has to be
established to collect, on a monthly/quarterly basis, all relevant financial information to be used to calculate the split across the various entities and contributors (both actuals year-to-date and forecasts for the remaining of the year) to perform that analysis. This is information is neither readily available nor of use to the business for its performance and therefore it is seen as an exercise purely for tax/transfer pricing purposes.

vi. In the case study given above, assuming that X-co also supplies goods to another group entity Z-co, a split of X-co’s results between results related to Y-co and to Z-co separately would also be required. This is necessary to be able to determine for each supply relationship of X-co separately whether the profit split is achieved.

Experiences of dealing with tax authorities in applying the profit split method.

39. In Europe, so far, tax authorities do accept the Profit Split Methodology as a method of last resort, i.e. they first ensure that none of the other methods could be used. Our observations from various APA and audit processes are as follows:

i. Tax authorities all raised the issue of subjectivity of the internal exercise described above and often challenged the robustness of the exercise. Their focus is on how the processes have been described, how value has been allocated and how the contributions are split (i.e. the value for the RACI as described above).

ii. In all cases discussions were held on other mechanics to corroborate the outcome, e.g.:
   a. Request to assess the employee base of the two entrepreneurs to see whether the ratio is aligned to the profit split outcome.
   b. Request to provide relevant salary data to support the split
   c. Request for outside validation by experts
      (external experts are in general not familiar with the detailed processes of an MNE and therefore can only give a view on high level perspective, not on a split or the contributions made by entity).

iii. The authorities argued in most cases that in building the profit split via the interviews and process mapping more people from their jurisdiction should have been involved in the interviews. Following from this they argued that country particularities were therefore not taken into account. Where market conditions are similar, however, this should not be required.

iv. To audit a profit split, the tax authorities of Y-co should have access to the financial data of X-co.
   a. Normally under Tax Conventions/Treaties such information is not available to tax authorities in other jurisdictions.
   b. The tax authorities of X-co furthermore audit X-co in its totality, while the tax authorities for Y-co are interested in getting confirmation of X-co’s result in relation to transactions with Y-co only. However, X-co for its local reporting does not split out its results between the various supply relationships (i.e. to transactions with Y-co and to Y-co) and therefore neither the X-co financial information nor the related tax audit will provide comfort to the tax authorities in the territories of Y-co and/or Z-co. The authorities in Y-co and Z-co’s territory could furthermore take different positions on all of the elements resulting in different outcome in each country. This would then require multiple MAPs/Arbitration with the tax authorities of X-co territory to ensure consistency. We would note that one probable outcome of the increased use of profit splits would be a significant increase in tax disputes and consequent greater need for bi/multi-lateral dispute resolution via MAP.
v. Tax authorities often raised the challenge that due to the true up process, X-co did not run any risk and therefore all profit should belong to Y-co and Z-co.

a. The profit split takes place on operating profit level, i.e. after incurring of any risk. Unless there is a very exceptional situation causing distortion by one of the parties (e.g. fraud) no adjustments should be made to the operating profit to be split.

b. The true up settlement does not impact how risks are managed. Based on the functional analysis, risk analysis, and process mapping, a split of the operating profit has been set at a particular level. Reaching that level via true up does not change anything in the risk management profile.

40. We trust that you will find the above comments helpful in understanding the potential impact of the proposals outlined in your paper. We remain committed to ensuring that each BEPS Action achieves its stated goals, whilst ensuring that genuine business arrangements are not unduly impacted to which this Action forms a key part.

41. We remain at your disposal should you wish to discuss the issues we have raised in this paper in more detail. Please contact neil.anthony@cbi.org.uk for more information.
Dear Mr Hickman,

“Transfer Pricing Centre” Association (“TPCA”) welcomes the opportunity to provide comments on the discussion draft on the use of profit splits in the context of global value chains.

“Transfer Pricing Centre” Association (“TPCA”) is a non-profit organization aimed at promoting transfer pricing knowledge in Poland, founded by specialists working for capital groups in Poland, mainly in energy and industry sector. Hence we hereby present the comments as representatives of business. However, since the Association is a legal person, we present the comments only on behalf of the Association. The comments expressed in the letter should be interpreted as opinion of the Association and not particular members of the Association.

We would like to confirm that have no objections with posting our comments on the OECD website.

We are at your disposal to discuss any aspect of our comments. We look forward to developments and further discussions on the topic.

Yours faithfully,

Sylwia Rzymkowska
Chairman of TPCA

Andrzej Podszywałow
Member of Program Council

sylwia.rzymkowska@cct.org.pl   kontakt@cct.org.pl
Subject: COMMENTS ON THE DISCUSSION DRAFT ON THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAINS (Action 10 of the BEPS Action Plan)

Scenario 1
For highly integrated businesses profit split analysis should be used to evaluate profits attributed to each engaged location. However, the description of scenario 1 underlines the role of Leadership Board and decisions taken by this body. This language might lead to a solution that significant people functions should be assigned to the Leadership Board (“LB”) and that the decision making process is the most important for the success of the group. We would like to comment on the process of taking decisions. Empowerment to take a decision within a company or a group depends on statutory regulations in the group and articles of association of a particular company. There are situations where a decision can be taken by a manager, a committee, designated chief officer or board member, whole management board, supervisory board, general assembly of shareholders, management board of a parent company, supervisory board of a parent company etc. We would like to underline that usually decisions taken (irrespective of who/what body takes a decision) results from work undertaken by employees, teams etc within various fields of expertise. Ultimate decisions (e.g. what new products are built etc.) can be taken by the LB but in fact those decisions stem from the work and positions of a group as a whole. Therefore, the decisive power of the Leadership Board in scenario 1 should not be the sole criterion in establishing profit share for each of the OEMs. Transactional profit split can be used to provide a TP solution to scenario 1 but should take into account all success factors.

Highly integrated functions should be analysed as a whole using consolidation approach to arrive at profit. Profit analysis for highly integrated businesses should be looked at not from the perspective of a single business line/a single subsidiary but from the perspective of value creation by all the business lines/all the group.
If the transactional profit split method was to be applied in scenario 1, we should have information whether:
- LB is directly related also to the “Parent company” and operates in its interests or not,
- OEMs or their subsidiaries compete or not,
- OEMs or their subsidiaries engage valuable or/and unique intangible assets (e.g. know-how) in connection with important location.

That information is important to determine the residual profit generated by a group of related entities in a particular field of operation (e.g. line of business, location). It is necessary to identify the differences in the functions, assets and risks OEMs perform and bear within the framework of joint actions agreed at the level of the LB, including LB’s costs of operation. Unrelated, companies usually develop and protect their unique assets and competencies which may cause that operating at the same level of technology and in a highly integrated manner can lead to different financial results. In particular cases, there may be a significant relationship between competitive factors generated on the basis of identified valuable assets (e.g. human capital, know-how, creditworthiness) owned by a specific OEM and a sum of profits realized jointly by all OEMs.
**Scenario 2**

Profit split analysis can be used to provide a TP solution in the case of scenario 2, especially taking into account that due to complexity of activities undertaken by RCo Group, it would be difficult to find unrelated comparable transactions.

We understand that subsidiaries:

- do not sell advertising services (on their own and as Parent’s agents),
- achieve revenues from cooperation with Parent (providing services in the area of development of the platform, localization services and so on).

In scenario 2, local subsidiaries should be remunerated for their services relating to promotion, adaptation to local market features. Profit split analysis applied after local services are remunerated should ensure that local subsidiaries participate in revenues from local advertising services (based on RCo data relating to each particular market/country) and costs realized in given locations.

**Scenario 3**

Profit split analysis can be used to provide a TP solution in the case of scenario 3 due to unique and valuable contributions of company P and S. In this situation role of the entities is complementary to each other. Companies P and S own highly valuable intangibles (e.g. customer relations, innovative technology, global trademark) which are an important and substantial source of value creation and competitive advantage for the MNE group’s business.

Scenario 3 does not indicate what are the drivers that cause customers to buy industrial equipment delivered by Group X. In particular, it is not clear what impact has the trademark on the level of sales. Depending on the potential power of the brand there might be various solutions to the case.

Identification and valuation of engaged intangible assets could provide a basis for the construction of the profit allocation key. An alternative solution would be to conduct market research in order to identify the relative importance of the identified intangible assets in the decision-making process of customers. Behavioral analysis can help determine the residual profit allocation key in an objective and verifiable manner.

**Scenario 4**

The case in scenario 4 can be interpreted as a joint venture/joint operations agreement. For a joint venture, sharing of risks goes in hand with sharing profits. Therefore, a transactional profit split method should be appropriate for dealing with sharing risks and undertaking a joint venture. Unrelated parties would agree such cooperation using joint venture rather than a sort of long term supply contract (if we take into account the profit sharing as a way of remuneration).

**Fragmentation**

We would like to underline that fragmentation of functions should be looked at from the broader perspective described in the discussion draft on Action 7 of the BEPS Action Plan (Preventing the artificial avoidance of the PE status). We are concerned by the proposal that the anti-fragmentation rule (expressed in par. 27.1 of the commentary on article 5) should not be restricted to cases where the same company maintains different places of business in a country but should be extended to cases where there places of business belong to related parties (see point 30 of the discussion draft).
If anti-fragmentation rule for PE purposes will be introduced, the use of transactional profit splits seems obligatory to provide arm’s length results for fragmented functions. We would like to express our concerns whether the expanding of the anti-fragmentation rule to related parties will lead to force-of-attraction of the PE and will be used also in the cases where companies of a highly integrated group perform various activities in a country due to purely business reasons.

**Scenario 5**

We would be cautious to attribute extra profit in the situation where a company has a right to take orders from local customers on behalf of their regional organisation. It would be very difficult from the perspective of the seller to decide what portion of sales relates to local needs of the client and what portion to the needs of the region.

In our opinion in this case transactional profit split might not be an appropriate method. Operating companies should be granted a remuneration that is appropriate for distributors of office stationery on their markets.

**Aligning taxation with value creation**

The given set of key value drivers (Scenario 1) lacks the essential drivers of demand. It seems that such "purely supply-side approach" does not provide a comprehensive analysis of the problem. More important than the production capacity (which for example can be obtained in outsourcing) may prove to be a long-term client relationships or know-how in the area of marketing management.

The functional analysis should be crucial to identify the drivers of value creation. Equally important is to estimate reliably the indicated value drivers and to determine their relative importance.

Determining the relative importance of value drivers should indicate allocation keys. It can also be achieved through market analysis in the context of a particular transaction, industry or sector and in order to avoid subjective assumptions. We think that the most important is simplicity and verifiability of the solution because such rules would be adopted by unrelated parties.

**Hard-to-value intangibles**

In practice, there are methods of valuation so-called “Hard-to-value intangibles” including partially developed intangibles (e.g. technological innovations at the early stages of development or commercialization). Due to the uniqueness of creative activities, high level of uncertainty and lack of strong links between expenditure and effects, cost approach is rarely useful in such cases. Valuation of the transaction subject should be clearly distinguished from determining of the transaction price.

We would recommend to use the result of professional valuation as a proper transfer price subject to adjustments addressing specific terms of a transaction, such as the method and timing of payments, additional obligations of the parties, creating a risk of contractual arrangements, etc.

It is difficult to identify any elements of the transactional profit split method that would be useful in the valuation process of hard-to-value intangibles with the exception of the arm’s length principle, which is used in all standards of valuation of intangibles.

**Scenario 7**

The case of scenario 7 should be looked at from the perspective of unrelated parties. In our opinion unrelated parties would not agree to conditions described in the case but instead would agree to a joint venture or joint operations agreement. In the joint venture situation cost overrun risk would be shared between the participants.
Scenario 8

Transactional profit split method might be used to calculate royalty in this scenario but only because of the assumption that the parties to the contract agree the conditions of the license fee in the launch phase of the investment project and agree to participation in all expenditures and all risks according to a fixed ratio. Such a situation should be classified as exceptional, in practice long-term projects of this kind occur frequently (transactions involving the property rights of the project at various stages of its development). There is thus the possibility of using market-based approach in the process of establishing the rate of royalties.

Should transactional profit split be chosen in this scenario, we would opt for application of scenario analysis to define minimum and maximum level of royalty taking into account various projections of expected sales, revenues and costs.
February 6, 2015

Comments on

DISCUSSION DRAFT ON THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAINS and other related transfer pricing issues

China International Tax Center / IFA China Branch

For all the discussion regarding the transfer pricing issues, in order to “assure that transfer pricing outcomes are in line with value creation” in the context of “other high-risk transactions” referred to in the BEPS Action Plan, we have the following comments for reference:

1. Why there is government intervention in the transfer pricing outcomes?

In modern economy, transactions are carried out in both the micro and macro environment, in which governments, markets and enterprises are interactive with each other, which also means that the profits shall be allocated not only between the enterprises but also between the markets and governments.

Normally, it is the enterprises that directly carry out the transactions, and they will also decide the transfer price between the related or unrelated parties; in this way, however, the market and government contributions (which are often indirect) are neglected, especially in the case of transfer pricing outcomes between the related parties.

Then comes the intervention of the government for the tax. Tax is the price for civilization; the government provides public goods and services in the compensation form of tax. If the government deems that the tax base is eroded, it will recharacterize the transaction for fair share of tax base. Even further, it will stand up to support its taxpayers for the fair share of profits.

Contributors to this comments are research fellows of the China International Tax Center and members of the IFA China Branch:

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2. How shall the transfer pricing adjustment mechanism be upgraded?

Since all transfer pricing outcomes are the result from the contribution by the enterprises, the markets and the governments, fair shares shall naturally and logically be allocated between all these parties, not merely having an eye on the enterprises.

In the past, the TP mechanism focuses on only the supplier side of enterprises with no emphasis of the market and no mentioning of the government.

In this regard, we suggest that two concepts be upgraded:

- Value creation be combined with value realization

The underlying logic is: it is the value that people care in the transactions, the parties who creates and realizes the value shall be compensated and shall enjoy the surplus. Thus, the transfer pricing outcomes shall be in line with not only value creation, but also value realization.

In the BEPS Mechanism, there is great discussion that transfer pricing outcomes shall be in line with value creation. Value realization in a broader sense can be regarded as part of value creation, but we suggest it is better to use value creation in a narrower sense to talk mainly about the supplier side; value realization better be brought forward to discuss the demand side. Both value creation and value realization enable a value becomes a value. In this way, the role of the enterprises and markets are clearer and their contribution to the value will be easier to be identified and differentiated.

- Arm’s-length-principle be combined with Fair-share-principle

Arm’s-length-principle usually applies to the transactions between the enterprises, in order to exclude the integration effect between the related parties. The key emphasis and benefit is the comparability analysis of the enterprises.

However, with this principle and method, the exterior contributions from the markets and the governments are not reflected; the cost-based transfer pricing method cannot satisfy the new need, the profit-based methods are therefore welcomed by governments, and even further, the simpler Formulary Method which takes care of all important contributing elements will better illustrate the Fair-Share-Principle.
3. **What is the implication to China?**

When the contributions from the markets and governments are taken into consideration, the Location Specific Advantage will stand out.

The LSA mechanism has great implication to China in the following aspects:

- **COST SAVING**

  With the discussion within both the UN and the OECD, the cost saving effect can be easily recognized and calculated. The China State Administration of Taxation clearly demonstrates its invention in its recent years working reports, with the emphasis on the cost saving from labor, capital, technology, social insurance and environment protection.

- **MARKET PREMIUM**

  The market premium concept is welcomed by the UN, but not accepted by the OECD yet. However, with the further development of the BEPS Project, there will be more cooperation between the governments, the Fair-Share-Principle will be better understood and accepted, the market premium mechanism will become true. With this concept, China and other countries may claim fairer share of transfer pricing outcomes by listing the advantages of the market size, accession policy, elasticity, etc.

- **GOVERNMENT CONTRIBUTION**

  This can be a very unique and valuable contribution of the Chinese government, in both the modification of the transfer pricing mechanism and the allocation of the transfer pricing outcome.

  Government contribution to the value creation and realization is substantially great but always neglected. Government is not recognized as a producing unit in the past; in the modern economy, its macro productive force is increasing accepted by the society. Especially in the case of the Chinese government, it is not only an expenditure unit in compensation for passive public service of security, but also an active investing party in the economy who then shall enjoy the surplus of the out-puts; the Chinese government undertakes more functions than other “market economy governments”, this might eventually be explained and illustrated with the analysis of the fiscal budget or other financial data.

Finally, from our understanding, the world economy is in a great crisis; for the sustainable development of the world economy, many economic policies including the tax policies need redesigning and restructuring. In this era of new globalization, we need first renew our concepts to catch up with the rising tide of the open economy, and then will come the upgraded techniques that will help materialize the new concepts and establish a new order for the economy.
January 29, 2015

Mr. Andrew Hickman,
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Centre for Tax Policy and Administration
2 Rue André Pascal
75775 Paris Cedex 16
France

Via e-mail to transferPricing@oecd.org

Dear Mr. Hickman,

Re: OECD Base Erosion and Profit Shifting (“BEPS”) - Action Plan 10

The Canadian Life and Health Insurance Association (“CLHIA”) is pleased to provide comments on behalf of its member companies on the Discussion Draft "Use of Profit Splits Methods in the Context of Transfer Pricing" (Discussion Draft) released by the OECD on December 16, 2014.

The CLHIA is the national trade association for life and health insurers in Canada. Our member companies account for 99 per cent of Canada’s life and health insurance business and provide a wide range of financial security products. Canadian life insurers operate in over 20 countries around the world and three of our members rank among the top 15 global life insurers by market capitalization. A quarter of the CLHIA’s members operate as subsidiaries or branches of foreign insurers or reinsurers from the United States and Europe. The CLHIA is also a member of the Global Federation of Insurance Associations (GFIA) based in Brussels.

The CLHIA supports the G20 and the OECD’s initiative to combat aggressive tax planning, including its focus on transfer pricing. However, we urge that the final measures taken by the OECD be proportionate and balanced, taking into account the unique commercial realities of the global insurance business model and avoid any unintended consequences which would impede the efficient functioning of primary insurance and reinsurance markets.

Use of Profit Splits Method in the Context of Insurance Sector

We understand the main focus of this Discussion Draft is to review application of transactional profit split methods to highly integrated multinational enterprises where finding reliable comparables may give rise to practical difficulties.
While there are a number of insurers and reinsurers with operations across the globe, the operation of a multi-national insurer or reinsurer in any particular jurisdiction is highly autonomous and rooted to the legal and regulatory environment in that country. Insurance products are designed to meet customer needs and priced to reflect the risk assumed and the regulatory requirements of jurisdictions that underwrite the risk. Even where an MNE operates a global reinsurance centre to assume third party and or affiliate risks, it would be inappropriate to view such an operation as highly integrated to the various domestic operations within an MNE.

In response to Question 22 in the Discussion Draft, we submit that in the value creation analysis of a life insurance business, additional weighting should be given to capital. Life insurance is a regulated industry, where regulations stipulate levels of capital required to support the operation. As a result, the mobility of capital within multinational insurers is subject to significant regulatory constraints. Capital acts as a buffer against the risks associated with the insurance business. Materialization of the insurance business risks will often lead to a requirement of additional capital. In this sense, capital is an effective indicator of where the substance of business risks reside and should be compensated by the residual profit of the life insurance business. This phenomenon is also evident in the arm’s length comparables.

In response to Question 31 in the Discussion Draft, there are practical difficulties in applying the profits split methodology to allocate profits between entities across multiple jurisdictions in the insurance sector, especially when it comes to measuring the combined profits of an insurance business:

- At the outset, insurance and in particular life insurance is a long-term business, the ultimate profit or loss emanating from a book of business would not be known for many years and it would most likely vary from any profitability expectations at the inception of a contract.

- The basis of taxation can also vary widely between jurisdictions. While some countries impose profit based taxation, other jurisdictions tax a percentage of premiums or investment income in lieu of profit based taxation. Even within jurisdictions that apply profit based taxation, there may be material timing differences in computing profit for tax purposes. As a result, for a particular year, the same insurance business may be considered to be in a tax profit position under Country A’s tax law but generates tax losses under the tax law of Country B. In this case, should the combined profits be a net income as determined by Country A, or a loss as determined by Country B, or Country A and B apply the same profit split ratio but one on the profits and the other on the losses as determined by their own tax law? As illustrated by this example, different approach could lead to dramatically different tax results.

To avoid unnecessary future controversies in applying the profit split method, we urge OECD to provide specific guidelines with regards to the use of this methodology with regards to insurance operations.

Yours Sincerely

Noeline Simon
Vice President, Taxation and Industry Analytics

N. Simon
Profit splits on Global value chains – Concerns and Recommendations

A REPRESENTATION

February 2015
OECD
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BEPS: Action 10 – Profit splits on Global value chains – Concerns and Recommendations

Background

On December 16, 2014, the OECD issued a Discussion Draft on the use of Profit Split method (PSM) in the context of global value chains. The Discussion Draft does not provide any specific guidance or modification to the existing OECD guidelines but only presents various scenarios where profit split method could be used. The Discussion Draft recognizes that one sided method may not be applicable in all situations and presents following ten situations (with nine examples) whereby profit Split method could potentially be used.

1. Global value chain
2. Multisided integrated business model
3. Unique and valuable contribution to intangibles
4. Highly integrated and enterprises share and jointly manage strategic risks
5. Fragmentation
6. Lack of comparables
7. Aligning taxation with value creation
8. “Hard to Value” Intangibles
9. Dealing with unanticipated return
10. Dealing with losses

In general, we recognize the efforts of G20 along with the OECD towards providing guidance on potential use of Profit Split in the context of global value chains. However, we foresee certain practical challenges in the implementation of the recommendations of the Discussion Draft in its present form for companies operating in India.

We wish to highlight the possible challenges and humbly put forth our recommendations for your kind consideration.
Concrete guidelines on application of PSM

**Concerns**

The discussion draft does not provide any detailed guidelines regarding the applicability of PSM but instead only provides various scenarios where PSM could potentially be used as an appropriate Transfer Pricing method. PSM by itself is subjective in nature and therefore, the application of PSM needs to be advocated with significant caution. It would be important for OECD to provide broad guidance/parameters about Function, Asset and Risk Analysis (FAR) leading to value creation and thereby warranting use of PSM. More detailed guidelines may be required in respect of circumstances requiring application of PSM as well as the manner of splitting profit.

**Recommendations**

It is recommended that the OECD provide more concrete guidelines with respect to the following aspects:

- **Value Drivers** – “value creation” and “value drivers” are the very basis for the application of PSM. However, these terms have not been defined in the Discussion Draft. These terms are susceptible to multiple interpretations. A “value” can be sales, income, profit, competitive advantage, synergies, economic ownership etc. depending on the facts of a taxpayer/ MNE group. Accordingly, it would be important to lay down guiding principles to be followed in determining appropriate value for the business and identifying value drivers in any business.

- **Allocation keys** - Application of profit splits are based on appropriate allocation keys in accordance with the value drivers of the business. It would hence be important to bring in more certainty in concept and method for scientific selection of allocation keys to be adopted in line with value drivers. The guidance on allocation keys is important to avoid aggressive or arbitrary positions being adopted by local revenue authorities resulting in formulary apportionment of profits.

- **Computation of System Profits** – The different group entities participating in PSM may be adopting different accounting methodology based on their local country requirements. In such case, guidance may be provided regarding the common reporting system or methodology that may be adopted for consolidation and determination of system profits. Similarly, there may be some income or expense elements that may be specific to any particular group company based on its FAR but may not be included in the overall System profit. Accordingly, OECD may provide
guidance on the various circumstances and income and expenses that may or may not be considered to derive system profit for the purpose of profits to be split.

- **Treatment of losses** - The OECD may provide detailed and clear guidance for exceptional circumstances where system losses may not be split or differently split or would be split only in some of the participating group entities and not all the entities. A clear guidance in this aspect is important to ensure that the tax authorities do not deny split of losses to entities in their jurisdiction leading to double taxation for the MNEs.

**Alternative structure and methods other than PSM could also be used in the given Scenarios**

**Concerns**

The discussion draft proposes various business models for the application of PSM. However, in most of the scenarios, based on the factual situations, the taxpayers may not structure the transaction in the way it is described but rather could alternatively carry out the transactions by following traditional structures and determine arm’s length return for each of the group entity by following one sided approach. Accordingly, in these scenarios, the MNE may determine the arm’s length return for each group entity based on their FAR profile in the value chain and profitability of functionally similar independent entities under TNMM or any other appropriate method. The Discussion Draft emphasizes and gives weightages to functions and risk rather than capital and ownership of intangibles for the applicability of PSM.

Even though the Discussion Draft specifically provides that the scenarios given in the Draft are only for discussion purpose but the tax authorities may try to impute the given business model on the facts of the taxpayers case and may apply Profit split for the purpose of transfer pricing of the taxpayer. For eg. scenario 8 provides for a joint development of intangible where marketing support entity has been regarded as contributing to the development of intangibles. Generally, marketing support entities are not considered as contributing to development of intangibles unless the FAR profile of such entities suggest otherwise. Therefore, there is a possibility that marketing support entities may be challenged by tax authorities for the application of PSM.

**Recommendations**

It is recommended that OECD may recognize the possible alternative structures in a particular scenario and then describe in detail the alternative methods that can be used in different scenarios. The
Discussion Draft has not discussed the traditional principal structures which are more prevalent in the MNE group structures and the applicability of PSM in those situations.

Further, the OECD may enlist parameters that may be considered in determining whether a group entity is carrying routine functions or contributing to value creation. A reference in this regard can be taken from Circular 6 issued by Indian tax authorities in relation to Research and Development (R&D) activities. Also, additional examples may be given taking into account transactions in the telecommunication and financial sectors where use of PSM is rampant.

Risk of taxation exposure due to creation of partnership or Association of persons (AOP)

Concerns

The discussion draft proposes various business models for the application of PSM. However, in most of the scenarios, the AEs getting profit share based on PSM may face commercial and taxation issues regarding partnership or AOP. This may lead to possible multilayer taxation in the hands of an MNE.

Recommendations

It is recommended that OECD may provide guidelines on the safeguards for taxpayers from getting caught in the commercial and tax considerations due to deemed constitution of partnership or AOP by tax authorities in their respective jurisdictions.

Lack of Comparables

Concerns

The discussion draft proposes use of PSM in case of availability of lack of comparables. The Discussion Draft presupposes that in most of the scenarios one sided methods are not reliable because adequate comparables do not exist due to the integrated, interdependent, synergistic operations of MNEs. However, the quality of comparables is an issue which is faced by almost all the taxpayers and tax administrations world over. In most of the cases, perfect comparables are not available. Still, the comparability analysis can be carried out under different Transfer pricing methods (based on the attributes of different methods) as long as the comparables are functionally similar and reliable adjustments can be made to such comparables. Therefore, lack of comparables may not be regarded as a relevant criterion for use of PSM. It is a possibility that based on the recommendations in Discussion
Draft, the tax authorities may resort to applying PSM on the ground of lack of comparability even where appropriate arm’s length price could be determined under one sided approach. Such a position could give rise to controversial situation in a practical scenario. Simple functions which can currently be benchmarked using one sided approach may not deserve an application of a profit split. As no comparable can be prefect comparable, situations to accept comparables with a one sided benchmarking should be permitted if reasonable adjustments could be made. Further, also, fragmentation of functions within the MNE may not clearly necessitate the use of PSM if there are comparables available in the local domain to benchmark by adopting TNMM or other permissible method.

**Recommendations**

More concrete guidance may be provided regarding use of PSM having regard to the possible applicability of one sided approach for determining arm’s length consideration for taxpayer. Lack of comparables in itself may not be regarded as an appropriate criterion for the applicability of PSM.

**Double taxation**

**Concerns**

The major concern in application of PSM, is the aggressive approach by the tax authorities which could be lopsided in favour of their jurisdiction. The tax administrations may in application of PSM not consider a holistic view of the group business model and the entire supply chain which may lead to economic double taxation for the group.

**Recommendations**

It is recommended that the guidelines should provide for a mechanism for coordination and cooperation between the government of two countries to exchange information relevant to determining the FAR profile of the parties and appropriate allocation of profit amongst the entities. A mechanism may be provided where such apportionment of profits may be discussed bilaterally even before the close of Transfer Pricing audit of the taxpayer to avoid long lasting disputes and economic double taxation.
The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the development of India, partnering industry, Government, and civil society, through advisory and consultative processes.

CII is a non-government, not-for-profit, industry-led and industry-managed organization, playing a proactive role in India's development process. Founded in 1895, India's premier business association has over 7200 members, from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 100,000 enterprises from around 242 national and regional sectoral industry bodies.

CII charts change by working closely with Government on policy issues, interfacing with thought leaders, and enhancing efficiency, competitiveness and business opportunities for industry through a range of specialized services and strategic global linkages. It also provides a platform for consensus-building and networking on key issues.

Extending its agenda beyond business, CII assists industry to identify and execute corporate citizenship programmes. Partnerships with civil society organizations carry forward corporate initiatives for integrated and inclusive development across diverse domains including affirmative action, healthcare, education, livelihood, diversity management, skill development, empowerment of women, and water, to name a few.

The CII theme of 'Accelerating Growth, Creating Employment' for 2014-15 aims to strengthen a growth process that meets the aspirations of today's India. During the year, CII will specially focus on economic growth, education, skill development, manufacturing, investments, ease of doing business, export competitiveness, legal and regulatory architecture, labour law reforms and entrepreneurship as growth enablers.

With 64 offices, including 9 Centres of Excellence, in India, and 7 overseas offices in Australia, China, Egypt, France, Singapore, UK, and USA, as well as institutional partnerships with 312 counterpart organizations in 106 countries, CII serves as a reference point for Indian industry and the international business community.
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The Confederation of Swedish Enterprise is Sweden's largest business federation representing 49 member organizations and 60,000 member companies in Sweden, equivalent to more than 90 per cent of the private sector.

The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft entitled "BEPS Action 10: Discussion Draft on the use of Profit Splits in the context of Global Value Chains" 16 December 2014 - 6 February 2015 (hereinafter referred to as the Draft).

General Comments

The Confederation of Swedish Enterprise appreciates the work by the OECD on the use of profit splits in the context of global value chains. As the global economy develops, the number of ways in which entities can interact with each other within an MNE is increasing and so is the number of ways in which value can be created. This leads to possibilities for MNEs to structure their value chains in many new ways. Due to the integrated nature of many MNE groups and the new ways in which they interact it is often, as acknowledged in the Draft, difficult if not impossible to find perfect comparables, and each case must be analyzed on its own merits and the fundamental distinction between unique and non-unique contributions should be maintained. In such situations the transactional profit split methods may provide an
appropriate solution when one-sided methods are not applicable as each party makes valuable contributions to the transaction.

However, the risk of disagreement between tax authorities over which allocation factors to use should not be underestimated. To avoid the risk for increased uncertainty, costly litigation and increased administrative burdens, a profit split method should therefore only be applied where no simpler alternative is available.

In addition, it is of utmost importance that the application of a profit split method is based on the facts and circumstances of each individual case to ensure arm’s length outcomes of the application.

It is important to keep in mind the diversity of different MNE groups, also those that are not fully integrated. Any profit split method needs to be developed in a way that it can be applied to any business model. This is especially important considering the constant development of the economy.

Below are our comments to some of the questions posed in the Draft.

Specific Questions

2. What aspects of Scenario 1 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?

A thorough functional analysis including functions, assets and risk should be conducted. Such analysis will facilitate the determination on which method is the most appropriate one.

3. Is the application of a transactional profit split method more useful than other methods for dealing with particular aspects of value chains, such as highly integrated functions, and the sharing of risks?

Not necessarily. That would depend on the type of functions and risks. Non-unique contributions should typically be rewarded with an arms-length compensations and not be part of a profit split. In certain situations, when dealing with unique and valuable contributions by group entities however, the transactional profit split method could be appropriate depending on the facts and circumstances of the individual case.

4. What guidance should be provided to address the appropriate application of transactional profit split methods to deal with these aspects of value chains?
The Confederation of Swedish Enterprise does not believe that a profit split method should be applied automatically under certain circumstances as this could lead to arbitrary application of formula approaches and use of hindsight by tax authorities that could potentially lead to more uncertainty and disagreement and unwillingness to invest. The most appropriate method under the arm’s length principle should always be used. To automate the application of profit split methods would mean a potential departure from the arm’s length principle and increased complexity and risk of double taxation.

Guidance on the appropriate application of profit split methods should include which allocation keys are recommended to share profits, what is meant by “significant integration” and more details regarding in what specific situations the method should be applied.

6. What aspects of Scenario 2 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?

A detailed functionality analysis should be conducted to establish where value is created and by which entity. The transfer pricing analysis of a multisided business models should not be any different than any analysis applicable to other types of businesses.

7. Does the way in which “unique and valuable” is defined for intangibles assist in defining the term “unique and valuable contributions” in relation to the transactional profit split method?

Yes, the definition of unique and valuable intangibles does contribute some guidance on what should be considered unique and valuable contributions. Any additional guidance to reach further clarity would however be appreciated. The existence of a unique and valuable intangible should however not lead to the assumption that a profit split should automatically apply.

8. What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method?

The same answers as to questions 2 and 6 are applicable here. The choice of business model used should not affect how the analysis on most appropriate method is applied.

9. Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm’s length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?
If it is assumed that Company S is the only company performing unique and valuable functions, an allocation using a profit split method could be done by first remunerating the routine activities to all parties involved, and then the residual profit could be allocated to Company S. If several companies where performing unique and valuable functions, the residual profit would be shared between these companies.

11. **In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks?**

The first step should be to conduct a comparability analysis and determine the risk of each company. If the risk is shared, and the risk would have had impact on the price of the transaction at arm’s length, then a profit split method could be appropriate to allocate the profit.

It is however dependent on the circumstances in each case what kind of contribution the risk represents. Sometimes the risk is a unique contribution that may represent the very essence of a transaction, whereas in other situations the risk bearing is not much of a contribution at all. In cases of multiple unique and valuable contributions consisting of risk bearing, the residual profit could be appropriate to allocate in accordance with a profit split method.

12. **Would a one-sided method produce more reliable results?**

This is naturally dependent on the circumstances in each case. A one-sided method could be preferable in a situation where the arm’s length profitability of each company can be appropriately determined on a single tested-party basis.

13. **What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?**

As mentioned before in the answers to question 2, 6 and 8, a complete functional analysis should be conducted.

14. **Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how?**

It is important that the transfer pricing area, even though dealt with in different reports from OECD, is treated as a complete system. This would include making sure that guidance on profit split methods is consistent and coherent with guidance on intangibles.
16. **What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?**

When elaborating and determining the most appropriate method, all facts and circumstances in a certain case should be taken into consideration. This assessment could include if the fragmented functions represent non-unique contributions, and for which a one-sided approach would be conceptually more suitable.

19. **What aspects of scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?**

To determine the nature of contributions from different parties, a functional analysis should be conducted together with an overview of the complete value chain.

20. **In what circumstances, if any, might an approach described in the last sentence of paragraph 32 be appropriate?**

We agree with the comments made by BIAC.

22. **In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?**

This needs to be analyzed on a case-by-case basis. Additional guidance on what factors would better reflect value creation would be very useful when using profit split methods. However, it is difficult to find common features for specific industries as they will mostly depend on the functional analysis and the contributions to value creations made by each party in each specific transactions. Nevertheless, listing examples could serve as guidance.

23. **What guidance is needed on weighting of factors?**

Since the nature of a profit split methodology is subjective, any guidance on how to weight different factors would mean additional certainty for taxpayers and would therefore be welcomed. However, since profit splits normally deal with unique and valuable contributions, it is hard to see how general guidance in this area could be provided.

24. **How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for example approaches based on concepts of bargaining power,}
options realistically available, or a RACI-type analysis of responsibilities and decision making)?

We do not support the establishing of new guidelines in this area as rules based on the concepts in question 24 are likely to lead to formulary apportionment.

26. **What specific aspects of transactional profit split approaches may be particularly relevant in determining arm’s length outcomes for transactions involving hard-to-value intangibles?**

27. **How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?**

We agree with the comments made by BIAC on questions 26 and 27.

29. **In what circumstances might it be appropriate under the arm’s length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss?**

The Confederation of Swedish Enterprise believes that profit split methodology should be developed in a way that it can deal with both the generation of profits and losses. In the majority of cases, losses and profits are treated and shared in the same way. Adapting different splitting factors for losses and profits would mean a focus on the minority of situations, which could increase the risk of double taxation.

30. **Are there circumstances under the arm’s length principle where parties which would share combined profits, would not be expected to take any share of combined losses?**

This depends on the facts and circumstances of each individual case. Performance based purchase contracts are often restricted to sharing limited profits only but not losses. In other cases, independent parties may agree to share both profits and losses (not necessarily equally). A profit split method should therefore typically also involve a split of losses (although not necessarily 50/50). However, depending on the circumstances it may be reasonable to apply models where losses are assumed by one party in return for a higher residual reward, while the other party is remunerated on a risk adjusted arm’s length basis.

31. **Paragraph 2.114 of the Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?**

The difficulties pointed out in paragraph 2.114 of the Guidelines are indeed still relevant and gives a good summary on the practical difficulties that is associated with the application of a profit split method. It is however just a summary of the
different challenges for a taxpayer, and given the technical complexity in applying a profit split, the guidelines should be expanded.

On behalf of the Confederation of Swedish Enterprise

February 6, 2015

Krister Andersson
Head of the Tax Policy Department
Dear Andrew

BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

Thank you for the opportunity to comment on BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains published on 16 December 2014 (the ‘Discussion Draft’).

Selection of the ‘most appropriate’ method is one of the cornerstones of a transfer pricing analysis. Businesses and tax authorities must select the method that is most appropriate in terms of the facts and circumstances of each case (necessitating a full functional analysis, accurately delineating the transactions concerned), as well as the data available in relation to the transactions to be priced and comparable third party transactions. We agree that a functional analysis for an entity or transaction needs to sit in the broader context of a multinational group’s business operations, relative to creation of value, and note that this has always been the case.

We believe that profit split is the most appropriate methodology to employ where the relationship between the parties, in terms of value that they add, is balanced as opposed to being clearly weighted towards one party and their activities are highly integrated. When profit split is considered it requires rigorous application, and it will not be the most appropriate method in cases where other methods and data provide a simpler route to a robust result. In particular, the robustness of a profit split method in terms of principled output is often hampered by the lack of availability of third party comparable data in developed markets; this must always be a factor that influences selection of the profit split method. Where reliable comparable data exists in some markets this is an indicator that the profit split method is not appropriate.

Where activities that lead to, for example, the development of valuable intellectual property, are not centralised into one group entity but shared, this may be part of cost contribution arrangements as opposed to evidence of the need to apply profit split methods, and it would be helpful if the work under different areas of the BEPS project were to provide guidance on these areas together.

It is essential that there is clear guidance in determining when a profit split method is appropriate within the wider framework of selection of the most appropriate method. We note that there is no intention that this framework be changed, and it is important that profit split is seen as just one indirect method that should be used in appropriate, defined, cases rather than an opportunity for apportionment of profits that
is inconsistent with how third parties would operate. In particular, where there is evidence that third party comparable data exists, this remains the most appropriate method for applying the arm's length principle.

Businesses are rightly concerned that an increased use of the profit split method could lead to an increase in audits, disputes and, if it is not eliminated, double taxation. It is essential that full and binding mutual agreement procedures (‘MAP’) or Advance Pricing Arrangements (‘APAs’) are available if the use of profit split is to increase, and the work on Action 14 will be critical here. In particular, many profit splits that have been implemented to date have been on a bilateral (i.e. two countries) rather than multilateral (more than two countries) basis. There are a number of reasons for this, but one is that it is difficult to manage the subsequent tax audit and dispute process in relation to several jurisdictions with different timetables, and a transfer pricing adjustment in one country can have consequences for many others (it will affect all those participating in the profit or loss to be split). Advance pricing agreements are a key way for businesses to obtain certainty, but are not always practical (or offered by all countries). There are also increasing difficulties in managing the process as the number of participating countries increases from two. A practical answer, albeit requiring process change by tax authorities, would be for there to be a requirement for profit splits to be audited jointly by the countries affected, with an automatic roll into a multilateral mutual agreement procedure for any adjustments agreed. This would be consistent with the overall objectives of the BEPS project and with existing transfer pricing guidelines on simultaneous tax examinations. Despite this existing guidance, such simultaneous tax examinations are in our experience used very rarely.

In addition to the potential for dispute, the application of a profit split method can be an expensive and time-consuming process, particularly in relation to updating and maintaining the method from year to year. It requires the time of many senior business people (in interviews) which takes them away from their commercial roles, and as such should be reserved for cases where it is the most appropriate method, i.e. that it is more suitable than other methods, rather than becoming a default to be applied to all circumstances. An additional useful safeguard against unnecessary costs would be a requirement that, where a tax authority asserts under audit that a profit split should have been used, agreement on the selection of the most appropriate method should be agreed with treaty partners (whether under MAP or less formally) in advance of a requirement for business to undertake the additional work and incur additional costs of discerning the detail of how a profit split would be tailored or creating any calculation of the result.

In practice in some cases (depending on the facts and circumstances, often related to sales) a revenue split is more appropriate than a profit split. This is because parties contributing to the operations of a group control their own costs and activities, but some revenues may be realised that benefit the group as a whole (performance of the contracts may be undertaken by entities other than the sales-generating entity). The OECD guidelines focus on a split of operating profit, and it would be helpful to provide examples where revenue is more appropriate.

Comments on the specific scenarios set out in the Discussion Draft and responses to the questions asked are set out in the attached appendix.
If you would like to discuss any of the points raised in this letter, please do not hesitate to contact either me (bdodwell@deloitte.co.uk), John Henshall (jhenshall@deloitte.co.uk) or Alison Lobb (alobb@deloitte.co.uk). We would be happy to speak on this topic at the Public Consultation meeting in March 2015 if it would be helpful.

Yours sincerely

W J I Dodwell
Deloitte LLP
Appendix: Comments on scenarios and responses to questions in the Discussion Draft

Value chains

As the Discussion Draft notes, value chains vary greatly across businesses, and no two businesses will be the same (even within sectors). This makes it impossible to make relevant and appropriate decisions on selection of method in the absence of a full functional analysis covering functions, risks and assets.

The principles set out in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (‘the Guidelines’) will apply, including:

- The selection of the ‘most appropriate’ method will be based on the functional analysis.
- The most appropriate method will take into account factors such as consistency with the behaviour of third parties, availability of evidence of comparable third party transactions or availability of third party transactions to which sufficiently accurate comparability adjustments can be applied, the underlying nature of the transactions, contractual arrangements and conduct of the parties.
- An economic analysis, including evidence of third party behaviour and/or evaluation of the contributions of each party, is required.

Scenario 1

1. Can transactional profit split methods be used to provide a transfer pricing solution to this scenario? If so, how?

The question to be asked is whether, if the three Original Equipment Manufacturing enterprises (‘OEMs’) were independent parties, they would agree to share revenues, risks and costs in order to maximise their collective and individual potential returns. Between third parties this would be based on a willingness to integrate their operations – and their conduct would reflect this. In Scenario 1, the over-arching Leadership Board might be an indicator of such willingness. Based on the limited facts provided, it would appear possible to use profits split methods to evaluate returns to the three OEMs. Whether it is appropriate to do so would depend on the outcome of a full functional analysis, including risks and assets, and assurance that conduct of the three OEMs and contractual arrangements are aligned. The inter-dependence of the operations (not limited to strategy or decision making) of the three OEMs, and whether the levels of contributions by the OEMs are broadly balances, are likely to be key factors. It would not, for example, be appropriate to use a profit split method just because one group company (say, a manufacturer) is dependent on another (say a distributor) to make sales of its products and the expected sales have a consequence for manufacturing output that is agreed as part of strategy.

2. What aspects of Scenario 1 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?

A full functional analysis would be required, taking into account functions, risks and assets. This would include transaction flows and the seniority, authority and decision-making behaviour of personnel. A change in facts may be sufficient to cause a change in selection of the most appropriate method.

3. Is the application of a transactional profit split method more useful than other methods for dealing with particular aspects of value chains, such as highly integrated functions, and the sharing of risks?
One of the reasons why a profit split method may be appropriate in this scenario is that the varied and unique contributions made jointly by the three OEMs may make comparable third party transactions (or transactions to which sufficiently accurate comparability adjustments can be made) hard to find. Where this is the case, the reliability of other methods that have a more direct relationship to third party comparables may be limited.

Highly-integrated functions may be an aspect of value chains which lends itself to profit split methods. The sharing of risks combined with a profit split method would allow for losses to be shared as well as profits. However, transactions between third parties may not share risk based on contributions or functions, but may agree a contractual allocation based on ability to control risk, financial capacity to bear risk etc. (See also our comments on BEPS Action: 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation and Special Measures) (‘the Discussion Draft on Risk, Recharacterisation and Special Measures’).

The scenario notes that some activities – e.g. contract manufacturing and sales – may be priced by reference to third party comparable data. It is common for such activities to be priced in this manner, and the integration of some aspects of the OEMs’ activities does not preclude these transactions from being priced using other methods.

In practical terms, the use of a profit split for unique contributions made collectively by the OEMs is likely to be manageable, as the OEMs are limited to three parties. In particular, businesses may wish to obtain APAs to give certainty of treatment. However, as businesses change over time it will still be necessary for the decisions around the split of profit or losses – and particularly the manner in which the profits or losses are split – to be monitored and adjusted as necessary.

4. What guidance should be provided to address the appropriate application of transactional profit split methods to deal with these aspects of value chains?

Additional guidance with detailed examples showing the outcome in a range of cases (including ‘borderline’ cases) will be necessary to aid businesses and governments with application of transactional profit split methods to value chains. Whilst none of the examples can be prescriptive, it would be helpful to show those cases where the value chains are genuinely integrated (as appears to be the case with some activities in Scenario 1 in the Discussion Draft) and those cases where there may be multiple transactions to price, but trading operations are not shared.

Guidance showing sources of third party data that may be relevant would be helpful, including for example commercial court decisions that provide evidence of how damages are calculated in cases of intellectual property infringement.

One of the issues in practice may be that a specific country – say a developing country that is the market country for sales – has a lack of publicly available third party comparables. The question that then would need to be addressed is whether the most appropriate method would be a resale minus method based on data from different markets, adjusted as appropriate, or whether a transactional net margin approach might be used. To the extent that other entities in the multinational group price their transactions based on non-profit split methods (being the most appropriate) using local or regional comparable data, it would not be the right answer to use profit split for some countries just because of a lack of local market third party data. It would be helpful if guidance could be used to illustrate this point to avoid unnecessary disputes.
Multi-sided Business Models – Scenario 2

This example is problematic in that it is not clear where activities are taking place, and in particular the distinction between data collected in a country via electronic means and the activities that are performed by functions within the business that drive revenue. Paragraph 16 sets out a wide range of activities, many of which relate to services being provided to entities in other countries, and only one (making suggestions on algorithms and technology, tailored to the local market) that might suggest a shared contribution to value.

As with all of the scenarios, a full functional analysis including risks and assets would be required to select the most appropriate method.

5. Can transactional profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how?

The key question is what would third parties do in comparable circumstances? Based on the limited facts available it appears that many of the activities mentioned are services (e.g. promotion, translation, regulatory compliance etc.), and should be priced as such based on third party comparable data for similar services. In developed countries such third party data for services is commonly found in databases. For countries without such data, adjustments to data available for other markets is likely to be the most appropriate.

The final question to consider is whether the value creation and unique contribution that may be made by the local subsidiary in respect of the algorithms and technology is sufficient to warrant a profit split to be the most appropriate method. Certain words used in the scenario indicate that this would not be the case such as ‘suggestions’ and ‘adaptation’ (which appear to indicate the activities are feedback and observation on the market, i.e. services). However, this is an area where the functional analysis and relative contributions of the parties will be important. If the adaptations and new features are a key contribution to value relative to the functions of the programmers and others in the RCo Group, then a profit split method may be appropriate.

There are no special features of multisided business models that, of themselves, would indicate that a profit split method is appropriate. Rather, it will be the nature of activities and in particular the level of integration of activities (similar to questions asked in Scenario 1) that will determine whether a profit split is appropriate.

6. What aspects of Scenario 2 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?

See answer to question 4. A full functional analysis, an understanding of the drivers of value in relation to the algorithms and technology and the relative contributions of the parties to these value drivers will be needed.

Scope – Unique and valuable contributions – Scenario 3

7. Does the way in which ‘unique and valuable’ is defined for intangibles assist in defining the term ‘unique and valuable contributions’ in relation to the transactional profit split method?
Broadly, yes. Comparable third part data for ‘unique contributions’ is unlikely to be available, and where these unique contributions are i) made by more than one group entity and ii) are (or are expected to be) a key driver of value, then profit split may be the most appropriate method. There is (or may be depending on the circumstances of the case) a close correlation here with cost contribution arrangements, and there should be consistency of approach in the profit split guidance and that being considered in relation to cost contribution arrangements. One point to note is that whilst all contributions might be undertaken with the expectation of creating value, there are circumstances where value may not, in fact, be created. Where there is a high degree of integration between the activities of group companies, it would not be appropriate to dismiss the profit split method solely on the basis that one party’s contribution was not, in fact, valuable. Similarly, it would not be appropriate to select a profit split method solely because a contribution is valuable (but may not be unique). A minor unique contribution by one entity is not sufficient to mean that a profit split is the most appropriate method – there are many third party examples where a minor but unique contribution has been rewarded as part of a service, or may not have been rewarded at all if considered insignificant by the provider.

8. What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method?

A full functional analysis is required, but based on the limited facts given, the profit split method does not appear to be appropriate to the circumstances. Company S should be rewarded for its valuable activities, including its ability to make sales and to provide high quality maintenance services. Third party comparable data is likely to be available for such services. Company S will be rewarded for its sales activities in Country S, and the benefit of having strong relationships and reliable maintenance programmes will feed into increased sales for Company S. The owner of valuable intellectual property would look to exploit its asset in as efficient a way as possible, and would, if engaging with third parties, look to contract with companies that would provide high-level maintenance services and drive product sales. This is a common commercial arrangement, and we would expect comparable data to be available. Company S is not contributing to the creation of the valuable intellectual property itself, but is part of the arrangements of Company P to exploit the valuable intellectual property it has created.

9. Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm’s length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?

See above – third parties entering into these arrangements would provide comparable data for the provision of valuable maintenance services. Sales would be rewarded in Company S, including additional sales driven by reliable technology and the availability of high quality maintenance services.

10. What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3?

See above. There does not appear to be sufficient integration of activities for profit split to be the most appropriate method. Third parties can, and do, operate to generate profits on their own account through sales and maintenance activities, just as others do through the creation and exploitation of intellectual property.
Scope – Integration and sharing of risks – Scenario 4

Comments on this section are closely linked to our comments on the Discussion Draft on Risk, Recharacterisation and Special Measures, and should be read in light of that paper. In particular, we agree that there are circumstances in the financial services industry where capital is put at risk on the basis of some highly integrated global financial trading operations, but even within the financial services industry there is a difference between integrated global trading models, for which profit split may be appropriate, and other models.

11. In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks?

It is the degree of integration of operations including but not limited to the management of risks that will determine whether profit split is most appropriate, as in Scenarios 1 and 3.

In Scenario 4, it is not clear what is driving the creation of value for the group. Is it the sales activities of Company A, or the reliability, technical specifications, usability, and price of the sophisticated medical equipment? Are the components – described as ‘key’ – the drivers of success of the technology overall? Could third parties have undertaken this development and production on a contract R&D basis? Are there suitable third party comparables available for such contract R&D activities? The existence of outsourcing arrangements with or between third parties would be an indicator that comparable data exists that provides better evidence of the arm’s length price than an indirect profit split could, and would therefore be the most appropriate method to select.

Assuming that all the components are significant to the success of the technology, the activities companies are integrated, and the relative contributions of each company are broadly balanced, then a profit split approach might be appropriate. However, this is based not on an analysis of risk but on the integrated and coordinated activities of the group. This would require an element of coordination that is not detailed in the scenario – each component would have to be compatible with the technology as a whole, for example.

12. Would a one-sided method produce more reliable results?

Possibly, depending on the facts – see answer to question 10 above.

13. What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?

See answers above.

Scope – Fragmentation

The introduction to this section assumes that multinational groups operate a centralised business model. It is important to note that not all businesses operate a centralised model. One alternative business model may involve outsourcing of certain activities in order to concentrate on core business activities. In many cases this leads to third party comparable data being available for outsourced activities, including logistics, warehousing, marketing and sales functions. It is not clear to us that the profit split method gives a more reliable outcome for pricing these activities intra-group, and indeed is likely to be less
reliable as it does not focus directly on what happens between third parties. In particular, there may be limited integration of activities suggesting that a profit split is appropriate. Paragraph 27 refers to integration, which is not clear from paragraph 26. It also suggests that the profit split method could be used to corroborate the outcome from a different pricing method. We have seen this use of a profit split, and agree that it can be helpful in some cases where the reliability of comparable data is in doubt. However, care needs to be taken to ensure that businesses are not required to duplicate costs by using more than one method.

14. Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how?

Yes. This is a question about the extent to which integrated activities are undertaken by different parties for the development of intellectual property. The outcome should be related to the behaviour and conduct of third parties.

15. Can transactional profit split methods be used to provide reliable arm’s length transfer pricing solutions for fragmented functions? If so how? Can other methods address the issue of fragmentation, and, if so, how?

There is a distinction between the centralisation of activities to achieve commercial efficiencies, similar to outsourcing of non-core activities, and ‘the issue’ of fragmentation, which implies a base erosion and profit shifting motive. Where different parties perform activities this should be considered in light of the overall value chain. It is not sufficient for these activities to be priced in isolation on a one-sided basis if a ‘residual’ is left in another location without itself being considered. However, where all activities are priced with reference to third party data then the fact that activities are undertaken by different entities in different locations does not mean a profit split is the most appropriate method. Fragmentation in terms of outsourcing similar to and on the same terms as that to third parties (many groups use a mixture of outsourcing and in-house capabilities), is not, of itself, an impediment to transfer pricing. Artificiality, in the form of contractual arrangements that do not mirror the highly integrated and valuable contributions of the parties, may however be an indicator that a profit split is appropriate.

16. What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?

See above.

Scope – Lack of comparables – Scenario 5

17. How can comparables be found and applied in Scenario 5? What method is likely to be appropriate for determining an arm’s length remuneration for the activities of the group companies?

A full functional analysis is required, but based on the facts provided, Scenario 5 lends itself to consideration of a revenue split, with a commission for regional sales activities (benchmarked against other comparable sales activities). This is likely to be more appropriate than a profit split, because the cost base of the entities are not, based on the facts given, integrated.
18. How can comparables be found and applied in Scenario 3 (or to any other relevant scenario in this discussion draft)?

See above – commission rates for sales activities are commonly available from databases.

19. What aspects of Scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?

A full functional analysis is required to determine, for example, whether in fact functions and activities are so integrated, and the levels of value-adding contributions by each operating company are broadly commensurate, that a profit split (as opposed to a revenue split) should be applied.

20. In what circumstances, if any, might an approach described in the last sentence of paragraph 32 be appropriate?

This may be a useful approach when a one-sided indirect method such as the transactional net margin method has been applied. Where a direct method has been applied, and there are suitably reliable comparable uncontrolled prices available, then this approach would add an unnecessary level of complexity to the transfer pricing analysis.

21. More generally, in what circumstances would a transactional profit split approach be useful in supporting the application of other transfer pricing methods, and what guidance would be useful to develop for the supporting use of such approaches?

Transactional profit splits can be useful as a corroboration for other methods. However, there is a significant cost burden for businesses related to any requirement to use more than one method (as discussed in paragraph 2.11 of the Guidelines) and in particular profit splits can be expensive. Use of profit splits as a second method should be reserved for cases of difficulty where there is clear additional benefit that can be gained from the profit split approach and/or where a corroborative profit split method is conducted at a higher level.

Aligning taxation with value creation – Scenario 6

22. In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?

There are a number of issues associated with providing generic guidance in relation to allocation keys, as the correlation between allocation keys and creation of value will vary from industry to industry and also, potentially, from business to business. Where third parties enter into profit sharing arrangements, typically in relation to joint venture activities, agreements may be based on the costs incurred by the parties, and costs have the advantage of being objective. However, costs without limitation would be inappropriate and might encourage inefficiency, so joint venture arrangements may contain a cost limit or pre-defined cost basis. In the example given in paragraph 37, headcount is only of value where it is tempered by value of production.

23. What guidance is needed on weighting of factors?
Factors should be weighted, as far as possible, with reference to the behaviour of third parties. This will depend on facts and circumstances. Commercial court cases can be a useful source of evidence to determine how this might be approached, particularly in relation to intellectual property infringement cases.

24. How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for example approaches based on concepts of bargaining power, options realistically available, or a RACI-type analysis of responsibilities and decision making)?

A qualitative analysis may be helpful where it can be put into a principled economic model, for example to quantify aspects of economic theories of bargaining.

25. Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an MNE operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate?

No. Any attempt to set a framework is likely to undermine the arm’s length principle and the appropriateness of the outcome to any given case that, inevitably, will not fit within the framework provided. If governments want to have a formulary apportionment approach based on weighted factors rather than one based on the arm’s length principle then that is a separate discussion; and one that will require full agreement of all participating countries.

Hard-to-value intangibles

26. What specific aspects of transactional profit split approaches may be particularly relevant in determining arm’s length outcomes for transactions involving hard-to-value intangibles?

Whilst there may not be a direct relationship between costs incurred and the value of contributions, between third parties there is little objective evidence of any other basis for a split of as yet unknown profits. Costs are a proxy for functions incurred and assets acquired or developed, and typically in development projects risks are related (perhaps limited) to the costs incurred. Appropriate control of costs is a key part of risk management for such projects.

Dealing with ex ante / ex post results – Scenarios 7 and 8

27. How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?

Between third parties it is expected that the contractual arrangements for situations such as that in Scenario 7 would include both a cost contribution arrangement and an agreement on how to split the profits based on the best estimate of the expected outturn from the project. Third parties would be unlikely to agree to a fixed return based on estimated costs where the estimates may be so inaccurate – and a built in adjustment clause would be used. This would include limitations to ensure cost inefficiencies are not incentivised.
28. Is the application of a transactional profit split method to calculate the royalty in Scenario 8, or in other circumstances to set a price, helpful? What are the advantages and disadvantages?

Where third party situations would include the licensing of such intellectual property rights on the basis of a royalty, then converting the projected results of a profit split to a royalty rate is an appropriate arm’s length approach. Clearly there will need to be sufficiently accurate and detailed data to support the projected income and the profit split analysis. In the example given, S’s contribution to the total value of the intellectual property is clearly significantly less than P’s, which also lends itself to a fixed royalty rate based on S’s sales. This is a helpful approach, commensurate with third party behaviour, and one which is practicable with reference to the application of the royalty rate over the period of the licence.

Dealing with losses – Scenario 9

29. In what circumstances might it be appropriate under the arm’s length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss?

We agree with the general principle that the factors used to split profits should be applied consistently, including during loss years. There will be only very limited circumstances, such as the one illustrated in Scenario 9, where there may be a material difference between the relationship of the factors and profits or losses, and selection of the most appropriate method would recognise this, taking into account what third parties would do. Such circumstances should be identified at the start of the application of a profit split model and documented, as this is what would happen between third parties. It is unacceptable to have a profit split scenario where losses are ‘orphaned’ under disputes between tax authorities where profits have been fully allocated and taxed.

30. Are there circumstances under the arm’s length principle where parties which would share combined profits, would not be expected to take any share of combined losses?

Outside of the financial services sector, we are not aware of evidence of third party situations where one party has negotiated not to take a share of losses in return for a smaller share of profits, but it is possible that they exist. In general, profit splits are most appropriate where both parties are making a significant investment in a project or activities, and their contributions are broadly equal. This means that circumstances where losses would not be shared are likely to be rare.

In the financial services industry, and in particular in respect of regulated activities, a return to capital is important in arm’s length situations. Similarly, in third party situations, capital providers (investors) would contractually bear losses arising. Under the arm’s length principle similar allocations of losses to capital providers within multinational groups operating in the financial services sector are appropriate and commonly seen. However, as above, we would expect the mechanism for the allocation losses to be identified and documented at the start of the profit split arrangement, as this would also happen between third parties.

31. Paragraph 2.114 of the Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?

Yes, these remain relevant. Whilst businesses have sophisticated accounting systems these may not report on an entity-by-entity or transaction-by-transaction basis to enable automated reporting of data for
a profit split methodology to be applied. GAAP differences and management vs statutory accounting accounts differences are also problematic. Significant additional manual input to the data is likely to be required.

32. Finally, what further points would respondents wish to make about the application of transactional profit split methods not covered by previous questions?

Profit splits are complex, and costly for businesses and tax authorities in terms of compliance and auditing. Whilst they are appropriate for integrated operations, they can be difficult to apply and lead to increased disputes. We polled a population of our clients in Europe, the Middle East and Africa on their current use of profit splits in a recent webcast, with the following results:

![Results of poll question from a recent EMEA Dbriefs webcast on BEPS: Risk, Recharacterisation, Special Measures and Profit Splits (29 January 2015)](image)

A key point to note is that 35% of businesses that have used a profit split method to date have an APA to support it. This is, not unexpectedly, considerably higher than the incidence of APAs in relation to other methods, and we would expect this trend to continue. Businesses will want assurance that tax authorities will have the resources to provide APAs to profit split methods if their use increases as a result of the BEPS project.
February 6, 2015

Mr. Andrew Hickman  
Head of Transfer Pricing Unit  
Centre for Tax Policy and Administration  
Organization for Economic Cooperation and Development  
2, rue André Pascal  
75775 Paris  
FRANCE

Re: Comments on Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

Dear Mr. Hickman:

We are pleased to submit comments on behalf of the transfer pricing professionals of Deloitte LLP (Canada), Deloitte Belgium, Taj (France), and Deloitte Tax LLP (United States) regarding the Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains. We appreciate this opportunity to share our views on this issue and hope you find our comments valuable to the discussion.

We look forward to continued collaboration with the OECD on this and other transfer pricing initiatives.

1 Deloitte LLP and Deloitte Tax LLP are member firms of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (DTTL). DTTL and each of its member firms are separate and distinct legal entities. DTTL itself does not provide professional services of any kind. Please see www.deloitte.com/about for a detailed description of DTTL and its member firms.
Very truly yours,

DELOITTE TAX LLP

By: Todd Wolosoff
    U.S. Transfer Pricing Leader
INTRODUCTION

We appreciate the opportunity to provide comments on the Discussion Draft on the Use of the Profit Splits in the Context of Global Value Chains dated December 16, 2014. We acknowledge the effort of the BEPS working group in developing this discussion draft, and welcome additional guidance for the selection and application of the profit split method.

We believe it is imperative that the work on profit splits include additional and specific guidance on the precise principles for the application of the profit split method. Such guidance should distinguish between circumstances in which profit splits may be useful in (i) setting transfer prices, (ii) testing transfer prices, and (iii) ultimately resolving potential disputes related to the transfer pricing practices of a multinational enterprise (MNE) following the action of one or more contracting states. The guidance should provide clarity on (i) the situations in which profit splits are appropriate, and (ii) the manner in which methods may be applied to split the profits.

As tax administrations might increase their use of profit splits for tax reassessment purposes, it is essential that taxpayers be able to rely on robust principles to avoid arbitrary reassessments that may have a dramatic impact on taxpayers in terms of double taxation.

The discussion draft presents a number of simplified case outlines. While we recognize that these are intended to facilitate further discussion regarding the application of the profit split method, caution should be exercised because these examples need to be further elaborated, especially with respect to taxpayers’ intentions and course of conduct. In addition, the guidance may consider that the profit split method may not necessarily be the best method in all the examples in the discussion draft.

We are concerned that, absent further specific guidance, tax administrations may inappropriately employ these examples to somewhat indiscriminately apply a profit split method to the limited global data to be made available by MNEs through country-by-country reporting.

In the remaining time until the September 2015 deadline for the issuance of final recommendations, we would request that the OECD emphasize on the following areas of work:

- Fully develop the examples provided in the discussion draft;
- Assess the relative reliability of the profit split method in comparison to the methods currently used by taxpayers in similar situations;
- Provide guidance on the steps and techniques needed for a reliable application of the profit split method, when that method is selected as the best method; and
• Provide safeguards against the apparent hazards for taxpayers and tax administrations alike to rely on profit split methods (such as potential partnership recharacterization for other tax purposes and seeking relief in a multilateral context).

Our comments below are presented in five sections. First, we share our experiences with the application of the profit split method. Second, we provide an outline of a reliable application of a “contributory” profit split method (i.e., the split of operating profits associated with a transaction using allocation keys). Third, we cover each of the examples provided in the discussion draft and provide our detailed comments and suggestions. Fourth, we provide comments regarding the governance of profit splits. Finally, we offer a few concluding comments.

1. Our Experience with the Use of Profit Split Methods

We would like to preface our comments with a discussion of the different profit split approaches, to avoid confusion. We believe these approaches have significantly different implications and potential applicability. It may be useful to consider a similar classification of approaches to the application of the profit split method:

• Residual Profit Split Method: This method applies in cases when two or more parties make non-routine contributions of intangible properties or services. In our experience, “non-routine” intangibles or services are defined as intangibles or functions for which reliable market price, margin, or profitability data cannot be obtained. Therefore, non-routine contributions are specific to the facts and circumstances of each taxpayer. The residual profit split method starts with the consolidated profit for the transactions under analysis, allocates profits to routine functions performed by the parties, and then splits the residual profits based on the relative value or cost of the non-routine contributions made by the parties.

• “Contributory” Profit Split Method: This method splits operating profits based on certain allocation keys that would best reflect the relative value or cost of each party’s total contributions (routine and non-routine).

• Comparable Profit Split approach: This approach may distinctly consider the availability of comparable uncontrolled transactions and the financial results unrelated parties obtain from participation in such transactions. Its reliable application would begin with the identification of a suitably comparable uncontrolled transaction (i.e., a closely comparable transaction between or among unrelated parties) and an analysis of the financial results of all parties resulting from that transaction following the application of appropriate adjustments.

The use of the term “transactional” means that the profits subject to the profit split are the profits associated with the controlled transaction or transactions under analysis. To the extent possible, a profit split analysis should not include financial results of other transactions between the parties. All references to profit splits in this document presume a transactional profit split.

In our experience, there is often limited available information to support a reliable application of the comparable profit split method. This is due to the lack of data and the challenges of establishing comparability. Except in a very few industries, arm’s length parties rarely engage in detailed collaboration arrangements and disclose sufficient associated details publicly. The application of a comparable profit split analysis would not only require the identification of a comparable uncontrolled
transaction, but also segmented financial data for all parties participating in that transaction. It is very
difficult to fulfill both requirements.

- **External Data:** In some selected industries, such as the Life Sciences, there are a significant
  number of uncontrolled licensing and collaboration agreements in the public domain. However,
  almost all companies that are party to such arrangements have multiple product lines and their
  segmented financial data from such arrangements is not available in the public domain. While
  we have seen the use of such uncontrolled agreements to set royalty rates, or supply prices, the
  lack of financial data usually prevents their use in a comparable profit split context.

- **Internal Data:** Taxpayers that engage in uncontrolled licensing or collaboration agreements with
  unrelated parties would have their own segmented data resulting from such arrangements. However,
  they would rarely have complete and detailed data regarding the financial results of
  their counterparties.

We have observed numerous instances in which the residual profit split method is employed.
Particularly where a combination of benchmarkable activities (e.g. sales or marketing services) and non-
routine production and supply chain functions contribute to the ultimate profit realized from the
intercompany transaction. Additionally, residual profit split allocation may have more common
application where agent-related contracting is performed by a related party on behalf of a principal
producer-seller, including the circumstance in which stripped distribution sales are present. We would
normally apply the residual profit split method in cases where (i) the parties to a transaction contribute
to creating a surplus profit that could not be generated had the parties been acting on their own (e.g.
both parties contribute to the creation of a significant intangible assets) and (ii) there are no comparable
uncontrolled transactions available to directly assess the value of such contributions. In our applications
of the residual profit split method, we define “non-routine” (or “valuable”) contributions as
contributions of intangible assets or services that whose value cannot be reliably established with
reference to comparable transaction, price, margin, or profitability data.

We note that in the financial services area, common practice has emerged among OECD member
countries in the financial services industry to treat rewards to capital as “routine” by reference to
benchmarkable regulatory risks that are consistently applied. In the financial services industry, non-
routine functions are regularly treated as vesting high profit intangibles in loan origination, high value
marketing and trading activities. Accordingly, the non-benchmarkable services and the high profit
intangibles are one and the same in the process of creating varying risks from taxpayer to taxpayer and
from year-to-year. However, these activities frequently combine with routine sales and other middle or
back office functions in the creation, management and termination of such assets.

In some other applications of the residual profit split method, where a party contributes an intangible
whose value can be assessed by comparable data, the royalty income attributable to that intangible
would normally be treated as a routine return, meaning the royalty attributable to routine intangibles
can reliably be determined by a one-sided method. The same principle is used in Scenario 1 of the
Discussion Draft – see Paragraph 10: “one-sided methods can reliably be used to determine arm’s length
pricing for the royalty.”

In many applications of the residual profit split methods involving the use of intangibles the intangible
development costs (IDCs) may be used as a means of allocating residual profits. The concept of IDC need
not be limited to an accounting definition, but may more generally include all economic costs incurred
by the parties, including opportunity costs of alternative ways of exploiting their resources. This is
predicated on the presumption that all parties to the transaction contributing to residual profits and bearing associated risk should earn the same rate of return for the development of intangibles or services they contributed. In certain cases, the capitalized cost of IDCs may be computed provided the data is available; and capitalized value may be used in allocating residual profit splits. In any event, the key point to be highlighted is that the use of IDCs in an application of the residual profit split method does not in itself necessarily imply that the value of the intangibles is equal to their IDCs, rather that each party contributing to the intangible development earns the same rate of return. This point is rather important as the use of IDC data does not mean that the value of intangibles is equal to their replacement cost, but just that a joint investment to develop intangibles should provide equal rates of return to all participants.

As might be inferred from above, in practice the reliable applications of the residual profit split method can be amongst the most time consuming and expensive transfer pricing compliance projects. Although a residual profit split analysis relies on a taxpayer’s internal data, challenges may exist in collecting and analyzing the required information. These challenges arise because (i) applications may require long-term historical data that is not readily available; (ii) applications may require segmented data from multiple sources; and (iii) selection of discount and capitalization rates, depreciation and amortization schedules require significant factual development.

Once a profit split is employed, due to the complexity of the data and calculations, tax authorities may be required to spend more time and expend additional resources reviewing and auditing applications of the residual profit split method.

In some cases, when IDC data is not available, we have seen applications of the residual profit split method using other allocation keys as proxies for the IDCs (such as estimated headcount or payroll for employees engaged in intangible asset development), or based on a quantitative measure of the bargaining power of the parties, or their opportunity costs.

We have observed a few rare instances in which a contributory analysis forms the basis for the application of a profit split (i.e., a split of operating profits based on allocation keys). We believe this is because the residual profit split method first makes reference to arm’s length results often measured using a TNMM and hence tends to provide more comfort that readily measurable contributions of the parties are remunerated first.

However, we currently see that the contributory profit split is more commonly used in the negotiation of unilateral or bilateral advance pricing agreements (APAs) or in the resolution of controversies. In our experience, this may reflect the fact that tax administrations and taxpayers find it more convenient and less risky to negotiate over a profit split. Also, the profit split percentages may be easier for negotiators to discuss. In such cases, negotiators may relate profit split percentages to the concept of fairness and more easily make comparisons to other cases. In these cases, once the allocation keys are agreed upon, they do not necessarily require further development.

For transfer pricing planning and compliance, however, taxpayers will need to justify their selection of allocation keys to tax administrations. Consequently, it is essential that OECD and tax administrations provide further guidance on the selection and application of allocation keys. Allocation keys rooted in sound economic principles rather than keys that are administratively predetermined are
more likely to be consistent with the arm’s length principle and will guard against an arbitrary global formulary apportionment approach.

Indeed, the varying contributions and risks borne under arm’s length conditions would not necessarily correlate to the results obtained by a combined global formulary apportionment. Material variances are more likely expected with respect to actual functions and risks deployed through “functional separate enterprise,” “natural home” and “centralization of management” strategies with respect to particular types of products each of which carry separate levels of risk and returns on asset value. While these treatments have been observed and tested by the OECD in the financial services area, such levels of functional integration and risk measurement have not traditionally been observed in non-financial services supply chain and distribution businesses.

Based on our research, the use of a contributory profit split has been observed in the context of decisions rendered by courts in settling commercial disputes. These court cases or the court’s decision on a specific profit split approach do not necessarily represent an agreed upon arm’s length result, and represent only the efforts of an independent party to settle the issues. They do, however provide an evidence-based approach to value drivers and allocation keys that may be used under a contributory profit split. They may also provide insight into arrangements which were not agreed to, or where challenged by arm’s length parties,

In our experience, taxpayers have been reluctant to employ a profit split method for purposes of establishing transfer prices in a planning and compliance context. This may be due to the following factors:

i. Profit split methods transmit global profit volatility to all jurisdictions, complicating MNEs’ efforts to provide reliable guidance to markets regarding their expected tax expenses and effective tax rate;

ii. The use of profit split methods may increase computational and analytical complexity and cost of transfer pricing compliance;

iii. The use of a profit split method may lead to potential recharacterization as a “partnership” for other tax and legal purposes;

iv. The use of a profit split method may exacerbate efforts to seek relief from double taxation, particularly where the split involves entities in more than two jurisdictions. In the latter situation, if the results of the profit split are challenged in one jurisdiction, it may not be immediately clear which other jurisdiction(s) should provide correlative tax relief, particularly if the challenge is not articulated in the context of a transaction between entities in specific jurisdiction.

We have observed that taxpayers prefer selecting the use of a use cost sharing or contract R&D/services arrangements in favor of a profit split method. In a cost sharing structure, taxpayers identify their significant intangibles that would be subject to joint development in multiple jurisdictions, and allow their entities in those jurisdictions to share the development costs and risks, so that each entity would have all relevant IP rights in its jurisdictions and field of use. In other cases, taxpayers centralize the development of the intangible property and other significant risk taking activities in one company. In both instances the need to split profits among multiple entities based on subjective factors, that may be subsequently challenged, is eliminated. These centralized structures are, however less appropriate to address the matrix organization of some MNEs, whereby key decision maker may be spread over different jurisdictions.
In summary, we have not encountered many cases where a contributory profit split method has been selected as the most reliable method. In our experience, applications of the residual profit method based on appropriate allocation keys are more common and less prone to subjectivity by virtue of their first reference to arm’s length comparables.

2. Outline of a Potential Application of the Contributory Profit Split Method

While our experience to date has been limited with respect to the applicability of contributory profit split methods, we understand that the Discussion Draft raises a number of questions regarding the potential application of a contributory profit split method (see Paragraphs 33-45). Our comments in this section focus on a potential application of a contributory profit split, without addressing whether it should be deemed the most reliable method.

We would expect that a contributory profit split method would be applied in situations where two or more related companies would have at arm’s length agreed in advance (ex-ante) to share the benefits associated with a certain business activity or activities.

The fundamental economic principle, consistent with the arm’s length standard, is that if multiple parties were to share symmetrically the risks and rewards of an economic activity (such as jointly developing a non-routine intangible asset), they would normally expect to have the same expected rate of return on their capital invested in connection with that activity.

The contributory profit split method may be applied either on an ex-ante basis for planning purposes, or on an ex-post basis to test compliance, depending on the taxpayer’s preferences and the availability of reliable data.

Based on our experience, we would expect a contributory profit split analysis to have the following steps:

1. Determine the scope of the business activities subject to the analysis. To the extent possible, as done in Scenario 1 of the Discussion Draft, narrow the scope of the business activities by excluding those entities and activities that make only routine contributions.
2. Determine the financial results of the business activities subject to the analysis. For multi-product firms, where only the activities related to one product is subject to a profit split, particular care should be given to the allocation of common costs.2
3. Determine of the nature and scope of contributions made by each party.
4. Determine, if possible, the amount of capital invested by each party in connection with the business activities within the scope of the contributory profit split method. Alternatively, identify the best proxy for the capital invested.
5. Select the appropriate allocation keys.
6. Calculate the allocation keys based using either a direct evaluation of the contribution of each party to the generation of the residual profit, or a reasonable proxy like the amount of capital invested, the opportunity cost, or the bargaining power. In calculating the allocation keys, depreciation and capitalization must be taken into account.

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7. Split the applicable amount of profits according to the allocation keys on either an ex-ante or ex-post basis.

Selection of allocation keys will need to be made on a case-by-case basis. We caution against the use of pre-selected allocation keys to be universally applicable for all cases. The Discussion Draft and other documents related to the Discussion Draft emphasize the importance of a “detailed functional analysis.” We would think that the insights gained from the detailed functional analysis must be incorporated in a careful selection of allocation keys.

The application of a contributory profit split will involve assumptions and necessitate the use of estimates and proxies for the determination of allocation keys. We believe it is highly desirable that such measures are rooted in a broader analytical framework that reconciles with the economic rationale for division of profit. There is a significant body of relevant economics literature that could be used for that purpose, some of which is referenced herein.

One significant consideration in establishing allocation keys may be the measure of opportunity costs, which reflects the amount of profits each party can earn on its own. This can then become the quantum of the split of profits created by the confluence of the contributions by all parties.

Economic theory can also be used to further refine the measures of opportunity cost based on tools developed in the fields of Game Theory\(^3\) that explicit model parties’ bargaining based on their impatience and risk aversion. Arguably parties with differing costs of capital (i.e., parties that can afford to be more or less patient) and differing hurdle rates of investment (i.e., parties that are more or less risk averse) would reach differing results from the bargaining.\(^4\) Also, it may be useful to incorporate insights from Industrial Organization and the theory of the firm.\(^5\) While it would not be expected that consideration of any of these theories can be distilled into a set formula, these economic principles may help to provide a framework against which to assess the merits of any proposed contributory profit split.

3. Comments in respect of the specific Scenarios presented in the discussion draft

3.1. COMMENTS ON SCENARIO 1

\(^5\) Theory of the firm explores the reasons why companies prefer to integrate certain functions and activities as opposed to contracting them from unrelated third parties. This is often described as a "make" versus "buy" decision. The literature offers at least three reasons for why “make” can be preferred over “buy;” (i) “make” allows the minimization of transaction costs (see for instance Williamson O., 1985. The Economic Institutions of Capitalism. The Free Press.); (ii) “make” avoids dealing with incomplete or unenforceable property rights (Hart O., 1995. *Firms, Contracts, and Financial Structure*. Oxford University Press.) and; (iii) “make” better aligns potential managerial incentives (Holmstrom B. and Milgrom P., 1994. "The Firm as an Incentive System." American Economic Review, vol. 84.: 972-991).
Overview: In Scenario 1, three controlled OEMs in Europe “license in technology IP from their non-EU parent, for which they pay a royalty, and coordinate their product offerings and investments through a Leadership Board (where each manufacturer is represented) “which takes decisions for the business as a whole (e.g. what new products are developed, where they are developed, where they will be built, in what plant investment is to be made, strategic marketing, etc.).” According to this scenario, “the success of the business depends on having a wide portfolio of products to sell across the European market.” In this scenario, “one-sided methods can reliably be used to determine arm’s length pricing for the royalty and for the contract manufacturing and distribution services.”

Controlled Transactions: We believe that it would be best to start with identifying the controlled transactions among the three OEMs:

- Contract manufacturing services performed by the OEMs on behalf of each other – which would may be more traditionally priced as there are reliable benchmarks for contract manufacturing.
- Finished product sales among the OEMs – which may be more traditionally priced as there are reliable distribution benchmarks.
- Provision of management, product development, and strategic marketing services among the OEMs. The issue may be interpreted as appropriate compensation for the exchange of services among the 3 OEMs that effectively pool their “entrepreneurial functions and risks.” The exchange of services among the 3 OEMs may result in a “complex web of transactions.” While it is not explicitly stated in the scenario, we presume that some of these services may be non-routine services, which may rely on the service providers pre-existing product IP or manufacturing or marketing know-how. Therefore, the exchange of services may also involve embedded intangibles.

Based on the descriptions in the scenario, additional controlled transactions we not identified.

Analysis: It appears that all tangible product transactions, including components and finished products sold among the 3 OEMs can be reliably analyzed using one-sided methods. Therefore, the analysis focuses on the exchange of services. This scenario appears to indicate that the 3 OEMs, apart from the licensed technology IP, (i) develop product IP (as there is reference to product development), (ii) develop manufacturing know-how that may go beyond what is necessary for contract manufacturing, and (iii) employ strategic marketing know-how.

Although the case scenario has not fully articulated the reasons as to why each of these intangible property items may be treated as “non-routine,” we proceed under the assumption that they are non-routine contributions. Considering the taxpayer’s desire to “pool entrepreneurial risks,” we would think that this case lends itself to an application of the residual profit split method. Because there are indicated reliable benchmarks to determine returns for routine manufacturing and distribution, the residual profits could be readily calculated. The challenge would then be to determine the value the contributions of each the parties (including non-routine intangible contributions). Given the facts of the case, these could be costs incurred by each OEM for people working in these three respected areas, taking into account their opportunity costs.

The scenario appears to indicate that the customers of the OEMs appreciate the ability to purchase a wide range of compatible products from the same supplier. Therefore, the coordination among the OEMs allows each one of them to offer a wide range of products, manufactured at a lower cost. If a contributory profit split is to be used in this case, the game theory could be applied here to consider the
strengths and weaknesses of the OEMs and potential bargaining outcomes to provide guidance for splitting profits.

Structuring Alternatives – Contract R&D and Services: Our analysis above is predicated on the taxpayer’s decision to continue with a decentralized business model. Consistent with the recent business trends, taxpayers in this situation may alternately centralize the Leadership Board, the control and development funding for the non-routine contributions in one location, which could be either one of the 3 OEMs or the non-EU parent company (which already owns the underlying technology IP).

Structuring Alternatives – Cost Sharing: In cases where multiple controlled taxpayers jointly develop intangible properties that each one of them may use, we commonly observe cost sharing arrangements. Instead of splitting residual profits according with reference to a measure of non-routine contributions, taxpayers choose to share the cost of development of commonly used intangible properties in proportion to their reasonably anticipated benefits. In this case, we could see the 3 OEMs sharing the costs associated with the Leadership Board, product development, and strategic marketing. As there are reliable benchmarks for the technology IP and tangible product transactions, such a cost sharing arrangement would address the issue of complex web of services transactions.

Responding to Question 1: In this case, the application of the comparable profit split method, in the sense of finding comparable functional and risk pooling among uncontrolled enterprises, and their financial results would be highly difficult if not impossible. As there are reliable benchmarks for routine contributions, it would be less reliable to apply a contributory profit split. Therefore, we would expect that only the residual profit split method would be applicable in this case.

Responding to Question 2: This example should be further elaborated to

- Discuss structuring alternatives taxpayers typically use to address transfer pricing complexities in these circumstances. Given the recent business trends toward centralization and elimination of duplicative functions, we would expect that a situation similar to Scenario 1 would be quickly superseded with a supply chain restructuring and having significant business reasons beyond transfer pricing simplification and tax planning.

- Identify the types of non-routine contributions by the 3 OEMs and explain why they would be non-routine. Based on the descriptions provided, we understand that the 3 OEMs may be jointly developing new products, manufacturing and marketing know-how. It would be helpful to clarify the extent and manner in which these activities go beyond that of the comparable companies identified for the analysis performed.

- Clarify if one of the concerns with the use of one-sided methods, though not explicitly stated, is the potential difference in profitability among the entities. If so, it would be helpful to provide guidance to taxpayers based on the coordination decisions.

- Define and enumerate the controlled transactions subject to the analysis before reaching the conclusion that “it may be difficult to find reliable comparables due to the very high degree of interdependence of the key functions, assets and risks of the associated enterprises.” We suspect that a key source of that difficulty would be the presence of non-routine intangibles, but question if there are other issues or concerns.
• Clarify that the Discussion Draft’s intention is to provide the taxpayers an option to use a reliable profit split method when they encounter a “web of complex transactions,” but not to force upon them a profit split approach, unless such an approach is justified by the presence of non-routine intangibles including non-routine intangibles that are embedded in service functions. If a taxpayer with a web of complex transactions chooses to use other methods to address transfer pricing issues, such methods should be judged on their merits, and not be dismissed immediately in favor of a profit split approach.

• Provide guidance on the implementation of the profit split method. Even if a profit split method is applied to determine actual or target profit levels for each enterprise, the results of the profit split would still need to be reflected in the individual transactions among the entities as payments for goods or services. Otherwise, the profit split approach may lead to a virtual partnership, with tax and legal business liability implications extending beyond transfer pricing. For instance, profit split allocations for services rendered by a separate entity (i.e. to compensate intangibles embedded in service functions performed for the MNE) should be clarified as a payment for services rendered and not as an allocation of the character of each type of asset and income among the associated enterprises.

• Further, a profit split allocation should not provide for an allocation of global losses (or conversely profit) from the relevant business activity if a participating associated enterprise in the activity does not bear risk for the loss. The Transfer Pricing Guidelines’ references to the economic substance of such arrangements should be referenced and preserved in determining who the economic risks belong to for tax purposes. Finally, the Transfer Pricing Guidelines’ principle that enables one associated enterprise or location of an enterprise to incur a loss and the other to earn a gain of business profits should be retained in accordance with the economic substance of arm’s length contractual arrangements that may be entered into by and among associated enterprises. These principles remain harmonious with allocations based on the value of functions (taking into account assets used and risks borne) in respective entities and locations and needn’t be discarded for a global formulary approach that may be expected to depart from the economic and commercial reality of the actual activities performed in each location or entity. Clarification would be helpful, that the use of the term “profit split” is broad enough to cover the varying paradigms for allocations of service fees determined by reference to the combined operating profits of a relevant business operation, as well as the allocation of assets and risks, as appropriate, among locations of a single enterprise.

• Clarify that the coordination among related party entities on questions of “what new product are developed, where they are developed, where they will be built, what plant investments are to be made” in and of itself would not create a controlled transaction among the taxpayers. The Risk and Recharacterization Discussion Draft also appear to indicate that creation of synergies within the group through the pooling or exchange of ideas, or implementation of an effective division of labor, or rationalization of the manufacturing footprint would be considered transactions. We believe that transactions should be defined as exchanges of intangible or tangible property, and provision of services. To include ambiguously defined transactions for the purposes of transfer pricing would likely lead to further controversy, increased compliance burden for MNEs, and ultimately adversely impact the international business environment.
Responding to Question 3: In cases involving highly integrated operations of multiple controlled corporations, a contract R&D and services approach or a cost sharing structure may serve as an alternative to a profit split method. We note that the primary consideration should be the taxpayer’s choice regarding how risk would be allocated among the parties and that tax administrations should confirm the reasonability of that choice before evaluating the relative reliability of alternative methods.

Responding to Question 4: Guidance regarding which contributions would be considered non-routine within the context of a residual profit split method would be useful for taxpayers. We recommend using the criteria that any contribution for which a reliable market benchmark can be identified should be treated as a routine contribution.

3.2. COMMENTS ON SCENARIO 2

Overview: In Scenario 2, the Discussion Draft offers the example of an MNE, RCo Group, that offers advertising services and related technologies such as targeting and user interfaces to clients, charging a fee to the client per click on hosted advertisement. The MNE also offers free online services to end-user customers and gathers information on their behavior, location, and personal information. This Scenario states “The technology used in providing the internet advertising services, along with the various algorithms used to collect and process data in order to target potential customers, were originally developed and funded by Company R, the parent company of the RCo Group. The transfer pricing issue in this case relates to the “local subsidiaries” of R that engage in local marketing and promotion, local regulatory administrative issues, provide consulting services, which all appear to be rather routine activities performed by independent outsourced business service companies. The scenario highlights that the local subsidiaries “also regularly interact with staff members in Company R in charge of developing the technology and make suggestions, notably on the algorithms and technologies used and their adaptation to local market features, and on new features that would be attractive to users in their market.”

Description of the Controlled Transactions: In Scenario 2, the only controlled transaction appears to be the services provided by the local subsidiaries. These subsidiaries appear to have been established by R for the specific functions they are supposed to perform on behalf of R. This Scenario clearly state that Company R has substantial control over the global and local intangibles. According to the Discussion Draft, the more substantial contribution of the local subsidiaries appears to be advisory services they provide to Company R regarding potential local market modifications.

Analysis: As with any services transactions, the issue is whether any of the services provided may be considered non-routine contributions. As indicated in our introductory comments, we believe that the distinction between routine and non-routine depends on whether there are uncontrolled transactions involving the same or comparable types of services. For this purpose, we enumerated the services provided by local subsidiaries and provided a discussion about the potential availability of comparable companies that provide the same types of services. Based on our analysis, all of the activities attributed to the local subsidiaries appear to be rather routine services that can potentially be sourced from independent business service providers.
i. “Promote the use of online services provided free of charge to users:” this activity appears to be a routine service that may otherwise be outsourced to marketing and promotion service providers.

ii. “Translate them into the local language:” translation of computer code from one language to another is a common and simpler outsourced IT service provided by independent companies.

iii. “Tailor them to the local market and culture:” Our reading of the scenario indicates that these services would not involve significant changes to the business model or the underlying technology, but rather stylistic changes. We believe that Company R may hire local marketing or public relations consulting companies to collect insights and data about potential stylistic changes that would make their website and services more attractive.

iv. “Ensure that the services provided respect local regulatory requirements:” In almost all market economies, law firms or individual law practitioners provide capable and extensive local compliance services, including preparing and filing necessary paperwork.

v. “Provide technical consulting to users:” Within the last two decades, we have seen a large number of information technology consulting companies emerging to provide such services to consumers and businesses. The larger outsourced information technology companies actually have significant capabilities, including their own proprietary technologies.

vi. “Generate demand for and adapt advertising services:” We believe that this type of activity would be the same as marketing and promotion activities, similar to the ones provided by large advertising agencies or outsourced marketing companies.

vii. “Interact with staff members in Company R in charge of developing the technology and make suggestions, notably on the algorithms and technologies used and their adaptation to local market features, and on new features that would be attractive to users in their market:” This appears to be an advisory service on information technology and local market intelligence. This type of advisory services is available from a mix of outsourced companies discussed above.

Responding to Question 5: In this case, the application of the profit split method would not be warranted if in fact the local subsidiaries are providing routine business services to Company R. In fact, considering their relatively routine contributions to the business, and also considering the potentially large value of the intellectual property of the companies that operate on a global basis with new technologies, we believe it may not be appropriate to expose the local subsidiaries to the volatility of the global profits only to reward them for relatively small contributions. The only controlled transaction in this case, provision of routine business services may be more easily analyzed using one-sided business models. Further, routine compensation for such functions should remain applicable whether or not there are gains or losses in the global operating profit.

There is often an argument that a third party service provider would not have the right incentives to provide Company R with the best possible service. We believe that Company R’s ability to better
monitor and incentivize a related service provider would not necessarily increase the related party service provider’s opportunity cost and potential arm’s length profits unless the distributor is in possession of non-routine intangibles.

Responding to Question 6: This example should be further elaborated to

viii. Discuss structuring alternatives taxpayers typically use to address transfer pricing issues in these circumstances. Given the recent business trends toward centralization and elimination of duplicative functions, we would expect that in a situation similar to Scenario 2, MNEs may enter into long-term service contracts with their local subsidiaries so that the local subsidiaries perform and provide all services on behalf of a principal company (in the example, Company R). The use of cost-plus service fees, with the plus reflecting the appropriate return for the types of services provided is commonly adopted by taxpayers. Regardless of the methodology used to determine the service fees, we believe the example should address why such service contracts would not be appropriate in this instance.

ix. Clarify whether the local subsidiaries also function as local “distributors” in the sense of invoicing local customers for the advertising services. If they perform such distribution services, there may need to be an additional compensation for such distribution activities.

### 3.3. COMMENTS ON SCENARIO 3

Overview: The Discussion Draft discusses the application of profit split methods in scenarios where both parties make “unique and valuable contributions.” In Scenario 3, the OECD presents an example of a distributor who’s “activities constitute a key source of competitive advantage for the Group.” The draft discussion paper reaches this conclusion on the basis that the distributor in Scenario 3:

i. Develops very close relationships with customers, including providing on-site services (often in remote locations),

ii. Carries an extensive stock of spare parts,

iii. Has a highly proactive maintenance program to detect likely problems before they arise, and

iv. Provides extensive advice to customers on equipment choice, makes modifications for particular local conditions, and for maximizing performance efficiency and efficacy (of the customer’s operations).

Controlled Transactions: In this scenario, the only controlled transaction is the purchase of tangible property (i.e., machinery and spare parts) by local distributor for resale to unrelated customers. This is the most common type of controlled transaction within MNEs. In this case, we understand that the distributor provides a number of value-added services, which is typically the case of the distributors of large industrial equipment that require maintenance and spare parts.

Analysis: In our experience, the vast majority of the distribution transactions are analyzed using “one-sided” methods such as the resale price method or the TNMM. We note that there are a large number
of independent companies that operate as value-added resellers of industrial or transportation equipment that can be used as comparable companies in the application of a TNMM. We also note that these independent distributors may also require strong customer relationships, technical knowledge and ability to provide maintenance services so as to remain an essential element in their respective supply chains. In some instances, if the comparable distribution companies are not providing the same range of on-site maintenance or spare parts provision services, an additional return may be assigned to the local distribution company (Company S) based on the profit margins earned by independent maintenance, repair and operations (“MRO”) companies. This is a fairly well established industry and the MRO companies provide on-site services for many industrial companies. These MRO companies use commercially available MRO software to anticipate problems and also engage in proactive preventive maintenance for their customers.

Response to Question 7: the Discussion Draft asks whether the definition of “unique and valuable contributions” in its Intangibles Guidance should be expanded to include the activities defined above. We believe that the activities listed in Scenario 3 should be determined as unique or valuable with reference to that which is typical and routine with respect to the potential available comparables. In this case it is not immediately evident that the activities would be atypical from that of a distributor of industrial machines and durable capital goods. Instead of an outright rejection of the TNMM, we would recommend a closer examination of the potentially comparable distribution companies. In our experience, such potential distribution companies have significant capabilities and strong customer relationships. Therefore, in principle, their profitability should provide a reliable arm’s length measure of profits expected of a local distribution company.

Response to Question 8: the Discussion Draft asks what aspects of the scenario can be further elaborated to make it more plausible to apply a profit split method. We believe that the Scenario 3 may use further elaboration in the following aspects:

“Company S is recognized as not merely a ‘routine’ distributor, but its activities constitute a key source of competitive advantage for the Group.” We believe that it must be clarified as to who recognizes Company S as a key source of competitive advantage. Is this a conclusion reached by tax administrations, or is it based on the company’s own pronouncements, or independent industry commentary? In our experience, almost every company prides itself on providing excellent customer service. For the activities of Company S to be a key source of competitive advantage, they must be unique, include some proprietary features that cannot be replicated by the competitors. Alternatively, such a competitive advantage might come from Company S (distributor) making a specific investment in a non-routine intangible asset that a third party distributor would never make, see for instance Williamson, op cit. The scenario does not indicate any such features.

v. “Very close relationships with customers:” All distribution companies have very close relationships with their customers, especially in the industrial machinery area. Their customers know the makers of the machinery and significant technical knowledge. We would like to understand how a controlled distributor may have closer relationships with its customers than the independent distributors.

vi. “On-site services at remote locations:” Independent MRO companies provide services for many customers regardless of physical location. Some additional clarification may be helpful as to why the “remote location” of customers would impact comparability under a one-sided transfer pricing analysis.

vii. “Carrying an extensive stock of spare parts:” Given the practice of transfer pricing in the last 3 decades, we have well-established practices to adjust benchmark returns to
account for a tested party carrying a relatively larger inventory than the comparable companies. It would be helpful to understand whether there may be other economic implications to the tested party carrying an “extensive” stock of spare parts.

Response to Question 9: We believe that distribution transactions are fairly well understood by taxpayers and tax authorities and both are generally able to work with the TNMM or similar market-based benchmarks or uncontrolled resale margins, to determine the appropriate level of compensation for the local distribution companies. A detailed functional analysis can be performed comparing the functions of Company S with those of the independent distributors and MRO service providers.

Response to Question 10: We do not see any advantages to the use of a profit split method as the activities of Company S are limited to the local market and there are reliable benchmarks for determining an arm’s length return. If it is determined that a similarly situated taxpayer should be further subject to the global business risks, the example provided in Paragraph 32 of the Discussion Draft where the TNMM range may be adjusted from year to year in response to the global profitability of the MNE may be applicable. There is a risk that where it may be interpreted that the use of profit split methods where the traditional methods are adequate to address transfer pricing issues, as in Scenario 3, may give rise to arbitrary results and only foster further controversy. It should be emphasized that in those circumstances where independent companies are available as comparables first consideration should be given to arm’s length information.

In short, expanding the definition of “unique and valuable” contributions beyond intangibles and for purposes of the application of a profit split method as the preferred method for distribution transactions may give rise to further controversy and double taxation.

### 4.4 Comments on Scenario 4

Overview: In Scenario 4, Company A is developing new medical equipment and it will purchase “certain key components” from related party companies B and C. All companies conduct the R&D for their respective parts, assuming the risk of failure. It is also stated that companies A, B, and C have agreed to a contract to determine transfer prices on a profit-sharing basis.

Controlled Transactions: The controlled transactions in Scenario 4 are the sales of components from companies B and C to Company A. The components will have significant embedded intellectual property.

Analysis: This is a case of joint development of intangible property. In this case, the taxpayer has decided to share the risk of development among all entities and had also agreed to a profit split approach. Accordingly, we believe a profit split approach would be applicable in this instance. As for the selection of an appropriate profit split method, we are concerned that an appropriately suitable comparable transaction can be identified in most similar situations. We are aware of examples in certain industries, such as aerospace and defense industry, where an OEM, acting as the principal contractor, agrees to pay suppliers a fixed percentage of the revenue in return for their development and supply of certain key components. However, such arrangements tend to be specific to each project and the corresponding revenue sharing percentages are not readily translated to other projects. Typically, in the case of a failure to develop a product or successfully complete the project, such an arrangement would not involve a direct sharing of losses on R&D expenses. On the other hand, as discussed in our general
comments, the residual profit split method may be readily applied in this instance with reference to the capital invested by each of the respective three companies provided it can be tracked easily and reliably.

Response to Question 11: In this instance, as the taxpayer had explicitly decided to share risks among the 3 parties through a profit split, the application of profit split methods would be appropriate. One of the key challenges in this instance would be to determine the appropriate sharing of the losses if the product development efforts fail.

Response to Question 12: One-sided methods, especially the cost-plus method can potentially be applicable if the taxpayer decides to share risks in a different manner. If companies B and C supply similar components to unrelated parties, their cost plus margins on such transactions, including their R&D investments, can be reliably calculated and used as a basis for the transfer prices for the components upon successful launch of the final product. If the product development fails, each party will be responsible for their own R&D expenses. If a taxpayer has access to such uncontrolled transactions that could be the basis for setting prices in case of successful development, an application of the cost plus method may be equally reliable as the residual profit split approach.

Response to Question 13: The critical aspect of Scenario 4 is the elaboration on how best the taxpayers can implement a profit split, if they so choose, without running into practical difficulties in implementation. More specifically:

i. How could a taxpayer choosing a profit split method mitigate the risk of being treated as a partnership for other tax purposes? Should distinctions be drawn between legal ownership and sharing of only positive profits through service fees compared with arrangements that result in the sharing of losses through reimbursements? Accordingly, operating profits may be determined by equalizing costs incurred by the non-legal owner of property. However, when revenues are insufficient to cover costs incurred by the legal owner of the property after reimbursements to the associated enterprises, retention of such losses by the legal owner may be distinguished from full sharing of losses.

ii. Can the taxpayers agree on a profit split based on projected financial results and projected R&D costs and make no further true-up adjustments?

iii. What would be the mechanism for implementing the cost share? In this instance, we presume that the profit split results will be worked into the transfer price paid by Company A to Companies B and C.

iv. What if the profit split results require the transfer price to be below cost? How will the taxpayer defend such a transfer price from the customs valuation perspective?

v. How would the taxpayers perform adjustments at the end of the year if it was determined that a split of actual profits was warranted? Can this be achieved by adopting a service model between capital and service providers who combine costs related to the activity to determine the operating profit?

vi. A further point of elaboration should address alternative arrangements taxpayers may make under the same situation. Namely, Company A may choose to fund the entire product development, engaging companies B and C as contract R&D service providers, and ultimately contract manufacturers, taking on all business risks associated with the development of the new medical equipment. If a taxpayer chooses such an approach and compensates
companies B and C for their contributions using one-sided methods, would there still be a basis for applying a profit split?

4.5 COMMENTS ON FRAGMENTATION

Overview: The Discussion Draft notes, without providing a specific scenario, that occasionally in the operation of a complex MNE, necessary functions may be fragmented amongst multiple subsidiaries, such as separation of distribution activities into specialized activities, and such as logistics, warehousing, marketing and sales, etc. The guidance notes that it may be difficult or impossible to find comparables for such specialized functions, and thus a profit split method may be appropriate.

Controlled Transactions: While no specific scenario is provided for fragmentation, we understand that this example includes a number of subsidiaries each one of which providing relatively simple services or functions such that their level of functionality would be less complex than those of independent companies that perform the same or similar services: “Because of fragmentation, available data on similar independent transactions may generally not have a comparable mix of functions, assets and risks to the tested party or parties. High levels of integration may mean that comparables from independent enterprises do not reflect the same functional and risk profiles.”

Analysis: We agree that an MNE may require the services of multiple entities, performing routine and limited functions, but why would not the MNE be able to attribute reliable returns to those entities based on the profitability of functionally similar independent companies through a reliable application of the TNMM? In an application of the TNMM, we would normally select a profit level indicator that would allow for certain profit comparisons despite differences between the size and scope of the activities of a tested party and the comparable companies. Typically, we use a return on costs for fragmented service providers, such as logistics, warehousing, and marketing, and a return on sales for sales entities. The Discussion Draft suggests that instead of benchmarking individual fragments, it may be possible to identify “a comparable for some or all of the fragmented activities on a combined basis,” and use “the principles of a contribution analysis (as described in Chapter II of the Guidelines at section C.3.2.1)” to divide the benchmarked profit. We would find this approach equally viable, but would rather split the profits based on also the most reliable profit indicator instead of a contribution analysis only.

Response to Question 14: In paragraph 28, the Discussion Draft references the Intangibles Guidance, and somehow associate fragmentation with the joint IP development, similar to what is in Scenario 4. We believe that the joint IP development where the taxpayer has chosen to share risks among participating entities, the application of the profit split methods is a well-established practice. In this context, there may not be a need to expand that practice beyond intangible development.

Response to Question 15: Instead of profit split methods, a simple application of the TNMM with an appropriate profit level indicator could to a significant extent address the issue of fragmented supply chains. We do not see a strict need for profit split methods.
Response to Question 16: The Discussion Draft should consider the potential application of TNMM for each fragmented supply chain element. If that application is reliably developed, there may be less need to consider profit split methods.

4.6 COMMENTS ON SCENARIO 5

In Scenario 5, the OECD delineates a circumstance in no apparent reliable comparables can be found for a group of controlled distributors that generate regional-level business for the company as a whole by developing relationships with large customers spanning the region. In our experience this can be a reasonably common fact pattern in which taxpayers address through “cost sharing” whereby the costs of maintaining relationships with global customers are shared among the companies that make sales to such global customers in proportion to reasonably anticipated benefits. Another common observed structure amongst taxpayers is one in which global or regional Principal companies are responsible for engaging all local sales and distribution companies on a contract basis to develop global customer relationships. While it is clear that there may be an opportunity to strengthen simpler, one-sided approaches through refinements such as the choice of comparable companies, it is not apparent that replacing traditional transfer pricing models with a global profit split model will be beneficial in this case; and in fact may give rise to further controversy and a higher incidence of double taxation

1. Questions 17 through 19 solicit comments on finding comparable companies for this Scenario 5. First, it is not clear, the presence of regional customer relations would necessarily result in an increase in the combined compensation had the transaction transpired between arm’s length parties. There is a fairly well-established practice of identifying and analyzing comparable distribution companies. The question would then be one of how to allocate the total distribution profits among the distributors. Both cost-sharing and profit split based on contributions could represent viable options...

4.7 Use of the TNMM range in connection with profit split (Questions 20 and 21)

In Paragraph 32, the OECD provides some considerations in respect of the TNMM that may be useful and considered as an alternative to the application of a profit split. Specifically, the discussion draft presents the possibility that taxpayers may consider adopting a policy that varies returns within the TNMM range as the global profitability of enterprise increases or decreases, allowing for some flexibility. We agree that this is a helpful suggestion. We believe that for many taxpayers it will be helpful to establish a linkage between TNMM profit targets and the global enterprise profitability. This suggestion would address our concern expressed earlier that distributor entities with limited control over the global profit flows should not bear the full brunt or the reward of the variations in profits. We believe that allowing for variations within TNMM ranges based on measures of global profitability (or other relevant factors for that matter) could address the issues that may be raised without unnecessarily increasing complexity or the potential for disputes and double taxation.

4.8 Aligning Taxation with Value Creation
The Discussion Draft notes that as part of the BEPS Action Plan it is attempting to revise its rules to align taxation with value creation. This is an ambitious objective, as many MNEs themselves struggle, strictly for business purposes, to determine what would generate value at any given time or market, as evidenced by increasing volatility in stock markets. In our opinion, this objective is theoretically correct and should be the ultimate objective of a profit split exercise. However considering the empirical difficulties, TAs should understand the need for developing manageable proxies and the use of established transfer pricing practices or economic theories.

Overview: The Discussion Draft goes back to the first example of the three OEMs operating in the European market, assume that any post-royalty, residual profits are split between the three controlled manufacturers based on three factors: production capacity, headcount, and value of production, which are intended to reflect capital investment, labor, and the contribution to actual output, respectively.

Analysis: We are concerned with the assertion that the residual profits be split on the basis of fairly high-level variables that may not necessarily correlate with value creation. We believe that all appropriate returns for manufacturing and distribution are reliably allocated before arriving at the amount of residual profits. Scenario 1 had postulated a number of areas such as product development, manufacturing and marketing know-how, where all three OEMs were making potentially non-routine contributions. We do not think that any of the proposed measures would reflect the size of capital invested by the parties for non-routine contributions.

Response to Question 22: We believe the question of looking at broad-based factors of value creation with an enterprise, without going through and defining transactions among them should be a method of last resort. As explained before, we believe that the residual profit split method can be reliably applied for Scenario 1, based on the IDCs. In cases, where IDCs are not available, taxpayers may consider proxies that may approximate IDCs. For example, if the historical R&D data are not available, they may be permitted to use, for example, the relative number of R&D personnel.

Response to Question 23: If the IDC data is not available and there are various measures of opportunity costs that may be used to determine allocation keys (see our discussion in Section 3).

If there are multiple measures of opportunity costs, we would recommend an equal weighting of the different proxies if they are equally reliable. We also note that a formula driven allocation of profits, however established, must be accepted by each jurisdiction. In cases of controversy, which is quite common in transfer pricing, a taxpayer using a contributory profit split may struggle the find the counterparty government for seeking double tax relief.

4.9 RACI Matrix – Scenario 6

Overview: Scenario 6 describes how a qualitative functional analysis can be converted to a quantitative profit split by using a matrix that assigns each entity one of the following 4 levels for each function:

- R: Responsible
- A: Accountable
- C: Consulted
- I: Informed.
As the Discussion Draft explains, RACI does not separately consider risks and assets but rather assumes that they are aligned with the functions. The RACI analysis is applied to “each of the group’s key value drivers.” The scenario neither enumerates the key value drivers considered, nor how the RACI matrix can be quantified to arrive at profit shares. In all instances, given the complexity of a profit split, it is important that taxpayers be given the flexibility to define and quantify value drivers in an economically reasonable way. That may include consideration for RACI and implied risk allocations.

Responses to Question 24 and 25: We believe that a qualitative analysis can only be helpful to the extent it builds a proxy for value drivers, including IDCs or quantifies opportunity costs, and helps taxpayers and tax administrations in the relative contribution of the parties taking into account economic theory and bargaining strengths. (See Section 3).

4.10 Hard-to-Value Intangibles – Cost as a Profit Split Allocation Factor

In Question 26, the Discussion Draft poses the question of how profit split methods can be applied for hard-to-value intangibles, considering that the cost of development is not necessarily associated with value. As explained in our introductory comments, if two or more parties are engaged on the same basis in a joint intangible development effort, we might expect them to earn the same, or at least a commensurate, rate of return on their invested capital. Therefore, the use of the IDCs, as appropriately depreciated and capitalized, provides an objective measures for profit split. We are concerned that in the alternative taxpayers and tax administrations may choose increasingly subjective or complex, and therefore, more contentious allocation factors. Given the well-established practice of using IDCs where there is reliable data on the IDCs and strong underpinning for the use of IDCs, more supportive guidance delineating circumstances in which the use of IDCs would be more or less suitable.

4.11 Ex-Ante vs. Ex-Post Profit Split Results (Scenario 7)

Overview: The Discussion Draft notes that there are sometimes significant differences between ex-ante and ex-post applications of a profit split method. In Scenario 7, two related enterprises agree to assume responsibility for the development of the two key components of a product. They agree to share residual profits on a 30-70 basis, based on the relative size of projected IDCs. However, each party remains responsible for its own IDCs and therefore the cost overrun risks. As a result, the actual development costs would not necessarily be split on a 30-70 basis between the parties.

Controlled Transactions: This case includes one of cross licensing. Each party develops its own intangible property to be contributed to a joint project.

Analysis: As it is common in joint intangible development cases, there are rarely uncontrolled comparable transactions to provide guidance on the relative value of intangibles or how the profits should be split. In many cases involving joint intangible development, taxpayers, would apply the residual profit split method, using IDCs (with appropriate depreciation and capitalization) as the allocation key for residual profit. In this instance, the residual profit split can be applied on an ex-ante
basis, determining the profit split percentages at the start of the project, or on an ex-post basis, determining or updating, the profit split percentages as the actual project results become available.

Response to Question 27: We believe that an application of the residual profit split on an ex-ante basis is more desirable, as it less based on expectations rather than results which can guard against arbitrage or the use of hindsight. Once that application indicates that the parties expect IDCs to be split on a 70-30 basis and agree to split residual profits by the same ratio, they can also agree to adjustments to share the IDCs on a 70-30 basis if necessary. Therefore, an ex-ante application of the residual profit split method, accompanied by a cost sharing arrangement, would avoid any concerns about an ex-ante versus ex-post comparisons. This approach of reconciling an ex-ante residual profit split with cost sharing would only work if the allocation key for residual profits is a monetary item. If the profit allocation key is a qualitative approach, like a RACI, such a combination may expectedly not be possible. In our experience, the best practice for taxpayers facing a situation similar to Scenario 7 would be to document the contemporaneously available business projections that may be the basis for any ex-ante contractual arrangements.

4.12 Converting an Ex-Ante Residual Profit Split to a Running Royalty Rate (Scenario 8)

Overview: In Scenario 8, Company P conducted the basic R&D and initial clinical development for a pharmaceutical product, but then licensed it to a related party, Company S for further development and marketing. It appears that Company P may continue to contribute to clinical development after the licensing arrangement: “For the purposes of this scenario, both companies are understood to contribute to the development of the intangible.” At the time of licensing, based on a capitalized cost of IDCs, the ratio of contributions of P and S is expected to be 80:20. The parties then agree to convert Company P’s 80 percent share in residual profits to a running royalty rate and conclude the license agreement using that royalty rate.

Controlled Transaction: The controlled transaction in this instance is one of licensing of intangible property, with the licensee and licensor taking on the joint responsibility for future development.

Analysis: This type of licensing arrangement is observable among unrelated parties in the life sciences industry. In general, the uncontrolled license agreements are structured in the form of a series of upfront and milestone payments, and a running royalty rate percentage on net sales. In general, the licensee assumes all future development expenses. There are rarely any development responsibilities assigned to the licensor, except for clearly defined tasks (such as the supply of the active ingredient, or completing in-progress clinical trials, etc.). In this instance, a similar approach may be adopted, with Company S engaging Company P as a contract R&D service provider for any work Company P may engage in for the future development. In the specific context of the life sciences industry, we expect that the transfer pricing analysis would be primarily based on the comparable uncontrolled licensing agreements. An application of the residual profit split method as described in this scenario may be applied as a confirmatory method.

Expanding the Scope of the Example: However, in many other industries, there would not be as much uncontrolled licensing activity and the amount of publicly available data on uncontrolled licensing agreements and the profit potential of the products may not be as readily available. Accordingly, the
residual profit split method may emerge as the primary method in such industries, with a complementary analysis of uncontrolled licensing data. However, our comments regarding the need for clear delineation of future R&D responsibilities between the licensor and licensee continue to be relevant across other industries. In many cases, it wouldn’t be extraordinary to expect the licensee becomes responsible for future R&D activities. Therefore, it would be useful to consider the possibility that, and characterization of, the licensor may be engaged to assist with R&D after the conclusion of the license agreement as part of this Scenario.

Response to Question 28: We believe that in industries where there are examples of relevant uncontrolled licensing arrangements, we would encourage the use of a certain royalty rate with reference to arm’s length results, rather than upfront residual profit split analysis regardless of the actual outcome of future R&D efforts. In industries where such uncontrolled licensing arrangements are not available, as explained above, the use of a cost sharing arrangement so that the actual IDC allocations match the projected IDC allocations. Under either approach, conversion to a royalty without true-up, or complementing the residual profit split with a cost share would be tremendously helpful for taxpayers to avoid the cost of reapplying the residual profit split analysis on an annual basis and would also reduce the risk of controversy as there would only be one set of financial data for the initial application of the residual profit split method.

In general, we welcome the OECD’s recognition that the profit split method may be used to determine transfer prices upfront for a specific transaction as useful step for taxpayers. Many taxpayers would prefer to account for the contributions by different controlled entities upfront and set transfer prices accordingly for the future licensing, services, or tangible product transactions. This approach, if adopted, may be helpful to MNEs to simplify their transfer pricing.

4.13 Should Profits and Losses be Split Differently?

Overview: The existing OECD transfer pricing guidelines note that references to “profit” should be applied equally to “loss,” however, the Discussion Draft raises the possibility of the existence of transactional profit split comparables where the parties may split profits and losses differently. Scenario 9 of the Discussion Draft provides an example where a banking group trades a structured financial product through an integrated model in different time zones. Profits are allocated using a profit-split method that places the greatest weight on compensation to its traders, including bonus performance. However, there may be significant losses and the correlation between bonus compensation and loss will not be equivalent to the correlation between bonus compensation and profit in profitable time. Consequently, the methodology includes adjustments when losses are incurred, based upon analysis of the compensation policy and the circumstances of loss.

Analysis and Response to Question 29: In such a circumstance we would expect that consideration should be given to whether contributions may be better measured with reference to a different allocation key for example relative changes, rather than absolute changes, in the key. Nonetheless we would not preclude the possibility that such an asymmetry between the allocation keys for profits versus losses may be applicable, depending on the allocation of functions and mainly risks. It should be contemplated that such arrangements, even though often not verifiable, exist on comparable uncontrolled transactions. Further, it is most common in a banking group for the capital provider to bear the sole risk of loss. This determination must be made in economic substance. Accordingly, losses derived from losses on capital placed at risk ought not to be shared when the trading enterprise has no
obligation and in fact does not bear economic cost for providing recovery or reimbursement to the capital provider. Where bonus compensation is guaranteed (e.g. for purposes of on-boarding high value employees or to pay for their retention), guidance would be helpful to determine whether such costs should be includable in the determination of the allocable operating profit or merely borne by the trading entity. Such costs may be viewed as extraordinary items that do not reflect the profitability of “continuing operations,” and as such may cause a trading entity to incur an above the line profit on continuing operations with a below the line loss in some instances identified with the guaranteed compensation charges. Which entity bears these charges may be eligible for contractual arrangement between the associated enterprises subject to economic substance and adequate capitalization of the trading entity.

Response to Question 30: This question asks whether there are circumstances under the arm’s length principle where parties that would share combined profits would not be expected to take any share of combined losses. We believe it would be an enormous undertaking to collect and analyze data to answer this question. Nevertheless, we believe that facts and circumstances of specific MNEs should dictate the appropriateness of allocating profit and losses on a symmetrical basis. We think the better approach is to evaluate the contractual arrangements for allocating the risks between a capital provider and its sales/trading service providers. Where the risks of loss are retained by the capital provider, the allocation of profits should be reflected in combination with a reward for the capital risk bearing. These considerations have been addressed in the 2008/2010 Reports on Attribution of Profits to Permanent Establishments, Part III, Section C-2(iv) (“The Role of Capital”). Further illustration of the Role of Capital and the value of risk bearing would be helpful, including whether percentage of profits comparables are more readily acceptable in current industry practice. The harmonization of profit split allocations with a “service model” treatment also would resolve characterization problems for payments between associated enterprises.

4.14 Availability of Reliable Data for the Application of the Profit Split Method – Response to Question 31

In our experience, the concerns expressed in Paragraph 2.114 of the OECD Guidelines remain valid (quotes are from the OECD Guidelines):

   i. Accessing Foreign Data: “associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates;”

   ii. Measuring Consolidated Profits: “it may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies;” and

   iii. Segmented Operating Expenses: “when the transactional profit split method is applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises’ other activities.”
In our experience, (transactional) profit split methods require significantly more detailed and often segmented financial data from the MNEs, covering past years, and future projections. Among the thousands of transfer pricing studies we prepare for our clients, the profit split methods are the ones that are most costly and time consuming for the taxpayers, and also require more review time from the tax authorities. It should be acknowledged, however, that an application of profit split on a larger basis than simply transactional, while still presenting clear challenges, may be supported by simpler, but still reasonable, economic reasoning.

In general, the financial data that MNEs may be required to disclose as part of the country-by-country reporting would be at a very high level for the application of any type of reliable profit split method. As discussed above, the (transactional) profit split method would generally be applied with segmented data covering only specific product lines.

While companies are working with increasingly sophisticated information technology, our experience indicates that the data collection and tabulation priorities of the MNEs do not include tracking data at the legal entity level. Most MNEs tabulate legal entity financial statement only for the purposes of statutory and tax compliance. Therefore, the type of data requests for the application of a profit split method can still require additional manual work. To this end, common understandings such as the use of a common GAAP may be crucial for the application of a profit split.

4 Matters related to Governance and the Use of Profit Split Methods

It is unlikely that an ideal profit split method exists that would be both perfectly correct (and therefore acceptable to all taxpayers and tax administrations and easy to implement. Within that framework, an improved governance structure might however help promote an efficient use of the profit split method, when profit splits are needed or desired.

While we believe that the global transfer pricing infrastructure, solely taking into account resourcing constraints and operational needs, should facilitate and accommodate the determination of transfer prices without reliance on the availability of the three administrative tools described below, we nonetheless expect they will be important to ensure favorable international tax governance:

i. **Development of Advance Pricing Agreements (APAs).** As noted before, profit split methods are subjective and complex and can result in differing views. Consequently, tax administrations’ efforts to increase the availability and expediency of APAs could be an useful tool in mitigating disputes and the advent of double taxation. One measure that may be useful in this context might be greater harmonization of requirements of an APA submission and the APA application process (making it quicker and less burdensome). The availability of generic information, absent specific taxpayer information, in respect of APAs concluded would increase transparencency and allow taxpayers to better assess risk and self-screen in respect of methodology and suitable value-drivers. In the context of the multilateral instrument, subject to certain criteria, TAs may have an opportunity to reduce admission or due diligence requirements where an APA has already been
concluded by other jurisdictions on the same issue.

ii. **Development of tax unity areas**, where tax administrations would agree on a given corpus of profit split rules and principles, applicable to their vicinity. With such a system, double taxation would be fully eliminated within the concerned area. It might even be envisioned that, within the tax unity area, a given body could be empowered to validate profit splits models, on behalf of the contributing states.

iii. **Global agreement among countries to find specific APA-like solutions for the largest or most complex MNEs or transactions**, having a wide international span, and a high number of hard to value intangibles. If the tax administrations of interested economies were able to agree on a set of objective criteria to identify significant global companies or transactions for which all parties might benefit an appropriate transfer pricing compliance model (which may include the use of profit split models along with others).

2. It will also be important to remedy any potential adverse impact of partnership treatment for tax and legal purposes. Common principles for determining where risk-bearing is shared with respect to income producing assets and where risk-bearing is retained exclusively by the legal owner (after remuneration for any development) may be a helpful approach for determining the scope for partnership or mere service provider treatment.

3. Use of contributory profit splits among 3 or more entities may create ambiguity in terms of seeking correlative relief. As an example, let us assume that the three OEMs in Scenario 1 of the Discussion Draft decided to apply a contributory profit split and relied on headcount as an allocation key. If one of the tax authorities disagrees with the taxpayer and makes an adjustment, where would the taxpayer seek correlative relief? In our experience, multilateral relief from double taxation would be difficult and time consuming. It would be useful to enhance the efficiency of multilateral double tax resolutions.

4. We expect that, as a consequence of BEPS, there will be a significant rise in the compliance burden that will be placed on MNEs as a result of the need to provide additional information to help improve the level of transparency and the potential for increased and more complex analysis in the determination of the prices themselves. We would hope that this would only be seen as acceptable for the groups if it in fact facilitates greater certainty and reduces the potential for controversy and double taxation. This can only be achieved if these efforts are coupled with definitive efforts to clearly delineate circumstances in which the use of a profit split would or would not be desirable and a commitment to ensure the efficacy and efficiency of resolving disputes and ensuring the elimination of double tax.

5 **Conclusion**
We believe the profit split method may be viewed as either a residual profit split or a contributory profit split (while comparable profit splits would theoretically be more reliable, data availability for their application is very limited). We would highly recommend carefully classifying different profit split methods.

The selection of a profit split method as the best method, and the choice between a residual and a contributory profit split would depend on the facts and circumstances of each taxpayer. We would recommend adopting a precise definition of routine versus nonroutine contributions. Our recommendation would be to define routine contributions as those that can be measured reliably based on available market benchmarks.

We believe that the examples provided in the Discussion Draft should also consider taxpayers’ preferences for risk sharing, and also some of the commonly used structures by taxpayers, such as cost sharing and contract R&D and services.

We believe that the economic theory provides useful tools for developing reliable allocation keys for an application of the contributory profit split method. We provided a discussion of a reliable application of the contributory profit split in Section 3, with references to various applicable economic theories.

Our experience to date that has been that profit split methods tend to be costlier and more time consuming than other methods for both taxpayers and tax administrations. Further OECD guidance on profit splits may make them more practical and readily applicable.

To develop the application of contributory profit splits on a combined basis, improvements in the international tax governance is required. To do so, TAs will need to develop tools or processes to give more certainty to taxpayers that apply a profit split method (APA, common validation processes, etc.).

We also believe that any advance towards a wider application of profit split needs, given the technical intricacies, to leave sufficient flexibility for taxpayer for adapting to its own set of circumstances while still being prescriptive enough to provide safeguards against the use of arbitrary allocation keys by tax authorities in the application of the contributory profit splits.
Comments on the Public Discussion Draft

**BEPS Action 10:**
Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

February 5, 2015

Mr. Andrew Hickman, Head of Transfer Pricing Unit, OECD, Centre for Tax Policy and Administration
By email: TransferPricing@oecd.org

We are pleased to comment on the public discussion draft *BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains* (the draft) through the consultation taking place from December 16, 2014 to February 6, 2015.

This document may be posted on the OECD website. Full credit goes to Robert Robillard, DRTP Consulting Inc.¹

1. **Scenario #1 (alleged value chain)**

1.1. The controlled transactions between the OEMs are the less controversial part of this transfer pricing arrangement.

1.2. If some sort of PSM is to be used in this scenario, why would it be solely on a residual basis for the “interdependent” OEMs?

1.3. Pooling of entrepreneurial functions can easily be disposed of with former chapter VII of the guidelines (whether it is with a direct or indirect approach).²

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² We will however assume that they are not meant to be low value-adding intra-group services as would probably be suggested by some tax administrations…
1.4. Having worked with these types of settings before, we must say that this scenario misses the original intended use of the residual PSM.

1.5. Unless partial formulary apportionment was in fact envisioned for these “interdependent” OEMs, the suggested PSM is not relevant in this case.

1.6. The PSM may be relevant to the whole MNE group provided that there is some transfer pricing controversy dealing with the IP licensing or the other transactions. That is, the PSM may apply to the global value chain. \(^3\)

2. **Scenario #2 (alleged multisided business models)**

2.1. This scenario is far from hypothetical. Question #6 raises discomfort for comments in this format and place.

2.2. As for question #5, it indirectly puts forward the key issue of the geographic location of sales for transfer pricing purposes. \(^4\)

2.3. On the one hand, this is a case were Chapter VII of the guidelines may again find application (with an indirect approach) provided that the alleged involvement of the subsidiaries amounts to more than simply incidental contacts between the subsidiaries and Company R.

2.4. In other words, “regular interaction” has its ways of transmuting itself into occasional phone calls or conference calls from our past professional experience.

2.5. Cutting to the chase, we have repeatedly observed, from both sides of the fence (that is, as a public servant and private practitioner), claims of “market customization” which should have given birth to so-call “marketing intangibles” that were indeed lightly documented by facts.

2.6. Based on the fact of the case, the “interaction” between the local subsidiaries and the Company R does not warrant the use of a PSM.

2.7. On the other hand, if the case was about the development of technology (that is, of IP), the PSM might have had some applications.

\(^3\) Both a straightforward PSM and a residual PSM could find application to the global value chain.

\(^4\) The apparent intricacies of this case do not make it much more different than other numerous cases that we have had the opportunity to work on in the past in various industries. None of these cases were resolved through a PSM.
2.8. But we do not see the relevance of the PSM in this scenario where the subsidiaries are, at best, helping in maintaining/updating the technology through what are likely incidental contacts with the IP owner. More qualitative and quantitative data would be required to warrant an alternative opinion on the case.

2.9. Obviously from a tax administration perspective, the PSM may indeed become relevant to the whole MNE group, provided that there is some transfer pricing controversy dealing with the development of the technology.\(^5\)

2.10. But in that latter case, the PSM would likely act as an indirect form of imposed re-characterization of the transaction by the tax administration.

2.11. That is to say, that a given tax administration would be looking to re-characterize the risk-profiles of some or all the subsidiaries in their relationship with Company R by ultimately allocating returns unwarranted by the FRA profile (functions, risks, assets) of said subsidiaries.

3. **Scenario #3 (alleged unique and valuable contributions)**

3.1. Scenario #3 highlights one of the traditional transfer pricing cases where the tax administration of country S will vouch for the use of the PSM, at least on a residual basis, to give “access” to its taxpayers (Company S) to a bigger share of the pie (that is, to increase its own national tax base).\(^6\)

3.2. The use of the PSM in this scenario would be an indirect way of imposing re-characterization of the transaction (risk-profile modifications) by the tax administration of country S.

3.3. As a side note, it is noteworthy that even the humble paper clip salesman will cherish his customer relationships. More complex products or services will indeed require more nurturing, but a sales process is still a sales process notwithstanding its ever-increasing complexity (which shall be reflected in the

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\(^5\) Again, both a straightforward PSM and a residual PSM may hence find application. This is a BEPS public consultation draft after all, so we shall play along…

\(^6\) Having seen this typical case numerous times, only in one instance did it ended up with a PSM. The taxpayer was afflicted by “transfer pricing audit fatigue”, having been the constant interest of the tax administration for over ten years. For the record, it should be duly noted that the facts of the case did not warrant the use of the PSM.
price of the product or the service, as a matter of fact, or in the accompanying service contracts, as applicable).

3.4. In this case, the “best method” is clearly a one-sided method to be applied to the distributor.

3.5. It could be the TNMM or the Resale price method, as the case may be (with the arm’s length sales as the obvious base).

3.6. There is little doubt that appropriate external comparables may be found by applying the guidance found in Chapter III of the guideline. We have also seen many cases where internal comparables were readily available.

3.7. The notion of “unique and valuable intangibles” for the respective parties has no practical application in this particular case.

4. Scenario #4 (actual integration and sharing of risks)

4.1. This is a typical case where the PSM may indeed apply to Company A, B and C in which case the arm’s length costs disbursed by each company (contribution analysis) may provide a worthy transfer pricing method to share the arm’s length revenues initially received by Company A.

4.2. However, the alternative course of action where Company A would compensate Company B and Company C for the services rendered would not in any fashion infringe the arm’s length principle.

4.3. In the end, it is about the actual and ultimate FRA profile (functions, risks, assets) of the parties involved. Since Company A is the sole distributor in the front office, it would not intrude with a proper application of the arm’s length principle if it acted as the “principal” in this transfer pricing arrangement.

4.4. The latter sub-scenario would however necessitate external comparables whereas the PSM would not. From that point of view, the application of the PSM to this type of cases is the enactment of pure global formulary apportionment (for the parties involved, that is) in spite of the fact that the OECD claims otherwise.
4.5. From a tax administration perspective, this is a case where the application of both transfer pricing methods should indeed be expected to produce similar results, on condition that the comparability analysis has been properly performed.

5. **Fragmentation**

5.1. The analysis of transfer pricing cases where there is “fragmentation of functions” has to be distinguished from the analysis of a “global value chain”.

5.2. The above-mentioned scenario #4 represents a global value chain transfer pricing case.

5.3. “Fragmentation of functions” falls within the scope of Chapter VII of the guidelines.

5.4. “Fragmentation of functions” rarely pertains to the analysis of a global value chain: fragmentation is usually about cost centers instead of profit centers in the MNE group.

5.5. Paragraph 27 of the draft is simply without basis with respect to new Chapter VII of the guidelines. See in particular paragraph Part D of the draft which is about cost centers (that is, “low value-adding intra-group services”).

5.6. In this specific context, the PSM has no relevance to transfer pricing cases where there is “fragmentation of functions” (unlike scenario #4 with respect to global value chain).

6. **Scenario #5 (alleged lack of comparables)**

6.1. For questions #17-19, see our above comments on scenario #3.

6.2. With respect to question #20, the approach described in the last sentence of paragraph 32 is highly debatable, to say the least, as it seems to suggest a formulary approach to arbitrarily select the point in the arm’s length range.

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6.3. To select a precise point in the arm’s length range, see paragraph 3.59 of the OECD guidelines as a starting point:

“Where the application of the most appropriate method (or, in relevant circumstances, of more than one method, see paragraph 2.11), produces a range of figures, a substantial deviation among points in that range may indicate that the data used in establishing some of the points may not be as reliable as the data used to establish the other points in the range or that the deviation may result from features of the comparable data that require adjustments. In such cases, further analysis of those points may be necessary to evaluate their suitability for inclusion in any arm’s length range.”

6.4. Or should we infer from the OECD proposal in paragraph 32 of the draft that §1.482-1(e)(2)(iii)(B) of the Code of Federal Regulations of the United States is now the official position of the OECD member countries?\(^8\)

6.5. As for question #21, the PSM has no relevance if the best method rule is indeed applicable. If guidance is developed on that matter, it will clearly indicate that compliance costs for taxpayers are soon to increase, once again.

6.6. An increase of tax disputes and litigations shall also be expected both between taxpayers and tax administrations and among tax administrations.

7. **Aligning taxation with value creation**

7.1. Contrary to the BEPS flawed assertions, taxation is already properly aligned with value creation.

7.2. It is the geographical location of that value creation that causes tax distress among the OECD member countries.

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\(^8\) §1.482-1(e)(2)(iii)(B) states: “[…] The reliability of the analysis is increased when statistical methods are used to establish a range of results in which the limits of the range will be determined such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range. The interquartile range ordinarily provides an acceptable measure of this range; however a different statistical method may be applied if it provides a more reliable measure.” [we underline]
7.3. BEPS is, and always will be, about a direct attack from the industrialized countries on developing countries and countries where the tax mix is not heavily dependent on corporate taxation.

7.4. If the real intent was to achieve the alignment of taxation with its ultimate value creator, corporate income taxation would be repealed.  

7.5. Corporate entities are creatures of the legal and commercial minds. They do not support the burden of taxes. Flesh and blood shareholders do. In taxation theory, this is economics 101.

7.6. Paragraphs 33-37 are putting forward the seeds of a global formulary apportionment approach disguised in a PSM format.

7.7. See paragraph 1.32 of the guidelines on that matter. Perhaps an update of that position may now be required.

7.8. There is considerable evidence in the literature that “factor weighting” is a losing proposition in global formulary apportionment methods.

7.9. It will suffer the same faith for the application of the PSM.

7.10. As “guidance” is developed and implemented unilaterally by tax administration, an increase of tax disputes and litigations shall be expected both between taxpayers and tax administrations and among tax administrations.

8. Scenario #6

8.1. Both from a taxpayer and a tax administration perspective, the fact that risks and assets would be overlooked in any given transfer pricing case is simply absurd.

8.2. In the end, scenario #6 can be expressed as follows: headcounts in Company A and Company B drive the allocation of the “total system profit” (that is, the

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9 To be clear, we suggest that corporate entities should be transparent for taxation purposes. The tax burden would ultimately fall on the individual shareholders of any corporate group or structure, that is, the “flesh and blood” individuals, a highly desirable result to start with for tax efficiency purposes.
consolidated profit just like in formulary apportionment) between both companies (which is a sham of a thorough contribution analysis).

8.3. This is disconcerting to put it mildly.

8.4. That approach goes against the most basic economic theory available where technology, if nothing else, plays a key-role to explain value.

8.5. Question #24 and #25 both relate to the design of squeaky clean global formulary apportionment methods where headcount is the sole apportioning factor.

8.6. This has nothing to do with the application of the PSM based on the facts and circumstances of a specific case. See Chapters I and II of the OECD Guidelines.

9. **Hard-to-value intangibles**

9.1. To answer question #26: none.

9.2. These cases are most likely the hardest cases to deal with since they may never give birth to any actual revenue stream.

9.3. It all depends on the facts and circumstances of the case.

9.4. If there is a type of case where one-size-fit-all should be unacceptable, this may just be it, even though the OECD keeps drifting toward the formulary apportionment philosophy.

10. **Scenario #7 (Dealing with *ex ante* / *ex post* results)**

10.1. Scenario #7 seems fairly self-explanatory.

10.2. Unanticipated results are part of the arm’s length picture.

10.3. Again, as “guidance” is developed and implemented unilaterally by tax administrations, an increase of tax disputes and litigations shall be expected both between taxpayers and tax administrations and among tax administrations.
11. Scenario #8 (Dealing with *ex ante* / *ex post* results)

11.1. Obviously in scenario #8, the PSM is an appropriate transfer pricing method.\(^{10}\)

11.2. However, we note that by design in this scenario Company S ends up with 100% of the risks with respect to “ex post results” (whether it is an increased burden of the royalty on its financial results or in a lower royalty rate in case of higher profits).

11.3. It would seem, smoothly going along with this “scenario”, that Company P should bear 80% of the “consequence” of the ex post results for consistency of the PSM.

11.4. It is not so much about “unanticipated event” than basic and intelligible implementation of the PSM based on the facts and circumstances of the case.

11.5. After all, if the comparability analysis, mainly the FRA (functions, risks, assets) profile, indicated that Company P was entitled to 80% of the profit, this is exactly what it should have ended up with. Otherwise the FRA profile would have been tainted by the ex post results.

11.6. From a tax administration perspective, a year-end adjustment may indeed be warranted in this type of scenario. This would not contravene the proper application of the arm’s length principle. Business contracts regularly include various adjustment clauses, ex ante that is.

12. Scenario #9 (dealing with losses)

12.1. We have had the opportunity to examine such models in our practice.

12.2. In our opinion, there is no circumstance where it might it be appropriate under the arm’s length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss.

\(^{10}\) We have seen and applied the PSM for royalty purpose in the past.
12.3. Question #30 relates to the “risk-return trade-off curse”.

12.4. As stated elsewhere\textsuperscript{11}, we are of the opinion that this notion has strictly no relevance to the determination of an arm’s length price.

12.5. It is a bottom-line driven notion that has considerably contaminated the transfer pricing comparability analysis in the last 20 years.

12.6. Paragraphs 41-42 of the Public Discussion Draft BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures) provide a good framework to analyze risks in transfer pricing.

13. Conclusion

13.1. Profit split methods can and should play a role in modern transfer pricing, that is, based on the arm’s length principle.

13.2. Notwithstanding every introductory remark included in this OECD document, we must nonetheless conclude that the PSM is now getting pushed for what it was not designed to be.

13.3. One of the misconceptions is that two-sided methods shall enable the resolution of the ills and wrongs associated with one-sided methods. Tax administrations may be in for some surprises.

13.4. As the PSM is pushed and “guidance” is developed and implemented, unilaterally by tax administration, an increase of tax disputes and litigations shall be expected both between taxpayers and tax administrations and among tax administrations.

13.5. In the end, the PSM is only relevant where the comparability analysis demonstrates that the FRA (functions, risks, assets) profile of the parties is indeed highly integrated. See paragraph 2.109 of the guidelines.

\textsuperscript{11} Robert Robillard, Comments on the Public Discussion Draft BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures), February 3, 2015.
13.6. It is disconcerting to see that the PSM may now be loosely considered for basically any transfer pricing type of case.

13.7. This philosophical approach with respect to the use, misuse and likely abuse of the PSM is indeed what global formulary apportionment is about.

13.8. Global formulary apportionment eliminates the relevance of a thorough comparability analysis from which follows the proper application of a transfer pricing method.

13.9. Instead, global formulary apportionment requires the inclusion of headcounts (as explicitly seen above) and other variables in a formula to allocate the consolidated profit. It is a cheap imitation of the detailed and systematic contribution analysis as envisioned for the proper application of the PSM.

13.10. Surprisingly, this OECD document has significantly drifted toward that approach.

13.11. This will not make the arm’s length principle “work harder”, quite the contrary. We clearly are at the gates of global formulary apportionment.

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Re: Commentary on BEPS Action 10 – Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

Richard Newby, Shiv Mahalingham, David Ptashne, Beau Sheil, and Arthur Balizan; Duff & Phelps LLC

Dear Mr. Hickman:

We appreciate the opportunity to offer commentary on the OECD's discussion draft covering the use of profit splits. The OECD's discussion draft on this issue (the “Draft”) poses questions, mostly through examples, to invite responses for when and how the transactional profit split method (“Profit Split”) can be best applied.

This response does not individually address the questions asked in the Draft, but instead comments generally on the direction one might infer the OECD is headed given the questions contained in the Draft. We also address several topics where our assessment is that the Draft either fails to provide adequate guidance or endorses approaches that are inconsistent with the proper application of the Profit Split. The lack of specific response to any particular matter or question in the Draft should not be taken to imply our endorsement of any position.

Potential for Overuse of the Profit Split

The Draft begins with language stating that the examples provided do not necessarily indicate a Profit Split is indeed the correct approach, and that a detailed functional analysis and method selection process should precede any application of the Profit Split. We agree with this.

The appropriate application of the Profit Split method is, of course, facts and circumstances dependent. However, we are concerned that when considered in aggregate the examples

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1 The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of Duff & Phelps as a whole or those of its clients.
and questions in the Draft seem to be indicating a shift towards adoption of the Profit Split in cases where it is not needed, or where it could prove less accurate than a one-sided method. While there are certain instances when the Profit Split is indeed the best approach, a shift towards a generalized application of the Profit Split without specific cause would be troubling.

The Profit Split often requires subjective assumptions, and as a result, proper application and implementation of the method is often a significant undertaking and should therefore be reserved for the correct circumstances. In nearly all situations it would be possible to apply some form of the Profit Split, but only with varying degrees of accuracy. When it is applied poorly, difficult-to-verify assumptions can have significant effects on the economic outcomes, resulting in increased uncertainty for taxpayers.

In our view, the Profit Split will most often apply when reliable comparables for the other available methods fail to adequately benchmark all important factors contributing to a particular pool of profit within an intercompany value chain. This may most commonly occur when more than one party to the controlled transaction provides non-routine, valuable contributions that hinder the identification of reliable comparable transactions (or comparable companies under the TNMM). We think it is useful to clearly indicate that this is the case in the Draft. Without such guidance, there is a danger that tax administrations (and, potentially, taxpayers) could use Profit Splits to arrive at transfer pricing results that are inconsistent with the arm’s length standard when it is to their benefit to do so. Including clear guidance that limits the opportunity for inappropriate application of the Profit Split will reduce the potential for abuse of this method by taxpayers and by tax administrations, and should reduce the likelihood of double taxation.

An additional concern is that, in practice, the Profit Split frequently is difficult and costly to apply with the required degree of accuracy. Smaller cross-border transactions and smaller taxpayers would bear a disproportionate compliance burden if Profit Splits were to be required in circumstances where another method would be more appropriate in the taxpayer’s situation. As a practical matter, for smaller cross-border transactions and smaller taxpayers, if a shift towards more Profit Split analyses occurs, there might be a pragmatic tendency to use poorly crafted models in an effort to comply, despite the lower quality analysis that would result.

Factors Not Considered in the Examples

Certain areas of the Draft suggest that factors that should play a significant role in intercompany pricing (and method selection) might be underemphasized or ignored. For instance, Scenario #2 of the “multisided business model” suggests that one side of the business, where free online services supply data and otherwise feed the development of a core product, is so interconnected with the core product that it could necessitate use of a Profit Split. This example is silent on risk allocations and the routine vs. non-routine nature of activities performed by the controlled parties, and implies that the risks borne by each side of the business are assumed to be jointly shared.
In addition to risk, other factors can also significantly affect Profit Splits, both in terms of whether a Profit Split is appropriate, and if so, how the calculations should be performed. All material and relevant factors should be identified and weighted appropriately. These include functions, risks, assets, and intangibles, but also lesser discussed factors such as bargaining power, timing, and any other factors of material relevance that would play a leading role in comparable circumstances. Many of the Draft’s examples ask for responses on which “aspects would need to be elaborated” to determine whether a Profit Split is appropriate. Each of the above factors needs to be identified, and then evaluated as relevant or not to the application of a Profit Split. Furthermore, additional factors not listed above may also be relevant. In our view, this level of due diligence is a fundamental prerequisite for deciding whether to select and apply the Profit Split, and the examples in the Draft do not adequately demonstrate the need to perform this analysis.

Lastly, any Profit Split method outcome needs to be reconciled with the principle of options realistically available to the parties involved. Given the subjectivity of applying the Profit Split, a seemingly robust analysis can easily lead to outcomes that one or more parties would not be willing to accept in an arm’s-length context. This is in line with the underlying principle that the Profit Split is best reserved for situations when the combined actions of two or more participants creates (or have the potential to create) more value than any one party could realize on its own. For example, if an owner of an early-stage technology is included in a Profit Split, its return for that technology (on a present value basis) should not be less than it could receive from a third-party sale or license arrangement. Indeed, the early-stage technology owner’s rationale for entering the Profit Split should be that its partnership with an affiliate creates more value than is possible via its realistically available options.

Problems with Functional Matrices

The Draft’s Scenario #6 provides an example and suggests a functional matrix might be appropriate to weight contributions of related parties with respect to value creation. The example includes other one-sided methods to remunerate certain functions, and thus is a form of residual profit split analysis. The specific functional matrix proposed is a “RACI” matrix, which is an illustrative tool that aims to identify participation and contributions among business entities based on the extent to which each affiliate is responsible, accountable, consulted and informed.

While this type of analysis can provide a snapshot of the business value chain, including a basic summary of the division of functions across affiliates, we feel it is in most cases insufficient to use such a matrix as a component of quantitative calculations. These matrices may ignore keys facts, such as the purpose of a business structure, historical contributions (e.g., risks, intangibles), and are subject to manipulation and disagreement. It is also a poor tool for evaluating ventures on a prospective basis. We feel this format is best reserved as an illustrative tool to summarize facts, and is at most a starting point for any numerical analysis.
A fundamental problem with the functional matrix approach is that the assignment of categories and weights is subjective. There exists no clear guidance for categorization or a standard method for classifying the relative magnitude between assignments, and since functions are unique to each situation, standardized guidance is not practical. For example, different thresholds for what constitutes "responsibility" may lead to confusion among taxpayers and taxation administrations. While these matrices can be useful tool for presenting facts, they are not as effective as a thorough functional analysis.

**Ex Ante Considerations**

Paragraph 45 of the Draft states that transactional profit split approaches have been suggested as a way to address significant differences between ex ante and ex post results. While it is common that unanticipated events will lead to profitability that is different than anticipated (ex ante), it might well be the case that anticipated events have a larger or smaller impact than projected. In either case, ex post results may appear unfair in hindsight. However, arm’s length results often are not fair. The primary reason is because at arm’s length, most negotiation and agreement on the mechanism for splitting profits take place ex ante, when important considerations such as actual costs, customer demand, development success, competitor moves, regulatory changes, and a myriad of other contributors to the ultimate profit to be split remain unknown.

It is for that reason that we are skeptical that application of profit split methods can reasonably be expected to consistently produce results that resemble arm’s length results when the analysis is performed after the fact (ex post). We concede it is sometimes the best method available in such circumstances, and therefore it has its place in ex post scenarios. Certainly it is a practical mechanism for ensuring participants can share in profits to some degree when it is unclear how they might have structured a deal from the outset. However, unless a transaction was initially structured by a taxpayer using a Profit Split approach for pricing, the outcome is likely to underemphasize the possibility that profits may in fact not be shared so equally in actual arm’s-length deals.

Section 2.130 of the 2010 OECD Guidelines advises that care must be taken to ensure that the application of a Profit Split is performed on the basis of information known or reasonably foreseeable by the associated enterprises at the time the transactions were entered into in order to avoid the use of hindsight. However, what we observe is that Profit Splits seem to be a method of choice for negotiated settlements of many controversies with complex fact patterns. In these cases, we often note that economic principles and pricing science are largely abandoned. Instead, simplistic, easily measureable factors that could only be known with hindsight are relied upon.

We acknowledge this approach likely helps facilitate settlement, but also demonstrates empirically to us that the principle of avoidance of hindsight is extremely challenging once uncertainties have been resolved. Applying a Profit Split to ex post outcomes of transactions between associated enterprises is like a married couple belatedly attempting to draft their prenuptial agreement at the time of their divorce, an insurance company and an insured...
trying to decide how to price coverage after an accidental fire has destroyed the insured’s home, or JV partners waiting to “see how things go” before deciding how to share the profits and losses.

Revised guidance on Profit Splits needs expanded discussion on the difficulties of the application of transactional profit split methods to ex post results and practical guidance on the avoidance of hindsight.

We are happy to discuss the issues we have raised in this paper in more detail. Please contact Richard Newby at Richard.Newby@DuffandPhelps.com or Shiv Mahalingham at Shiv.Mahalingham@DuffandPhelps.com for more information.
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February 5, 2015

Dear Andrew:

We appreciate the opportunity to comment on the OECD Discussion Draft related to the use of Profit Splits in the Context of Global Value Chains as part of its work related to Base Erosion and Profit Shifting (“BEPS”) Action 10.

In the attached we provide both an executive summary which summarizes our main observations as well as a more extensive discussion of the economic principles which underlie our comments.

We very much appreciate your consideration of these comments and are hopeful to be able to discuss them further at the public consultation being held on March 19th and 20th.

Sincerely,

Tim Reichert and Perry Urken  
Economics Partners, LLC
Executive Summary

The OECD Discussion Draft related to the use of Profit Splits (“Draft”) correctly points out that traditional one-sided transfer pricing analyses may not reflect the value created by local MNE affiliates. We agree that in many cases the application of Profit Split methods may be the most reliable means of addressing this issue.

However, we believe that Profit Split methods will result in outcomes that most reliably reflect value creation if such methods are rooted in properly measured levels of capital for each entity. There are two primary reasons for this view.

First, the value of investments and capital can be measured, as opposed to “functions” and “activities,” that can be described but not quantified. An emphasis by practitioners and tax authorities on “functions” (which can be described in numerous and varied ways), and a corresponding de-emphasis on capital, has in our view led to many of the well-known problems with one-sided methods. More generally, an emphasis on “functions” and “activities” often leads to faulty and manipulative characterizations of entities and entity-level activities by both tax authorities and taxpayers.

By contrast, physical and financial capital are measurable – usually at the entity level. Further, returns to investments in physical and financial capital are reliably “benchmarkable” using standard and well accepted cost of capital models. Therefore, physical and financial capital are also “routine.”

It is our experience that investments in intangible capital can also be reliably quantified. Assuming a general and broad enough conception of capital that recognizes that many forms of capital investment exist and give rise to profit, these estimates can be used as an input in profit split methodologies. Such investments are typically non-routine (non-benchmarkable), and therefore claim the profits remaining after physical and financial capital has been accorded an appropriate return.

The second reason is that it is an economic fact that profit realized by a business enterprise is by definition the result of, and the return to, capital. Capital investments are the claimants of profit, and therefore of taxable income. It follows that the application of the arm’s length principle should emphasize capital when examining the question of profit (and taxable income) allocation. If profit is the return to capital, and the goal of the OECD is to allocate profit in a manner consistent with the arm’s-length principle, then much of the work of practitioners and tax authorities should be centered on the proper measurement and classification of capital at the entity level. (“Functions,” by contrast, represent the combination of both labor and capital inputs, and labor inputs are compensated through market wages that are generally not directly linked to profits.)

Practically, however, we recognize that transfer pricing structures that allocate profits based on an MNE’s decisions to allocate invested capital across taxing jurisdictions with different tax rates leaves open a potential avenue for BEPS. As the OECD points out, MNEs are free to organize their financing structures in a variety of ways, making it possible to concentrate the allocation of capital to “low substance” (so-called “cash box”) entities based in low-tax jurisdictions. Left unchecked, BEPS can occur if a large amount of capital is first supplied to low-tax cash box entities, and then these entities then make a disproportionate share of the MNE’s positive net present value investments.
In contrast to other proposed means of addressing this problem (including those presented in the OECD Discussion Draft regarding BEPS Actions 8, 9, and 10), we identify a methodology which we believe fully addresses this concern in a manner consistent with the arm’s-length standard. In short, we propose that the income of cash box legal entities that receive transfers of capital (broadly defined) reflect an arm’s-length payment for this capital.

In the context of a cash box, there are two types of transfers of value for which compensation could potentially be made. First, controlled transfers of investment opportunities with a positive net present value should be treated as compensable. An investment opportunity with a positive net present value is one whose investment cost is less than the present value of the profit that is expected to result from the investment. Positive NPV only occurs when an investment is expected to have value on net. That is, the investment will earn more than its cost of capital. **Paying a transferor the “NPV” of an investment opportunity is identical to paying the “excess” returns (i.e., “economic profit”) to the transferor, and leaving the required returns on the investment in the transferee.**

This approach makes perfect economic sense from both the transferor and transferee’s perspectives. Because the future investments associated with the opportunity will in fact be made by the transferee, the transferee needs to earn an appropriate return on such investments. Merely shamming the transaction would ignore this economic fact. Correspondingly, from the transferor’s perspective, the value of the opportunity foregone is the net of the investment cost and its return. Thus, paying the NPV of said investment opportunity leaves both the transferee and the transferor whole.

This leads us to the second component of our proposed remedy. The application of the arm’s-length standard to the intercompany supply of financial capital can address the concern that BEPS may result from low substance entities earning their required return on investment. Assuming that an investment opportunity was conveyed to a low substance entity, and that the NPV of the opportunity was paid to the transferor, tax authorities might still recognize that the low substance transferee may have required financial capital from sources outside itself. If the investment in the investment opportunity was enabled by the supply of capital from another controlled entity, it seems clear that the arm’s length standard would require that a capital return be paid to that affiliated capital provider. **Because, as noted above, payment of the NPV of the investment opportunity to the transferor would, ex ante, leave only the required return to capital investments expected to be made by the cash box, these profits left over in the cash box would be (on an ex ante basis) exactly equal to the required return on capital that must be paid to the affiliated capital provider, completely eliminating BEPS in this scenario.**

Further details on these principles, as well as the economic reasoning which underlies them, is provided in Section I of this document. In Section II, we specifically address Questions 7-10, 14-16, 17-19, and 22-23 of the Draft based on the principles outlined above. Section III provides discussion and examples regarding our proposal regarding the application of the arm’s-length standard to the supply of capital.
Complete Comments on Discussion Draft

I. Overview

The OECD, in its recent discussion draft ("the Draft") entitled "BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains," ("GVCs") invites public comments in order to "[clarify] the application of transfer pricing methods, in particular the transactional profit split methods." This document contains Economics Partners’ response to this invitation.

The OECD is correct to identify global value chains as a particularly important and difficult area of Multinational Enterprise ("MNE") regulation. For purposes of this paper, we define a GVC as a situation in which a Multinational Enterprise exhibits three key characteristics: 1) its operations are multinational in scope; 2) its operations are highly coordinated and interdependent; and 3) its operations are difficult to segment into easily benchmarked functional components (i.e., "routine" or "benchmarkable" functional components).

GVCs very often provide an example of what economist and Nobel laureate Ronald Coase (1937) identified as a lack of comparability between the economic activity that occurs within firms and markets. As Coase pointed out, resources inside firms are directed through hierarchies and "command," rather than by spontaneously arising prices in markets.¹ Coase and other economists who focused on the boundaries of the firm demonstrated that firms exist in cases where the complexity and cost of economic interaction is high, making it difficult for the market price mechanism to direct labor and capital toward a specific end (e.g., production of a specific product or service). Firms exist where markets function poorly because of high "transactions costs" associated with the use of market prices between uncontrolled parties to coordinate and combine capital and labor into valuable products and services.

One implication of Coase’s work, as well as that of other economists, is that market benchmarks for controlled transactions are often difficult to obtain.² It is this difficulty that has the potential to mitigate against the use of transactional methods such the CUP method, and for that matter one-sided methods such as the TNMM, to price certain types of transactions occurring within GVCs.

We note that this problem is very different from an issue hypothesized by Avi-Yonah (1995) and others, who argued that within MNEs there exists gains from vertical integration that gives rise to the so-called "continuum price problem" ("CPP"). The CPP is a hypothesized gain (profit increment) that results from vertical integration by the MNE. In Avi-Yonah’s view, this profit increment will remain “unallocated” even after benchmarking returns to all of the firm’s functions or risks using market benchmarks. That is,

² For purposes of this paper, we define “transfer pricing” as the act of assigning a monetary value, or price, to movements of resources or economic contributions that occur within a firm. A “transfer price” is a price that is assigned to movements of resources or contributions that occur within a firm, in essence the amount charged by one segment of an organization for a product, service or intangible that it supplies to another segment of the same organization. Conventionally, and in this paper, such resource movements or contributions are referred to as “transactions,” or “exchanges.”
assuming that one can find market comparables for all of the MNC’s value-creating activities or assets, the sum of market benchmarked returns to these functions and/or at-risk assets will not equal total enterprise profit. This hypothesized unallocated portion of the MNE’s total operating profit represents, in Avi-Yonah’s view, a failure of the arm’s length principle.

Academic research related to MNEs, and other research related to antitrust regulation of vertical mergers, makes it clear that Avi-Yonah’s conjecture is incorrect. There is no continuum price problem.

The evidence against the existence of this unallocated profit increment – that is, the failure of the CPP hypothesis – is important from a policy standpoint. The reason for this is that, if the CPP exists, it implies not only that profit split methods are a necessity in virtually all instances of GVCs, but that profit split methods cannot map profit shares to metrics that we associate with value creation. That is, the unallocable portion of the MNE’s profit, which purportedly exists simply because the MNE is an MNE, would have to be allocated in some formulary way. This would, as Avi-Yonah foresaw, significantly erode the utility of the arm’s length standard. That is, if profit split methods are needed uniformly for MNEs, and formulary methods are required for the unallocated portion of the MNE’s profit, then we may as well apply formulary methods more broadly to the global profit of MNEs and abandon the arm’s length standard.

Nonetheless, it is a fact that GVCs are usually characterized by the existence of residual profit – that is, profit that exists after benchmarking the MNE’s activities and/or assets that can be benchmarked (which, for reasons discussed directly below, will generally be only a subset of the firm’s activities or assets). That is, residual profit is profit attributable to the value creating, but non-benchmarkable, activities that take place within the MNE.

Residual profit is the result of what Coase recognized – namely, the functional incomparability that often exists between the activities that markets coordinate and those coordinated by vertical integration (firms). In other words, given that economic activity governed by markets is usually different from that occurring inside firms, one should expect (and in fact we find) that much of the activity occurring inside firms cannot be benchmarked using market information (i.e., comparable benchmark companies or comparable transactions). This, in turn, gives rise to residual profit – profit within the GVC that is attributable to the non-benchmarkable activities and assets of the MNE.

It is also a fact that the existence of this residual profit gives rise to a common, and difficult to audit, technique for using transfer pricing to increase operating income in low-tax jurisdictions (or to decrease taxable income in high-tax jurisdictions). Specifically, the existence of residual profit creates a temptation for MNE managers to use entity “characterization” in an advantageous way.

If a market analogue, or price benchmark, exists for a given activity or asset inside the firm, the asset or activity is referred to as “routine.” By contrast, assets or activities without a market analogue are

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3 We use the terms “benchmarks” and “market comparables” in a relatively general way, to include both firms that are comparable to functions and assets within an MNE, and transactional price benchmarks (e.g., uncontrolled licenses of intangibles, or uncontrolled prices for tangible goods that may serve as transactional value benchmarks).
considered “non-routine.” Thus, non-routine assets and activities are those to which residual profit naturally accrues. This means that MNE managers may at times have an incentive to advantageously characterize (or mischaracterize) the assets and activities of some entities as “routine” and others as “non-routine.” For example, if the consolidated enterprise is highly profitable, then it may be advantageous from a tax point of view to characterize entities in low-tax jurisdictions as non-routine, and entities in high-tax jurisdictions as routine. This is an example of the problem of Base Erosion and Profit Shifting (“BEPS”).

We see the problem of base erosion and entity mischaracterization as closely related to a misunderstanding of the nature of capital, and its relationship to profit, in the context of an MNE. Profit, including residual profit, is always the result of, and the return to, capital (that capital may be financial, physical, or intangible capital). Profit is never, properly speaking, a return to “functions” or “activities.”

The twin facts that: 1) profit is always attributable to capital of some form; and 2) residual profit exists for most GVCs (i.e., most of the activities and/or assets that exist within the firm do not have a market analogue or benchmark, leaving residual profit in the GVC); together imply residual profit is attributable to capital of some form. That is, the activities that cannot be benchmarked require invested capital (these investments, as we discuss later, may be investment in assets such as customer relationships, organizational capital, technology, etc.), and as a result it is that capital which causes of residual profit.

Transfer pricing regulation and practice rightly emphasize the concept of “comparability” – that is, the degree of similarity between controlled and uncontrolled transactions or economic contributions. In so doing, tax administrators have strongly emphasized functions and functional comparability. Comparability has generally meant “functional” or activity-level similarity.

However, for the reasons that Coase and others have described at length, as a general matter one should not expect that the functions and activities that occur inside firms to be comparable to the activities that occur in the open market. That is, functional comparability is likely to be rare. Decades of experience in transfer pricing regulation and practice have in fact borne this out.

The concept of comparability must remain the bedrock concept that underpins transfer pricing regulation and practice. However, the administration of the arm’s length standard, the regulation of GVCs, and the application of the concept of comparability would be greatly aided by an increased emphasis on capital, as a complement to the longstanding emphasis on functions. There are three reasons for this.

First, as noted earlier, capital is the cause and claimant of profit (and therefore taxable income, toward which the arm’s length standard is directed). Profit follows capital, therefore regulation centered on the

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4 It is important to note that the more colloquial use of “routine” to mean “simple,” or of low value, is not a correct application of this term in the transfer pricing context.

5 Functions performed are the result of both capital and labor inputs. Indeed, economic theory treats the firm as a “production function,” involving labor inputs and capital inputs that are combined to produce an output of some kind. Revenue earned by the firm, less its purchases from other firms, is distributed by labor and capital markets to labor and capital inputs. Labor inputs are paid in the labor market, at an arm’s length wage rate. Similarly, capital is “paid” in the capital markets, earning profits (equity capital) or interest (debt capital). Nor is profit a “markup on costs,” or a “margin on sales.” Profit may be measured as a percentage of sales, total costs, or for that matter value added costs, but it is defined as the return to investments in the capital employed by the firm.
allocation of profit should logically be concerned with the capital (very broadly defined) held by the controlled entities in question.

It is true that functions often correlate with capital type and capital intensity – that is, certain types of functions may involve more or less capital, and capital of a certain type. Therefore an emphasis on functional similarity will likely correlate with similarity of capital requirements and capital cost (and therefore with market profit outcomes). However, from an economic point of view, it is important to recognize that functions are only a proxy for what we are ultimately interested in when designing and applying transfer pricing regulation. That is, function and activity-level similarity is at best an indirect way of examining the questions that are central to the allocation of profit in a manner consistent with value creation – namely, what kind of capital, and how much of it, exists within a given controlled entity?

Indeed, we note that even firms with extremely similar functions (functional comparables) often tend to have very different capital intensities, due simply to capital-labor substitution. These differences in capital intensity (e.g., capital per dollar of sales or costs) give rise to very different profit requirements in order to cover the capital employed, and therefore very different profit results. In a competitive market, firms that produce the same products or services with different mixes of labor and capital will sell their products for the same price (earn the same revenue per unit), but will have very different levels of profit (have different profit margins). This is true even in the case of industries such as distribution, which are characterized by relatively small book capital balances relative to the size of operations.⁶

Second, and perhaps much more importantly, an emphasis on capital makes it easier to apply the concept of comparability, and to allocate profit in a manner consistent with value creation. Capital follows certain economic laws and regularities across markets and geographies.

For example, it is true as a matter of theory, and it is an accepted empirical fact, that physical and financial capital rarely give rise to a barrier to entry or competitive advantage. Therefore portfolios of physical and financial capital tend to earn returns close to the cost of capital.

More to the point, physical capital and financial capital are broad economic categories that tend to have the roughly the same required (and realized) rates of return. As such, financial capital (or physical capital) at one firm is very likely comparable to financial capital (or physical capital) at another – even if the particular characteristics of the capital differ across firms. That is, physical and financial capital has roughly the same opportunity cost across markets, geographies, and firms. Further, cost of capital models are both well understood and well accepted, allowing for straightforward adjustments to capital returns where systematic or other risks differ materially across firms.

Similarly, it is conventionally understood that intangible capital may (and often does) give rise to barriers to entry, allowing the firm to earn rates of return on capital greater than its required rate of return (cost of capital). This means that as a broad category intangible capital is the cause and claimant of the portion of the firm's operating profit that is left over (this may be positive or negative) after physical and financial capital has been remunerated.

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Taken together, these economic facts pertaining to capital mean that the firm’s total returns can be allocated between intangible capital (very broadly defined, as we discuss below) and physical and financial capital. This same reasoning applies at the legal entity level. In our view, this framework, or underlying economic model, greatly simplifies profit splitting in the context of GVCs and ensures that such profit splitting conforms to value creation.

Third, capital as a conceptual category is much more objective than the concepts of “functions” and “activities.” Functions and activities are observable but not measurable. For this reason, a temptation, or moral hazard, will always be present to taxpayers and tax authorities when describing a taxpayer’s functions for purposes of comparison to market benchmarks. This lack of measurability leads to descriptive manipulation.

By contrast, capital is measurable. Specific values are reported for either the capital stocks of a given firm or entity, or the investments that lead to capital stocks. As such, capital is much more administrable concept than is “functional comparability.” Moreover, capital is already a key, operative, concept in tax law and property law (e.g., capital gains and losses, depreciation deductions, and many other tax laws rest on capital measurement).7

Historically, when transfer pricing practitioners have focused their attention on capital, the tendency has been to rely on an overly narrow conception of capital. That is, capital has been thought of as limited to physical capital and certain kinds of “hard” intangibles (technology and trademark). This approach ignores broad, and economically very important, categories of intangible capital such as customer based assets, organizational capital, and investment opportunities.8 Investments associated with these forms of capital are objectively measurable, and much research exists demonstrating their value. Moreover, many of these investments are made by entities that have been functionally characterized as “routine” (often incorrectly meaning “low profit”) distributors or manufacturers.

The application of transfer pricing analyses which reliably measure and incorporate the full scope of the capital investments made by MNE affiliates may result in the allocation of additional income to certain entities, relative to the results obtained under standard one-sided transfer pricing methodologies which provide only a discrete “functional return.” For example, take the case of a hypothetical entity that provides important and quantitatively significant sales and marketing services, in addition to performing straightforward distribution activities, on behalf of an affiliate. This entity employs physical capital (e.g., warehouses and equipment), financial capital (working capital), as well as intangible capital (e.g., investments made with retailers to secure shelf space, and investments made in customer relationships and goodwill) in its operations.

A standard function-driven analysis may allocate a discrete level of profit using, for example, the operating margin results reported by a set of seemingly comparable “routine” benchmark firms. While in our view these benchmark companies may offer a basis for evaluating the arm’s-length returns to

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7 We grant that reliable balance sheet and cost data at times do not exist for some controlled entities within a GVC. However, in an age of low cost information generation, it seems to us that these cases are resolvable.

8 For an interesting treatment of the concept of organizational capital, and its application to transfer pricing, see Brian Lebowitz, Dark Matter and Grey Matter in Transfer Pricing, Tax Notes International, Vol. 73, No. 12, pp. 1117-1121.
benchmarkable physical and financial capital employed by the MNE affiliate, it is quite possible that the intangible capital-related contributions of the entity are different either in kind or degree (or both) from those of the benchmark companies. In such a circumstance, it may make sense to allocate income to the entity equal to the sum of the returns to its (benchmarkable) physical and financial capital, plus a portion of residual profits (i.e., profits in excess of arm’s length returns to the physical and financial capital employed in the GVC) that are attributable to the entity’s intangible capital investments.

In short, in our view the ubiquity of residual profit (again, for Coasian reasons), and the economic fact that profit is attributable to capital, imply that transactional profit split methods should be more commonly employed, and should focus on capital and capital returns. It is with these principles in mind that we have approached the Draft.

In the following section, we address Questions 7-10, 14-16, 17-19, and 22-23, of the Draft based on the principles outlined above.
II. Draft Questions 7-10, 14-16, 17-19, and 22-23

Questions 7-10, 14-16, 17-19, and 22-23, 26, 27, and 29-30, all pertain to the theory and application of the transactional profit split method. Many of these questions involve specific fact patterns and/or highlight specific theoretical and practical issues encountered when considering the application of the transactional profit split method.

A. Questions 7-10

The Draft includes a discussion of the relevance to transactional profit split methods of “unique and valuable” contributions to a GVC. An illustrative example is provided of an MNE that manufactures high technology industrial equipment. In that example (Scenario 3), a parent, P, conducts research and economically and legally owns technology, economically and legally owns trademark intangibles, and provides broad strategic guidance to its subsidiaries around the world. Subsidiary or Company S is responsible for sales and marketing in Country S. In the course of its business, Company S develops and maintains close customer relationships, carries an array of spare parts, conducts a proactive maintenance program, provides extensive advice to customers on equipment choice, and ensures that customers benefit from customization of equipment where appropriate. The Draft states that Company S is not merely a “routine” distributor, because its activities constitute a “key source of competitive advantage” for the MNE.

This Scenario highlights the possibility that traditional benchmarking of Company S, relying upon functional similarity to uncontrolled distributors would ignore important customer-based intangibles generated by Company S. That is, by stating that Company S is not “routine,” Scenario 3 implies that treatment of Company S as a benchmarkable (i.e., “routine”) distributor would improperly remunerate Company S.

Importantly, we read the Draft’s inclusion of the sentence indicating that sales and marketing activities constitute a “key source of competitive advantage” as implying that a competitive advantage stemming from “unique and valuable” activities is an important fact that lends itself to the use of a transactional profit split method. While this is true, it is crucial to recognize that in order to conclude that the transactional profit split method is the most reliable transfer pricing method under the facts of Scenario 3, it is not necessary that the distribution activity is a “key source of competitive advantage.” Nor is it necessary that the sales and marketing activity is a “unique and valuable” contribution.”

Strictly speaking, all that is necessary is that the sales and distribution activities of Company S are not benchmarkable using uncontrolled distributors’ financial results. That is, the sales and distribution activities of Company S are non-routine.\(^9\) While it is more likely that the sales and marketing activities of Company S are not benchmarkable if these activities are “unique and valuable,” and/or give rise to “key competitive advantage,” neither of these characteristics are necessary. Because of the “Coasian incomparability” problem, many activities inside the firm are incomparable to those occurring in the

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\(^9\) We emphasize again that the terms “routine” and “non-routine” have been the source of much confusion in transfer pricing. They mean only “benchmarkable” and “not benchmarkable,” respectively.
open market. Therefore, many activities within the GVC, including those that do not give rise to a competitive advantage or economic profit, are likely to be non-routine (not benchmarkable).

In short, residual profit can exist irrespective of whether “competitive advantages,” or “unique and valuable” activity exists with the GVC. In our experience, significant confusion exists around this issue, and most practitioners believe that profit split methods are limited in their application to cases in which “unique and valuable” contributions exist in more than one entity. In fact, again, it is only necessary that non-benchmarkable contributions exist in more than one entity. These need not be unique, nor must they be highly valuable.

The existence of residual profit begs the questions of how one quantifies and allocates that residual profit. Taking up the question of quantification first, an emphasis on capital, as opposed to “functions,” allows us to make finer distinctions, and more reliably quantify residual profit, than we otherwise would when examining fact patterns such as Scenario 3.

In particular, the fact that it is the sales and marketing investments of Company S that are non-routine leads naturally to the question of whether certain other assets or activities of Company S might be routine. In general, economic theory views physical and financial capital as “competitive,” meaning that these forms of capital do not give rise to a competitive advantage or barrier to entry. This, in turn, means that the physical and financial capital of Company S can be benchmarked by reference to Group X's cost of capital, or the cost of capital of sales and distribution companies. In other words, on the basis of economic theory and empirical research, we would view Company S as having some activities and/or assets that are routine (i.e., benchmarkable physical and financial capital) and others that are not (non-benchmarkable sales and marketing investments).

The advantage of this approach is not only that it conforms better to economic theory (again, profit is the return to capital), but also that it conforms better to the economic reality. In Scenario 3, Company S has two kinds of capital, but only one “function” broadly construed (i.e., sales and distribution). Emphasizing functions, to the neglect of an examination of the capital base of Company S, misses the fact that parts of Company S are easily benchmarked, thus decreasing the reliability of the analysis by leading to “all or nothing” conclusions (either Company S is a “routine distributor” or it is “non-routine and highly valuable”). The truth likely resides in the middle – Company S is has routine components (its physical and financial assets can be benchmarked by reference to the cost of capital) and non-routine components (its sales and marketing efforts cannot be benchmarked).

We recognize it is common for practitioners and regulators to benchmark distribution returns using PLIs that do not properly account for the market relationship between the capital intensity of distributors and their margins or value-added cost markups. The traditional belief held by most transfer pricing practitioners (and regulators) is that capital is not relevant for distributors because distribution is not a capital-intensive activity. However, the evidence tells us otherwise. Our research, which is both the subject of an internal White Paper (cited earlier) and analyses presented to and discussed with high-level representatives of the IRS’ Transfer Pricing Operations group, demonstrates a clear positive relationship between distributors’ capital intensity and their profitability, as measured by the operating margin.
Turning now to the allocation of residual profit, it is important to recognize that, by their very nature, sales and marketing costs generally do not return revenue only in the period in which these costs are sunk. Rather, they return revenue (and operating profit) over time as customers repeat their business with the firm. As such, from an economic point of view, sales and marketing costs constitute an investment, and give rise to intangible capital.

In the context of Scenario 3, this means that the sales and marketing costs of Company S should be capitalized into a stock of “in service” marketing and sales investments. This sort of approach relies on the calculation of an economic useful life, and allows for a proper matching of returns to investments over time. The resulting stock of marketing and sales-related intangible capital then claims residual profit in proportion to other stocks of intangible capital in the GVC (i.e., those of Company P).

In light of the foregoing discussion, below we provide our responses to Questions 7 through 10, posed in the Draft. These questions pertain to Scenario 3.

| Q7) Does the way in which “unique and valuable” is defined for intangibles assist in defining the term “unique and valuable contributions” in relation to the transactional profit split method? | A: In our view, the modifier “unique and valuable” tends to promote a view that only a narrow set of activities, or cost categories, gives rise to valuable intangible assets. This, in turn, leads to a narrowing of the set of activities that are treated as contributions for purposes of a transactional profit split. In our view, investments or activities need not be “unique and valuable” in order to be considered either as intangibles or as contributions in a transactional profit split. They need only be “non-routine,” or equivalently “not benchmarkable using comparables.” This position is consistent with both economic theory and with regulatory guidance in the United States and elsewhere. |
| Q8) What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method? | A: The scenario does make clear that the controlled sales and distribution entity is not “routine.” However, in light of the fact that Scenario 3 is contained in a section entitled “Unique and Valuable Contributions,” it may make sense to clarify that by “not routine” the OECD means “not benchmarkable using uncontrolled distributors,” rather than “not unique and valuable.” In addition, it would be important to understand whether the contributions of Company P are benchmarkable using transactional information such as license agreements for similar technology and/or trademark intangibles. |

10 We note that it may in some cases make sense to simply compute a total net return to this stock by multiplying it by the required rate of return. For example, this may be true in competitive or monopolistically competitive industries, or in situations in which it is known through functional analysis that such investments, while important and non-benchmarkable, do not give rise to a barrier to entry.
Q 9) Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm’s length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied? A: In our view, a transactional profit split method is a logical method in any situation in which the activities and assets of the parties to a transaction cannot be benchmarked using market information. In the case of Scenario 3, in order to ensure that one does not double count returns to non-routine contributions (i.e., non-routine capital), it would be important to provide an appropriate return to the physical and financial capital of P and S, and then to split the remaining profit (residual profit) according to the relative contributions of P and S (one very logical allocation key is capitalized stocks of intangible capital, broadly defined). Alternatively, in cases in which the physical and financial capital intensity of distribution and sales comparables is roughly the same as that of Company S and the intangible asset investment intensity is similar among the comparables (e.g., marketing and sales investments as a percentage of sales), it is possible to use the total returns of the comparables to benchmark Company S, and capitalize only its “excess” marketing and sales investments. However, it must be stressed that this latter approach (which is commonly employed) requires that the physical/financial capital intensity of the comparables is consistent with the “tested party” and that the intangible investment intensity is similar among the comparables.

Q 10) What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3? A: The main advantages are that the transactional profit split method seeks to recognize the joint contributions of the participants in the GVC, and that it provides a framework that accounts for the “Coasian incomparability” problem (i.e., the frequent existence of non-benchmarkable components of the GVC). The main disadvantage occurs, in our view, when profit split analyses are based on subjective functional descriptions which can potentially be used to manipulate “routine” return levels, or the allocation of residual profit, or both. As should be clear, our view is that this disadvantage is significantly reduced through a proper understanding of, and emphasis on, capital.

B. Questions 14-16

The Draft also discusses what it refers to as “Fragmentation.” Fragmentation is a situation in which a very narrow function such as “marketing” or “warehousing” resides in one legal entity in one taxing jurisdiction. Fragmentation presents a problem for taxing authorities because very narrowly defined activities are usually not amenable to benchmarking using financial data from uncontrolled companies. That is, market analogues do not exist for such activities – such activities are non-routine in the strict sense of the term.

A related form of fragmentation occurs in situations wherein one controlled party owns “bare legal title” to intangible assets, possibly performing only administrative activities pertaining to them, while other
controlled parties perform the more substantive activities related to the intangibles such as R&D, or brand development, etc. Here, the problem presented is twofold: first, whether the remuneration of the bare legal title holder should extend beyond the value of its administrative activities (e.g., does the legal title holder have an arm’s length claim to a royalty), and if not then how does one remunerate the very limited administrative activities that likely lack a market analogue (market comparables).

In our view, the problem of fragmentation is not primarily the result of MNEs’ choices regarding how to structure their global value chains. Rather, the problem of fragmentation is the result of an over-emphasis on functional comparability, and a corresponding de-emphasis on capital and financial comparability.

To illustrate, in functionally fragmented situations in which one cannot find, for example, a set of uncontrolled warehousing firms that can be used to benchmark the returns to a legal entity that engages only in warehousing, one can still recognize that warehousing requires physical and financial capital that is routine in the sense that such capital does not constitute a barrier to entry or competitive advantage. As such, in the open market, this capital – and therefore the warehousing function – would garner a return roughly equivalent to the cost of capital for firms that are roughly similar.

A means of addressing the problem of fragmentation of ownership over intangibles, which is mentioned in the Draft at paragraph 28 and discussed at length in the OECD’s interim Guidance on Transfer Pricing Aspects of Intangibles, is also available through a proper understanding of, and emphasis on, capital. Fragmentation of ownership over intangibles occurs most notably in situations in which one party makes investments in intangibles, but lacks the managerial wherewithal to control those investments. Said differently, one entity is a low substance “passive investor” of sorts in intangible assets (for example, it makes financial investments in R&D through a contract R&D arrangement), while another entity contains the active management of the assets.11

Transfer pricing practitioners have generally failed to recognize that this fact pattern may represent a circumstance in which valuable capital, in the form of an investment opportunity, is not properly accounted for in the transfer pricing surrounding the “fragmented” arrangement. As economists and Nobel laureates Merton Miller and Franco Modigliani pointed out, at any given time the “net present value (i.e., the net of investment cost and the present value of the stream of returns on investment) of a firm’s future investment opportunities” constitutes a large portion of the total value of the enterprise.12

An investment opportunity with a positive net present value is one whose investment cost is less than the present value of the profit that is expected to result from the investment. Positive NPV (in contrast to positive present value, or “PV”) only occurs when an investment is expected to have value on net. That is, the investment will earn more than its cost of capital (equivalently, at the time the investment is made, the present value of the profits expected to be earned from the investment exceed the cost of the investment).

11 A separate, but related, issue is whether any payments made by the passive entity to acquire intangible assets were consistent with the arm’s-length principle. In order to focus on the issue of fragmentation, the discussion in this section assumes that such payments are arm’s-length.

From an economic point of view, controlled transfers of positive net present value investment opportunities are transfers of value. Paying a transferor the “NPV” of an investment opportunity is identical to paying the “excess” returns (i.e., “economic profit”) to the transferor, and leaving the required returns on the investment in the transferee. This approach makes perfect economic sense from both the transferor and transferee’s perspectives.

Because the future investments associated with the opportunity will in fact be made by the transferee, the transferee needs to earn an appropriate return on such investments. Merely shamming the transaction would ignore this economic fact. Correspondingly, from the transferor’s perspective, the value of the opportunity foregone is the net of the investment cost and its return. Thus, paying the NPV of said investment opportunity leaves both the transferee and the transferor whole.

Indeed, to simply disallow required returns on the passive entity’s investments would, by definition, enrich other entities who would earn the required returns on the passive entity’s financial capital investments. Moreover, there is, in the open market, such a thing as a passive investor. It follows that a controlled entity with economic substance comparable to a passive investor should not be treated as a sham, but rather as what it is – a passive investor capable and deserving of earning (in general) its required return.

We are conscious of the concerns related to BEPS that arise with respect to the realization of significant income by extremely low substance MNE affiliates (cash boxes). However, we believe that solutions such as those proposed in the OECD’s Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization and Special Measures) which artificially restrict returns to levels which are likely below the cost of capital are not consistent with the arm’s-length principle. Instead, as discussed in more detail in the final section of this document, it may be that the application of the arm’s-length standard to the intercompany supply of capital can effectively address this concern in a more principled and objective manner.

In light of the foregoing, we now turn to questions 14 through 16 in the Draft.

For example, a number of publicly traded firms in the apparel sector acquire valuable brands, invest in the development of these brands, and license these brands to third parties, all using a very small internal staff with a minimal degree of “functions” as defined in the Draft. The royalty rates received by these companies reflect the fact that the licensees must make significant investments to commercialize the branded product, but still leave the licensor with substantial returns.
Q 14) Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how? A: In our view, yes. As discussed above, the problem of fragmentation of ownership over intangible assets generally reduces to the question of whether the net present value of (the economic rents associated with) future investment opportunities was properly accounted for (i.e., compensated) in any business restructuring that gave the passive entity the opportunity to make investments in intangibles. The corollary of this is that profit split methods should recognize that the “routine” return to be earned by the passive investor is the required rate of return on its investments in intangible development costs.

Q 15) Can transactional profit split methods be used to provide reliable arm’s length transfer pricing solutions for fragmented functions? If so, how? Can other methods address the issue of fragmentation, and, if so, how? A: The problem of fragmented functions results from a dependence on functional comparability. That is, functional fragmentation occurs when potentially comparable firms that would otherwise be used to estimate “functional returns” perform a wider array of functions than the “tested party” (the controlled entity being benchmarked). In our view, this problem can be substantially mitigated by treating capital investments as the “routine” contribution of the tested party, particularly when these investments take the form of physical and financial capital investments (including the financial investments of a passive intangible asset investor). Other methods such as transactional methods can be used as well, but with difficulty. For example, if a controlled entity performs limited warehousing or logistics functions, it may be possible to benchmark these by reference to uncontrolled agreements for similar services.

Q 16) What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate? A: As explained in our response to the preceding question, we believe that the problem of fragmentation is more usefully framed by analyzing capital and capital investments, rather than functional comparability. Doing so may facilitate addressing this problem by applying a benchmarkable rate of return to investments made by passive investors.

C. Questions 17-19

A similar set of issues is examined in the Draft section entitled “Lack of Comparables.” Therein, the Draft states that “where a lack of comparables is such that it poses a serious impediment to the reliable application of one-sided methods, transactional profit split methods may be useful in circumstances where they can be reliably be applied to determine an arm’s length outcome in accordance with the functions of the parties.”

We agree. Indeed, we wish to stress again that the problem of functional comparability is quite possibly the norm, rather than exceptional, for the reasons put forward by Coase. For this reason, transactional
profit split methods that allocate residual profit after routine returns are accorded to routine contributions may very well be the norm rather than the exception.

The Draft offers a scenario (Scenario 5) in which an MNE group operates as a supplier of office stationary in a region. In this scenario, each local entity has a purely local business, along with a “shared” regional business (a shared set of regional customers that order from the MNE group at local nodes). Questions 17-19, which correspond to Scenario 5, are given below, along with our replies.

Q 17) How can comparables be found and applied in Scenario 5? What method is likely to be appropriate for determining an arm’s length remuneration for the activities of the group companies? A: If functional comparability is the operative concept when comparing potential benchmark companies to the controlled entities, then finding comparables may be difficult. On the other hand, if capital, and financial comparability, are emphasized then it should be relatively straightforward to benchmark the routine physical and financial capital associated with local fulfillment functions. As for methodology, as discussed below in our response to Question 19, the proper methodology to apply to Scenario 5 depends upon whether regional customer-based assets are locally owned, or owned by the group.

Q 18) How can comparables be found and applied in Scenario 3 (or to any other relevant scenario in this discussion draft)? A: Answered earlier.

Q 19) What aspects of Scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate? A: Because of the mixing of purely local and shared regional businesses, it would be necessary to ensure that the purely local business has reliable “standalone” financial statements. The shared regional business can then be analyzed separately. The key question for the shared regional business is whether each local business economically owns the customer relationships in its jurisdiction. If so, then presumably each local entity will pay a service fee to other affiliates for their assistance in fulfilling customer orders. That is, each local “node” pays other affiliates for fulfillment activities and earns the residual profit associated with regional orders emanating from its own jurisdiction. In this case, physical and financial capital investments by “fulfilling” entities can be used to determine routine returns, and cost plus this routine return can be used to determine the service fee. On the other hand, if the regional customers are considered “jointly owned,” then the residual profit would presumably be shared according to the relative magnitudes of the capitalized stocks of marketing, sales, and other customer intangible creating activities.

D. Questions 22-23

The Draft contains a very important section entitled “Aligning Taxation with Value Creation.” Therein, the Draft reiterates the importance of aligning taxation with substance (one of the three pillars of the BEPS Action Plan).
The Draft does not define economic substance, but it does seem to imply at paragraph 37 that substance is closely correlated with the number and type of employees, production capacity, and value of production. We agree that these are important and useful indicators of economic substance.

The Draft states at paragraph 33 that “[t]he BEPS Action Plan has as one of its three pillars ensuring that taxation is aligned with substance, and Action 10 covering profit splits falls under the heading of assuring that transfer pricing outcomes are in line with value creation. The Plan notes that ‘the rules should be improved to put more emphasis on value creation in highly integrated groups.’” The Draft goes on to say that “profit split methods may be viewed as one means of achieving this closer alignment between profits and value creation.”

However, the Draft then states that profit split methods rely allocation keys, and that while there should be a strong correlation between residual profit allocation keys and value, a common criticism of profit split methods is their “perceived subjectivity: allocation keys can be difficult to verify from objective evidence.”

In order to remedy this perceived problem, the Draft puts forward an allocation key based on a weighting of headcount (employees), production capacity, and the value of production. That is, the draft puts forward an allocation key based upon substance. Consistent with the discussion above, this type of allocation methodology has two highly significant shortcomings. First, the weighting formula employed in such an analysis is inherently arbitrary and subjective. Second, these types of allocation factors cannot be objectively linked to profit generation based on market evidence.

It is crucial to understand that substance and value creation (as the Draft seems to define it), while often correlated, are in principle (and practice) two very different things. Value “creation” occurs when the firm combines capital and labor to produce something of value that is paid for by customers. That is, in economics, the term “value creation” usually refers to revenue creation – i.e., the making and selling of products and/or services by the firm. However, this revenue is first allocated to labor and other purchased inputs, leaving the remaining profit (revenue less costs) to the firm’s capital stock (properly and broadly construed). In other words, value creation (revenue creation) and profit creation are two different, though related, things.

As an illustration of this difference, consider an uncontrolled firm that generates $100 of revenue. This $100 of revenue is created through a combination of $99 of labor, and a capital investment of $10. This firm is obviously very labor-intensive, but not at all capital intensive. The $100 of revenue less $99 of costs leaves $1 of profit (a one percent operating margin), which yields a 10 percent rate of return on capital. This firm is obviously a “thin margin” firm, but it still earns an acceptable rate of return because it employs little in the way of capital.

Firms generally need less in the way of margin (profit per dollar of sales) to cover their capital inputs (their required capital return), the less capital they employ per dollar of revenue. In other words, in the

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14 We recognize that in finance the term “shareholder value creation” means earning profits greater than a firm’s cost of capital.
open market, low capital firms are generally low margin firms – precisely because profit is the return to capital.

Now imagine an identical controlled entity. An allocation of profit to it based upon substance-related allocation factors such as headcount would almost certainly over-allocate profit to it (it would earn an implied rate of return on its capital that is likely much greater than its uncontrolled counterpart). Of course, this implies that such an allocation would thereby under-allocate profit to other controlled entities in the GVC.

Ultimately, the only economically correct allocation key is capital, both because it can be measured without subjectivity or arbitrariness and because profit is the return to capital. Labor (i.e., headcount) may correlate with capital. Similar, revenue may also correlate with capital. As a result, substance-related profit allocation keys such as labor and revenue may in some cases be proxies for the “profit drivers” of a business (its capital stock). Nonetheless, our view is that such proxies should only be used if the item for which they proxy (capital) is for some reason unavailable, or cannot be reliably measured.

In light of the foregoing, we turn now to questions 14 through 16 in the Draft.

| Q 22) In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector? A: The guidance should reflect an emphasis on the economic fact that capital causes and claims profit. The particular form(s) that that capital takes depends upon the industry context. In general, our view is that a broader and more varied conception of capital is needed (i.e., it must be recognized that investments in customer-based assets, organizational capital, and technological capital all give rise to intangible capital). |
| Q 23) What guidance is needed on the weighting of factors? A: We believe that “factor weighting” such as that described in the Draft is generally an unnecessary, and in some cases dangerous, consideration. Capital represents the only allocation key which is empirically and objectively related to profits earned by business enterprises. The consideration of weighting factors implies the use of substance-related measures other than (or in addition to) capital. We believe that such measures are unnecessary, improperly conflate substance and profit, and are potentially subjective and arbitrary. Nonetheless, we do recognize the fiscal hazards associated with low substance investors that make high rate of return investments (positive NPV investments). We believe that the two measures that we have discussed – i.e., recognition of the value of transferred investment opportunities at their NPV, and recognition of the supply of capital to a low substance entity as a compensable controlled transaction – would alleviate, if not eliminate, these hazards. |
III. Arm’s-Length Compensation for the Supply of Capital to Cash Box Entities

The preceding discussion has centered on the principle that profits generated by business enterprises are generated by invested capital, and that in order to remain consistent with the arm’s-length principle the allocation of profits among MNE affiliates should be consistent with the MNE’s invested capital footprint. Transfer pricing analyses which effectively account for investments made by MNE affiliates in benchmarkable and non-benchmarkable assets are expected to mitigate BEPS and ensure better alignment of profits with value creation within the group.

However, we recognize that this approach does leave open the possibility that these goals may be compromised in cases where capital (broadly defined) is transferred to very low substance entities without sufficient compensation. Such entities (i.e., “cash boxes”) may realize arm’s-length returns through the deployment of this capital while their taxable income does not sufficiently reflect the cost of the capital made available to them.\textsuperscript{15}

There are two types of capital transfers for which compensation could potentially be made in this context.

First, controlled transfers of investment opportunities with a positive \textit{ex ante} net present value should be treated as compensable. An investment opportunity with a positive net present value is one whose investment cost is less than the present value of the profit that is expected to result from the investment. Positive NPV only occurs when an investment is expected to have value on net; that is, the investment will earn more than its cost of capital.

Paying a transferor the “NPV” of an investment opportunity is identical to paying the “excess” returns (i.e., “economic profit”) to the transferor, and leaving the required returns on the investment in the transferee (on an \textit{ex ante} basis). Recognition of the value of transferred investment opportunities (equal to their \textit{net} present value) will leave transferors of valuable investment opportunities in business restructurings whole. Similarly, the transferees in these restructurings will, on the average, earn their cost of capital on investments associated with the transferred opportunity – as they must, given that they are making real capital investments in order to exploit the transferred opportunity.

Assuming that an investment opportunity was conveyed to a cash box, and that the NPV of the opportunity was paid to the transferor, tax authorities may choose to examine cases in which the transferee required financial capital from affiliates in order to make the investments. That is, tax authorities may choose to apply the arm’s length principle to the supply of capital to the cash box.

Business enterprises generally obtain financial capital in one of two ways. Operating enterprises that directly own operating assets and employ these assets in a profitable manner can generate cash internally in excess of its operating needs. This capital can be reinvested in other assets and investment opportunities.

\textsuperscript{15} This point is presented in a forthcoming article in \textit{Tax Notes International} by Brian Lebowitz, entitled “The Arm’s Length Standard as a “Special Measure” Under BEPS”.
Alternatively, enterprises without the wherewithal to generate their own investable cash may obtain financial capital from other parties, either in the form of equity or debt. At arm’s-length, business enterprises always bear an economic cost in order to obtain capital from other parties.

In contrast, many MNE affiliates obtain equity capital on what is effectively a costless basis from the perspective of the impact on reported pre-tax income. Given that the arm’s-length standard is applied to evaluate the pricing of an extremely wide variety of intercompany transactions, it seems that it is worth considering whether arm’s-length consideration should also be provided in exchange for the provision of equity capital to cash box entities. Under this approach, the application of the arm’s-length standard to the supply of equity capital would require the imputation of an arm’s-length capital charge from low substance capital recipients to capital providers which would be reflected in the taxable income reported by both parties.

The application of this approach would generate a “no free lunch” result for a pure cash box entity. Because, ex ante, payment of the NPV of the investment opportunity to the transferor would leave only a required return to capital (i.e., a required return on investment) in the cash box, what is left over in the low-substance cash box after this payment is exactly equal to the required return on capital that would (at arm’s length) be paid to the affiliated capital provider.

This approach is illustrated in the hypothetical examples below. Our first example centers around a hypothetical cash box entity with no substance. This cash box is supplied with both (a) an investment opportunity with an expected internal rate of return (15%) in excess of the company’s cost of capital (10%); and (b) $100 of financial capital in the form of equity which can be used to execute this investment opportunity.

As presented in the following table, by investing this $100, the cash box expects to realize returns of $15 per year in perpetuity (note that we show only the first three years in the tables that follow). This fact pattern corresponds to an internal rate of return on the cash box’s investment of 15%, and a net present value of the investment opportunity of $50 ($50 equals $150, which is the present value of the expected returns, discounted at the cost of capital, less $100 of investment cost).

In the tables that follow, we assume two different capital charges. First, we impose a charge consistent with the expected economic profits of the investment opportunity. As shown in Row g, economic profits are computed as the excess of expected returns on the investment over the cost of capital. Second, we impose a charge to reflect the arm’s-length cost of the capital supplied. As presented in Row i, this capital charge is computed by applying the cost of capital rate to the amount of the capital supplied to the

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16 Capital contributions generally do not result in the recordation of an expense for the recipient. In cases where shares are issued to an ultimate parent company in exchange for capital it is questionable whether these shares provide true incremental value to the capital provider.

17 MNE affiliates do commonly obtain debt capital from related parties. However, because highly risky investments in assets such as intangible property are rarely provided in the form of debt in the market, our conversation in this section is restricted to the transfer of equity capital among MNE affiliates.

18 For presentational purposes, in this example the charge for investment opportunity is presented as an annual payment equal to expected annual economic profits. The charge could also be paid as an equivalent lump sum computed as the present value of gross expected income discounted at the cost of capital ($50). We note that, as we have discussed, this is exactly equal to the net present value of the investment opportunity.
cash box (*i.e.*, the amount of the investment made, or $100). After making these payments for the capital supplied, the payments made by the cash box completely exhaust the income realized from its investments. This outcome is reflective of the lack of value created by this cash box.

Application of Arm’s-Length Standard to Supply of Capital

Hypothetical Cash-Box Entity With No Substance

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<th>Assumptions</th>
<th>Yr 1</th>
<th>Yr 2</th>
<th>Yr 3</th>
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<tr>
<td>b Investment</td>
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<td>d WACC</td>
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<td>f=b*d Market Cost of Capital</td>
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<tr>
<td>g=e-f Economic Profits (Net Returns on Investment)*</td>
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<td>h=e Operating Profits</td>
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*Alternatively can be calculated as PV of Row e using WACC as discount rate less investment

A second example is provided below for a hypothetical entity which does have significant substance. This entity independently generates its own cash flow through prior investments in income generating assets and is not dependent on other affiliates for the new investment opportunity which will require $100 in capital. However, it does receive $25 in debt capital from an affiliate in order to make this investment.

Similarly to the prior example, by investing the $100 in this new opportunity, the cash box expects to realize returns of $15 per year. This return is in excess of the cost of capital, but since the investment opportunity was generated internally by the subject entity, the entity retains the resulting economic profits. However, it is required to pay a fee equal to the arm’s-length cost of the $25 in capital that was supplied to it. As presented in the following table, this “full substance” entity does retain the majority of profits generated from its investment made. This outcome is consistent with the value that the entity created from the use of cash and investment opportunities generated by its directly held assets.
### Application of Arm's-Length Standard to Supply of Capital

#### Hypothetical Entity With Full Substance

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<td><strong>Assumptions</strong></td>
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</tr>
<tr>
<td>k=h-i-j Reported Profits</td>
<td>12.5</td>
<td>12.5</td>
<td>12.5</td>
</tr>
</tbody>
</table>

*Economic Profits (Net Returns on Investment) is calculated as Gross Returns on Investment minus Market Cost of Capital.*
SUBJECT: DISCUSSION DRAFT ON THE USE OF PROFIT SPLIT IN THE CONTEXT OF GLOBAL VALUE CHAINS

6 February 2015

Dear Dr. Hickman,

EY appreciates the opportunity to provide comments on BEPS Action 10: “Discussion draft on the use of profit split in the context of global value chains” (the Discussion Draft) as released by the OECD on 16 December 2014. This letter presents the collective view of EY’s global transfer pricing network.

We appreciate the approach adopted by Working Party No. 6 on the Taxation of Multinational Enterprises to obtain comments by posing questions with respect to a number of scenarios. This is likely to contribute to a discussion that takes into account not only the theory underlying the profit split method, but the practical aspects as well. We understand that these scenarios have been provided to illustrate points for discussion only and should in no way be taken to imply that transactional profit split methods will be the most appropriate method in the circumstances outlined in those scenarios. We note that our responses should be read in the context of the scenarios provided and might be different if the fact pattern would be amended or further elaborated upon.

In the sections below, we provide some general comments with respect to the Discussion Draft (and the profit split method in general) as well as our comments with respect to the various scenarios in the Discussion Draft.

If you have any comments or questions, please feel free to contact any of the following:

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Yours Sincerely,
On behalf of EY

John Hobster / Ronald van den Brekel
General comments

The Discussion Draft mentions that the integrated nature of many MNE groups and the ways in which they interact can, in some cases, make it difficult to apply a one-sided transfer pricing method in a reliable manner and it may also be difficult to find comparables (or comparables for which reasonably reliable adjustments can be made). In such cases, the profit split method may be an appropriate method. However, MNEs and tax administrations may face (practical) challenges when applying this method. In light hereof, we would like to take the opportunity to provide some general comments, in addition to the more specific comments in response to the scenarios described in the Discussion Draft. Our general comments are provided below.

Uncontrolled proliferation of profit splits in non-BEPS situations

As a general comment, we are concerned with the suggestion that the profit split method may provide a solution for practical difficulties arising from the integrated nature of many MNE groups and the ways in which they interact with each other. In our view there is a very high risk of tax authorities taking the position that a profit split method should be applied because companies are highly integrated, because the success of the business depends on having a wide portfolio, because of an overarching management team etc. This would lead to an enormous increase in the application of the profit split method in practice, where currently other methods are being applied successfully. A true risk exists in the form that this would in fact lead to formulary apportionment. The introduction of profit split methods in these circumstances would create extra challenges as well, e.g. how to deal with virtual teams, what to do if members of a virtual team move or are being replaced etc. These challenges, in our experience, may be greater than those with respect to one-sided methods. Therefore, if the OECD wants to extend the use of profit split to highly integrated value chains, it will be of the utmost importance to provide very clear guidance as to the situations for which it would be applicable. If the OECD would not do this, this would lead to an uncontrolled proliferation of the use of profit split with an enormous increase of controversy and uncertainty. This would be relevant for a number of cases that would not be considered BEPS cases.

Profit splits and corroboration

In many instances, the existing OECD Guidelines lead to organizations relying on one-sided transfer pricing methods such as the Transactional Net Margin Method (TNMM) or on the Comparable Uncontrolled Price (CUP) method. However, as noted in paragraph 2.11 of the OECD Guidelines, there may be difficult cases in which it can be helpful to apply more than one method to reach a conclusion consistent with the arm’s length principle. With this in mind, and in our practical experience, the profit split method in some cases can be useful to corroborate the outcome of other methods. Similarly, it is possible to use other methods to corroborate specific elements of a profit split depending on the facts and circumstances. We would welcome additional guidance on such use of a profit split method, in particular for the scenario of volatile results under the profit split on a year-by-year basis; e.g. what would be the effect if the corroborative analysis (using the profit split method) in a certain year leads to a loss and the primary method indicates a stable routine result. Another question is how to proceed if the outcome of the corroborative analysis differs from the outcome of the primary analysis performed. If the difference is not substantial, tax authorities have accepted an adjustment in the primary method (i.e. to change the point within the range).

Furthermore, guidance on transfer pricing documentation requirements for such a corroborative method would be required, e.g. with respect to the level of detail of detail required and timing issues. For example, we can imagine that the profit split method could be used to provide additional support in a controversy context, many years after the transactions under dispute have taken
place. In our view, the use of the profit split method as a corroborative method in such cases could be useful and should in principle be accepted.

Importance of the bargaining analysis
It is our experience that a bargaining analysis can be informative in determining whether and how to apply a profit split. The value of such an analysis is currently not explicitly recognized by the OECD in the Discussion Draft. A bargaining analysis by reference to the options realistically available to the participants in a global value chain could describe the parameters of the arrangement that each separate legal enterprise would negotiate had they been independent parties acting at arm’s length. By way of example, a bargaining analysis could indicate whether a particular legal enterprise would accept a routine return or successfully demand a share of the non-routine return (as well as the associated risk) arising from the transaction. It would be helpful if the value of a bargaining analysis was more explicitly recognized by the OECD Guidelines. We suggest that the OECD consider the existing guidance on bargaining analysis and options realistically available set out in Chapter IX of the OECD Guidelines and how it can be developed to inform the application of profit split methods.

Life cycle and changes contributions
When considering how to apply a profit split, it is necessary to consider the potential impact of (project) lifecycles and how contributions to value creation may change over time within a taxpayer’s business, e.g. from entering into a new market to becoming established. It would be helpful if the OECD could include guidance for tax administrations and MNEs on consideration of profit splits over longer periods of time (e.g. more than one year). This could also include practical guidance on assessment of profit split outcomes over multiple years.

Practical obstacles to implementation
Implementing a profit split can create significant complexity for a taxpayer. In some instances, data required to calculate the profit split may not be readily available from a company’s systems or may not be easily compared across multiple entities, countries and/or IT systems and implementing a profit split may then create considerable challenges for a taxpayer. It would be helpful if the OECD could include some practical guidance for tax administrations and MNEs to help them manage this issue in a way that does not create an undue compliance burden.

Detailed comments
In the sections below, we provide our comments with respect to the various scenarios described in the Discussion Draft. To make sure the main issues and challenges with respect to the profit split method are properly addressed, we provide our main comments with respect to each scenario. This means that not all questions raised in the Discussion Draft are answered separately.

Scenario 1
As a general remark, we reiterate our general comment on the uncontrolled proliferation of profit splits above. This is specifically relevant for Scenario 1 because certain interactions between related parties will inherently not be observed between unrelated parties. The existence of such interactions should not be seen as a first indication that one-sided methods cannot be applied in a reliable manner and that the profit split will provide a solution. The profit split method may create practical challenges as well, and the result of selecting the profit split method may be that one type of
practical challenges (i.e. the ones regarding one-sided methods) may be exchanged for another type of challenges (i.e. those regarding the profit split method). It would in our view be more appropriate to further explore whether the application of the one-sided and/or the comparability analysis performed may be refined.

Another specific concern with respect to Scenario 1 is that if a one-sided method cannot be applied in a reliable manner, it is unlikely that there will be market / comparables data that can be reliably used for application of transactional profit split methods in this scenario. In the absence of such market / comparables data, the taxpayer would have to rely on internal data for application of a transactional profit split method. In our experience, such internal / taxpayer data is only available in a limited number of cases or for elements of the value chain only. The question is whether the profit split method, taking into account these challenges, could be applied in a more reliable manner than the one-sided methods initially considered.

Whether the profit split method can be applied in a reliable manner would have to be determined by means of a detailed comparability analysis, including a detailed functional analysis. In general terms, additional information would be needed, but it is difficult to describe in a few sentences which additional information would be needed to determine whether and when the profit split method can be considered the most appropriate method. This comment also applies to the other scenarios described in the Discussion Draft.¹

Specifically with respect to Scenario 1, we believe strong support would have to be provided to support the view that an overarching leadership board would lead to a profit split as this is a commonly seen management structure in the marketplace. If this is envisaged to ever be the case, we recommend that the OECD add specific guidance in this regard.

While specific features of value chains within MNEs, such as highly integrated functions, can be complex and may give rise to practical challenges, we do not believe that the transactional profit split method is inherently more useful. We refer to our previous comments with respect to the fact that the profit split method too may give rise to these challenges and that these challenges should be taken into account to determine whether the profit split would lead to a more reliable result.

Scenario 2
With respect to the questions whether the transactional profit split method can be used to provide an appropriate transfer pricing solution in the case of Scenario 2, we refer to our comments with respect to Scenario 1 regarding the need for a detailed comparability analysis and the need to recognize the specific challenges that may arise when the profit split method is selected.

To determine whether a transactional profit split method or another method would be appropriate in this case, additional information is specifically required with respect to the value chain, each company’s respective contributions and their relative bargaining power.

Scenario 3
With respect to Scenario 3, the question is raised whether the way in which “unique and valuable” is defined for intangibles assists in defining the term “unique and valuable contributions” in relation to the transactional profit split method. In our view, the notion of unique and valuable intangible assets

¹ For readability, this comment will not be repeated as part of our comments for the other scenarios.
is helpful, although it is important to recognize that paragraph 6.17 of the OECD Guidelines semantically restricts the definition to “unique and valuable intangibles” whereas paragraph 2.109 semantically expands the definition to “unique and valuable contributions” [emphasis added]. The most reliable application of transactional profit split methods would consider all unique and valuable contributions, including unique and valuable assets (tangible and intangible) as well as unique and valuable functions being performed and important risks being assumed. Although the definitions of “intangibles” and “contributions” are open for interpretation and could potentially be synonymous, using the term “contributions” is more appropriate with respect to transactional profit split methods. At the same time, there is an inherent risk that the tax administration of the distributor country could argue that the activities go beyond those of a routine distributor, without substantiating this, e.g. through a comparability analysis. The tax administration in that case should also be prepared to accept losses in case of non-reliable and non-performing equipment.

Another question posed with respect to Scenario 3 is what the advantages and disadvantages are of considering the application of a transactional profit split for this scenario. The advantage of applying a transactional profit split method is that, in the absence of market / comparables data to apply other methods, transactional profit split methods may provide a means to allocate profit to the entities involved for all their respective routine and non-routine contributions. Disadvantages include the difficulty that may be inherent to the application of the profit split method in the absence of appropriate data to apply the transactional profit split method, and the increased administrative complexities to implement, monitor, and test the intercompany pricing for transactions.

The advantages and disadvantages mentioned above are not limited to Scenario 3, but are likely to apply to many cases where a profit split method is applied.

**Scenario 4**

One of the questions posed is whether transactional profit split methods can be used to provide reliable arm’s length transfer pricing solutions for fragmented functions. We believe this may be the case in situations where a number of related parties jointly perform a function for which the TNMM can be applied in a reliable manner. Consider for example a situation in which one related party performs logistics / warehousing activities and another related party employs sales associates. Together these entities perform functions similar to those observed among unrelated distributors. The TNMM could be applied to determine the net margin attributable to the combined distribution activities, and a transactional profit split could be applied to allocate the profits between the two companies involved.

In a similar manner, the profit split method can be useful in low margin businesses where no comparable independent companies can be found to benchmark the results of individual companies in the value chain, to split the profit over the parties performing routine functions. This may, for example, be the case where an MNE member generates a turnover that significantly exceeds that of any potentially comparable independent company (e.g. an MNE group member engaged in the distribution of commodities) and no reliable comparability adjustments can be made in this regard.

We recommend that the OECD further clarify that fragmentation in itself should not lead to the conclusion that a profit split is the right method. As indicated above, the profit split method could be applied in case of jointly performed routine functions. Basically, fragmentation is then a specific form of lack of comparables. However, it should not lead to the conclusion that profit should be split between fragmented routine and non-routine functions.
**Scenario 5**

In Scenario 5, it may be possible to apply one-sided methods (e.g. the TNMM) for each of the three supply chain "segments" provided in paragraph 31. Each segment may merit its own, customized comparable set (e.g. customized by geography, level of market, function, etc.). Otherwise, adjustments can be for material differences between the identified comparables and the activity in each segment.

The question is posed how comparables can be found and applied in Scenario 3, or to any other relevant scenario in this discussion draft. There seems to be an underlying notion that in many scenarios it will be difficult to find ("perfect") comparables. First, in practice, in many instances taxpayers are able to provide the relevant comparables. Second, the mere absence of perfect comparables should not lead to the conclusion that a profit split should be applied. This would lead to cases that routine functions should share in losses as well. Theoretically this is not correct, and in our experience, this would lead in many cases to tax administrations not accepting the losses. Therefore, we suggest that the OECD clarify that such is not the intent of the question.

The Discussion Draft mentions that in cases where available comparables for the application of a one-sided method may not reliably reflect the level of functions or risk in the tested party, concepts of a transactional profit split approach may sometimes offer the means to vary or flex the results under a one-sided method (paragraph 32).

The approach described in paragraph 32 might be appropriate where the “tested party” devotes some non-routine contributions (i.e. functions, assets, risks) to the relevant intercompany transaction(s). This circumstance assumes that the tested party’s non-routine contributions are relatively less (in terms of expected value) than the non-routine contributions of the other party / parties to the intercompany transaction. The approach described is perhaps most relevant to non-routine or routine risks that are not observed in the comparables, as the approach effectively assigns additional variability to the tested party’s returns rather than increasing the returns relative to the comparables.

More generally, the question is posed in what circumstances a transactional profit split approach would be useful in supporting the application of other transfer pricing methods, and what guidance would be useful to develop for the supporting use of such approaches. We refer to our response above regarding fragmented functions. In situations where imperfect market / comparables data are available to apply other methods, a transactional profit split approach using internal taxpayer data may be helpful to corroborate / test the results of the other transfer pricing methods.

However, guidance would be required to make sure that taxpayers are not required to support the outcome of a one-sided method by means of a corroborative profit split analysis, in cases where the one-sided method can be expected to produce a reasonably accurate outcome. We refer to our previous comments that not every unique feature of an MNE or MNE member should be seen as an indication that a profit split method (either as primary method or corroborative method) would be required. In particular the guidance should provide a framework of the analysis to be performed, and should introduce safeguards against an excessive demand for the use of a profit split method by tax administrations. The guidance should in our view provide a framework of defining whether a one-sided method alone does not produce reliable outcomes, and to determine how the profit split method can be used to support the one-sided method.
**Scenario 6**

In respect of Scenario 6, the question is posed how other approaches can be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for example approaches based on concepts of bargaining power, options realistically available, or a RACI-type analysis of responsibilities and decision making)?

We believe that a RACI analysis can be a useful tool to develop a profit split and could be viewed as an extension of the functional analysis which underpins any transfer pricing analysis. Depending on the facts and circumstances, the use of a RACI analysis can help to identify contributions of labor that correlate with value creation more strongly than a simpler allocation key e.g. headcount. It would be helpful if the OECD recognize the value of such analysis. Furthermore, we refer to our general comment that it is our experience that a bargaining analysis can be informative in determining whether and how to apply a profit split. A bargaining analysis, by reference to the options realistically available to the participants in a global value chain, could describe the parameters of the arrangement that each separate legal enterprise would negotiate had they been independent parties acting at arm's length. We suggest that the OECD consider the existing guidance on bargaining analysis and options realistically available set out in Chapter IX of the OECD Guidelines and how it can be developed to inform the application of profit split methods.

Furthermore, it may be possible to perform a contribution analysis within the functional analysis whereby the relative contributions to value creation are addressed with reference to appropriate supporting evidence.

**Scenario 8**

The question is posed whether the application of a transactional profit split method to calculate the royalty in Scenario 8, or in other circumstances to set a price, can be helpful. In our experience using a royalty (or some other mechanism) to implement the results of a transactional profit split method is significantly helpful. The advantages of using an implementation mechanism such as a royalty include, for example, the significant administrative simplifications for implementing the results of the transactional profit split method and the fact that using royalties aligns with how unrelated parties commonly implement pricing for intangible property transactions, even though these transactions may well have been negotiated based on profit allocation principles.

The primary disadvantage of using such an implementation mechanism is that the implementation price may not achieve the intended result based on the original allocation of functions, assets, and risks. However, this can be mitigated to the extent that the pricing mechanism and legal arrangements are structured in such a way where fluctuations between actual relative to forecasted results are shared between the entities.

To avoid misunderstandings, we recommend that the OECD clarify that a fixed royalty is one example of such a mechanism, but that this does not imply that other types of royalties (like a residual royalty) should not be considered at arm's length.

**Scenario 9**

The question is posed in what circumstances it might be appropriate to vary the application of splitting factors for a profit split method, depending on whether there is a combined profit or a combined loss?

In cases where the profit split method was selected because of the highly integrated nature of the activities performed by the companies involved, one would expect the splitting factors to be the
same, regardless of whether there is a combined profit or loss. In these cases, the companies involved are essentially jointly responsible to the combined profits and losses. We can imagine the splitting factors in such cases to be different where there is an unexpected, extended period of losses, and where independent parties could be expected to have either terminated or renegotiated the arrangements.

Another example is the situation where the allocation of losses evidently does not align with the functional analysis of the related parties involved. This may be the case where losses occur as a result of the performance of one party who, based on the functional analysis, can be considered to be responsible for the occurrence of the loss. We refer to paragraph 47. In case the loss is caused by the materialization of a risk that is inherent to the joint activities of the parties involved (e.g. a market risk), and not so much due to malfunctioning, the risk and the loss should be split between the parties. In other cases, there may be a conceptual or fundamental variance between value creation (giving rise to profits) vis-à-vis loss creation, and the incidence of losses may require additional analysis to understand the nature and cause of the loss. In the banking sector for example, it may be relevant to consider whether it concerns normal trading losses, operational losses or credit losses. This can mean that it might not be appropriate to take the same, consistent approach to the splitting of losses as one would apply to profits.

Furthermore, there may be regulatory reasons that make it difficult (or impossible) to split losses in the same way as profits are split. For example, in the banking sector the conditions for a banking license may not permit a company to absorb losses. In this regard, the OECD guidance should recognize that there is a need to take into account the practicalities of managing the transfer pricing treatment for large integrated trading books and that requiring a transaction-by-transaction analysis each time a loss occurs may create a disproportional administrative burden. For instance, depending on the factual analysis undertaken, it may be acceptable if both losses and profits are split using a consistent approach over time.

Practical challenges
Finally, the question is posed whether the practical difficulties as mentioned in paragraph 2.114 of the OECD Guidelines are still valid, and whether other practical difficulties are encountered. An overview of the main practical challenges we observe in practice is presented below. Some of these have been touched upon in the sections above. Practical challenges include:

- Identification of comparability data for application of transactional profit split methods (internal data, or external data) is particularly difficult in practice.

- What data is used to calculate the value chain profit or system profit; local accounting standard, IFRS or management reporting data? Many organisations generate the value chain profit based on management reporting data but would need to configure their ERP system so that it can produce data under certain accounting standards.

- Profit split at gross or net level; in practice data will not be readily available and would need to be prepared for the profit split analysis. A profit split on a net basis requires applying various allocation keys, e.g. when the parties involved perform functions that are not related to the transactions subject to the profit split method. If there are many costs determined by applying allocation keys, the reliability of the data gets impacted.

- The residual profit split method works reasonably adequately for transactions involving the development of intellectual property and other intangibles with relatively short
development cycles. Longer cycles can present problems for adequately quantifying and rewarding risk and value added at different stages of development.

- Timing of true ups; even more clearly than in the case of applying a one-sided method, true ups raise questions. For example, if there is recalculation of the value chain profit resulting in an adjustment when does it have to be processed? Can it be reflected in the transfer pricing going forward or is there any requirement for a transfer pricing adjustment in the same fiscal year. Moreover, the question arises with respect to which transaction a true-up should be made, in case where multiple transactions are aggregated for purposes of the profit split method. Indirect tax consequences should also be borne in mind in this regard.

- There is no clear guidance regarding the use of a range when using the profit split method. While it seems reasonable to assume that some flexibility can be applied (e.g. only make a true-up in case of material deviations), additional guidance in this regard would be appreciated.
Comments on the discussion draft on the use of Profit Split in the context of global value chains (BEPS Action 10)

06/02/2015
1. Discussion of the main arguments

Being practitioners of the Profit Split applied to certain IC transactions, we are keen to provide our comments on the draft paper issued on December 16th, 2014 from the OECD on the use of Profit Split in the context of global value chains in the framework of the works on BEPS Action 10. Our comments are limited to certain points of the draft paper for which we have a direct experience.

1.1. Unique and valuable contributions

Answer to question 7

The Guidelines refer to “unique and valuable” intangibles meaning those intangibles (i) that are not comparable to intangibles used by or available to parties to potentially comparable transactions, and (ii) whose use in business operations (e.g. manufacturing, provision of services, marketing, sales or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible.

The second part of such definition is too generic and therefore can be misleading. It must be stressed that unique and valuable contributions constitute a key source of competitive advantage for the business and, as such, are unique and specific to certain business organization and cannot be commonly found in other third party transactions.

Answer to question 8

In the case illustrated under scenario 3, we would suggest to describe more in detail the unique contributions made by the distributor. As an example, unique contributions may consist of i) selection and management of the dealer network, ii) local investments in the form of marketing expenditures done to foster the brand awareness associated to the products, iii) down-stream activities such as after-sales activities supporting the reputational value of the brands.

Furthermore, we would better illustrate the role played by the distributor in the sale of the industrial equipment within the specific economic sector in order to better appreciate its unique and valuable contributions in relation to its business value chain.

For instance, the role of the distributor is key when the industry sector is characterized by the following features:

- strong and concentrated competition
- tendency of the industry to standardization and outsourcing of certain production phases in order to reduce the investments in fixed capital; OEM also arrange common production platforms organized in joint-ventures in order to reduce fixed costs
- sector driven by the buyer’s preferences, while product technical features are more and more standardized across the models
- brand/reputation is a key value for the buying decisions and as such is managed not only at the level of the IP owner but also by the marketing initiatives taken in the local markets

Answer to question 9 (first sentence)

We consider that the application of one-side methods could not provide an arm's length remuneration to the parties involved in the transactions, as neither the cost plus nor the resale minus would be adequate to capture the interdependence of the decisions taken by producers and distributors, respectively to run what is a unique business.

Despite the fragmentation of the business across different countries, decisions-making is spread and the final outcome is the result of a multi-level decision making process where the different parties dialogue and interact, each providing for its own specific contribution; the outcome of such integration are economies of scales, synergies and spillover, of which all parties participating to the integrated business take advantage.

Such participation to the decision making process should be supported by a throughout functional analysis, showing that the relevant parties have i) an adequate organizational structure (headcount, breakdown by department), ii) the proper competencies (academic and professional background, specific skills of key-people involved) and iii) the financial capabilities to manage/mitigate potential risks (in accordance with the OECD Guidelines (2010), section 9.32).
While the hierarchy among the 5 OECD TP methods (CUP, CPLM, RPM; TNMM and PS) has been cancelled, the Profit Split Method is remained in the common practice as the method of last resort, only after excluding the feasibility of the CUP and of one of the one-side methods (CPLM, RPM and TNMM).

In our opinion, the application of the Profit Split Method should receive a full legitimization, by identifying in what cases the Profit Split Method is the most adequate.

Answer to the second sentence can be found in “Answer to question 18”.

Answer to question 10

The application of the Profit Split Method better captures the complexity and the dynamism of an integrated business model. Consequently, the final result of each party to the transaction will depend on the real global performance of the business.

The disadvantage of the Profit Split is complexity, so that the imposable income could not be easily predictable as in the cases of the one-side methods.

1.2. Lack of comparables

Answer to question 17

In the light of the highly integrated business model and of the significant contributions made by the parties, comparable transactions between unrelated parties cannot be found for the application of a one-sided approach. Furthermore, the economies of scales, the synergies, etc. generated by the parties should be addressed for transfer pricing purposes as a comparability factor, thus, de facto excluding the possibility to find comparable data (for which reliable adjustments cannot be done) and therefore excluding the possibility to use the transactional net margin method.

Nevertheless, in line with OECD guidelines it is possible to make use of comparables in the context of the profit split method in order to substantiate an allocation key that reflects a division of profits that would have been achieved between independent parties under comparable circumstances. Thus, the use of comparables within the profit split method has a completely different meaning than the use of comparables within the transactional net margin method. In the case under analysis comparables are used to derive a profit split ratio which would be applicable between unrelated and independent parties (being distributor on the one side and manufacturer on the other side), leaving aside the internal market activity. For such an exercise within a profit split scenario, the degree of comparability is of less importance as this exercise only aims for deriving a comparable profit split (ratio). It is not aiming for determining a range of profit margins relevant for the less complex entity as the transactional net margin method does, but rather to estimate the respective weights in the contribution analysis.

Answer to question 18

With reference to scenario 3, the steps to apply the Profit Split would be as follows:

1. Identification of profit to be split

The Integrated Operating Result represents the operating profitability of a market, which is the Profit to be split between the Distributor and the Supplier. Figures are provided as an examples.
### Table 1: Integrated Income Statement Business

<p>| | |</p>
<table>
<thead>
<tr>
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<tr>
<td>Total Net Revenues (Distributor)</td>
<td>1,480,605</td>
</tr>
<tr>
<td>Total Cost of Sales (Manufacturer)</td>
<td>(1,270,029)</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>210,575</td>
</tr>
<tr>
<td>Overheads and Operating Items (Distributor) (A)</td>
<td>(122,723)</td>
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<tr>
<td>Overheads and Operating Items (Manufacturer) (B)</td>
<td>(49,474)</td>
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<tr>
<td><strong>Integrated Operating Result</strong></td>
<td><strong>38,378</strong></td>
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<tr>
<td>(A) Total SG&amp;A Expenses</td>
<td>(124,309)</td>
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<td>Total Local Operating Items</td>
<td>1,586</td>
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<tr>
<td></td>
<td>(122,723)</td>
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<tr>
<td>(B) Central Overheads</td>
<td>(44,611)</td>
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<td>Central Operating items</td>
<td>(4,863)</td>
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#### 2. Identification of return for routine manufacturing and distribution activities

The table below shows the range of Potential Operating Results of the Distributor, deriving from the application of the comparables’ interquartile Berry Ratio range (it may be that other PLI are used) per each year analysed, and how it has been calculated.

### Table 2— Potential Operating Results of the Distributor

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<th>Berry Ratios</th>
<th>year 2009</th>
<th>year 2008</th>
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<tr>
<td>75° Percentile</td>
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<td>Median</td>
<td>1.22</td>
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<td>25° Percentile</td>
<td>1.16</td>
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<table>
<thead>
<tr>
<th>Potential Operating Results of the Distributor</th>
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<tr>
<td>75° Percentile</td>
<td>31,399</td>
</tr>
<tr>
<td>Median</td>
<td>26,845</td>
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<tr>
<td>25° Percentile</td>
<td>20,060</td>
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</tbody>
</table>

The table below shows the range of Potential Operating Results of the Manufacturer, deriving from the application of the comparables’ interquartile ranges per each year analysed, and how it is calculated.
### Table 3 – Potential Operating Results of the Manufacturer

<table>
<thead>
<tr>
<th>Total COGS, Central Overheads and Central Operating Items</th>
<th>1,319,504</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Cost Plus Ratios</td>
<td></td>
</tr>
<tr>
<td>year 2009</td>
<td>year 2008</td>
</tr>
<tr>
<td>75° Percentile</td>
<td>8.86%</td>
</tr>
<tr>
<td>Median</td>
<td>4.40%</td>
</tr>
<tr>
<td>25° Percentile</td>
<td>1.40%</td>
</tr>
</tbody>
</table>

### Potential Operating Results of the Manufacturer

<table>
<thead>
<tr>
<th></th>
<th>year 2009</th>
<th>year 2008</th>
<th>year 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>75° Percentile</td>
<td>116,893</td>
<td>111,226</td>
<td>137,874</td>
</tr>
<tr>
<td>Median</td>
<td>57,993</td>
<td>54,914</td>
<td>66,808</td>
</tr>
<tr>
<td>25° Percentile</td>
<td>18,504</td>
<td>32,216</td>
<td>32,374</td>
</tr>
</tbody>
</table>

3. Identification of split share of each party according to the contribution analysis

The contribution percentages represent the Profit Split shares, since they indicate how independent enterprises would have divided profits in similar circumstances.

The contribution percentages of each party to the Integrated Potential Operating Results are calculated as follows (values in k Euro).

The Integrated POR is determined combining each Distributors’ POR with the relevant Manufacturer’s POR.

### Table 4 – Integrated Potential Operating Results

<table>
<thead>
<tr>
<th>Potential Operating Results of the Distributor</th>
<th>year 2009</th>
<th>year 2008</th>
<th>year 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>75° Percentile</td>
<td>31,399</td>
<td>30,535</td>
<td>36,779</td>
</tr>
<tr>
<td>Median</td>
<td>26,845</td>
<td>20,801</td>
<td>14,262</td>
</tr>
<tr>
<td>25° Percentile</td>
<td>20,060</td>
<td>10,362</td>
<td>7,290</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Potential Operating Results of the Manufacturer</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>75° Percentile</td>
<td>116,893</td>
<td>111,226</td>
<td>137,874</td>
</tr>
<tr>
<td>Median</td>
<td>57,993</td>
<td>54,914</td>
<td>66,808</td>
</tr>
<tr>
<td>25° Percentile</td>
<td>18,504</td>
<td>32,216</td>
<td>32,374</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Integrated Potential Operating Results</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
</table>
The contribution of the Distributor to reach the combined potential result (Integrated POR) is measured and the weight of each Distributor POR over the Integrated POR.

Table 5 – Potential operating results and contribution percentages: Distributor

<table>
<thead>
<tr>
<th>Contribution of the Distributor</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>75° Perc. Distributor + 75° Perc. Manufacturer</td>
<td>21.2% 21.5% 21.1% 21.3%</td>
</tr>
<tr>
<td>Median Distributor + Median Manufacturer</td>
<td>31.6% 27.5% 17.6% 25.6%</td>
</tr>
<tr>
<td>25° Perc. Distributor + 25° Perc. Manufacturer</td>
<td>52.0% 24.3% 18.4% 31.6%</td>
</tr>
</tbody>
</table>

The contribution of the Manufacturer to reach the combined potential result (Integrated POR) is measured and the weight of each Manufacturer POR over the Integrated POR.

Table 6 – Potential operating results and contribution percentages: Manufacturer

<table>
<thead>
<tr>
<th>Contribution of the Manufacturer</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>75° Perc. Distributor + 75° Perc. Manufacturer</td>
<td>78.8% 78.5% 78.9% 78.7%</td>
</tr>
<tr>
<td>Median Distributor + Median Manufacturer</td>
<td>68.4% 72.5% 82.4% 74.4%</td>
</tr>
<tr>
<td>25° Perc. Distributor + 25° Perc. Manufacturer</td>
<td>48.0% 75.7% 81.6% 68.4%</td>
</tr>
</tbody>
</table>

4. Determination of transfer prices which succeed in apportioning to each party the relevant share of profit or loss

\[ \text{Determination of the} \]
\[ \text{Target Operating Result of the Distributor} = \text{Distributor Contribution} \times \text{Integrated Operating Result} \]

Table 7 – Range of Target Operating Results of the Distributor

<p>| Profit Split share range of the Distributor (Affiliate) |   |   |   |</p>
<table>
<thead>
<tr>
<th>Maximum</th>
<th>31.6%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum</td>
<td>21.3%</td>
</tr>
<tr>
<td>Integrated Operating Result</td>
<td>38,378</td>
</tr>
<tr>
<td>Range of Operating Results Target of the Local Distributor</td>
<td></td>
</tr>
<tr>
<td>Maximum</td>
<td>12,119</td>
</tr>
<tr>
<td>Minimum</td>
<td>8,158</td>
</tr>
</tbody>
</table>

Answer to question 19

More emphasis should be put on the creation of unique and valuable contributions made by the parties involved.

4.1. Dealing with ex-ante/ex post results

Answer to question 27

As for other methods, transfer prices may be established by applying the Profit Split on budget data as “temporary prices subject to balance” and then revised based on more reliable data, periodically during the year based on forecast data or at the year-end based on the actual results.

Prices may be revised by means of credit/debit notes.

It has to be noted that Profit Split need to rely upon accounts in line with international accounting standards certified by Auditors. Otherwise, relying on statutory accounts that could differ substantially, and not only for timing effects, the measure of the integrated profit/loss will be impossible. Assuming that a reconciliation between the accounts based on international accounting standards and statutory accounts is usually available in large MNE, this should not prevent from the application of the Profit Split Method.

4.2. Dealing with losses

Answer to question 29

We cannot imagine any case where third parties would accept that the allocation keys would diverge depending on the final sign of the business result.

Therefore, the splitting factors should not vary depending on whether the integrated business result is a loss or a profit.

It may be possible to imagine that third parties would put some threshold/floor to their participation to the losses/profit engaged by the business. However the same threshold/floor should be applied consistently both in presence of losses and of profits.

Answer to question 30

When combining the integrated profit and loss accounts, attention should be taken that costs not inherent to the integrated business are excluded from the allocation of profits/losses to be shared. It may be in some large MNE that
certain entities perform activities (manufacturing R&D, etc.) for other regions. The accounting system should be able to segregate such costs, in order to exclude them from the Profit Split computations.

4.3. Final remarks

Answer to question 31

From the perspective of the tax administration, the main difficulty arises from the use of taxpayer internal data and from the unpredictable imposable results of the split of the combined profit. This may prevent tax authorities to accept the adoption of the profit split method in the framework of tax audits and APA. However, guidance may be provided to taxpayers and tax administration on how to ensure that the application of the Profit Split method is supported by an adequate and promptly updated documentation, illustrating:

- How the integrated business income statement is created.
- What cost items are considered and what accounts are used to create the integrated business income statement.
- What comparables are used as weights for the allocation of the profit among the parties.
- How the process of setting prices is run and how prices are periodically monitored and adjusted in relation to the final actual data.
Discussion Draft on BEPS Action 10: Discussion draft on the use of profit splits in the context of global value chains- issued December, 16th 2014

Dear Sir or Madam,

I am pleased to respond to the OECD’s request for comments. This comment was prepared with my very best intentions to help with this process and is submitted today on my own capacity.

For a couple of years, I was Head of the Global Operational Transfer Price Management of the Merck Group, a large German-based Pharmaceuticals & Chemicals Company. My organization - being part of the Finance and Accounting organization – has been managing all operational transfer pricing aspects in terms of implementation, monitoring, data reporting and supervision of IC transactions within the group.

With this comment I would like to put the OECD’s attention to some basic ideas from economic theory which might be helpful to establish a framework and guiding principles on how to deal with globally integrated value-chains and in more detail, how to manage key allocation matters.

Please contact me in case you would like to discuss them in further detail or in any consultation.

Sincerely,

Dr Frank Schoeneborn

Business contact:
Dr.-Ing. Frank Schoeneborn

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Home: www.merckgroup.com
I. General comment

In my view, the provided discussion draft provides a comprehensive overview on the transfer pricing challenges which do result from global value chains. The given examples are relevant for many MNEs and should foster a productive discussion. Global value chains create a lot of questions among transfer pricing experts whereas other stakeholders within a MNE purely focus on the global profit. The question, in which country what part of the global profit is actually earned and why, is not of interest for them at all. Consequently, bonus plans for managers take use of global financial key figures and therefore, internal or external tax and transfer pricing experts will hardly find someone within the organization who can contribute with acceptable arguments to a meaningful allocation of global income to different countries just for taxation purposes. Looking at the heterogeneous scenarios in the discussion draft, there should be a more generic and customizable framework instead of dealing with case by case considerations and ending-up with a catalogue of scenarios. It is always on how to deal with very unique, complex and integrated value-chains which require a certain profit split as traditional transfer pricing methods do not lead to acceptable results.

My comment provides in particular an answer to questions 22, 23 and 25 of the discussion draft and delivers a proposal for a framework for a multifactor profit split. The main objective was to identify an allocation key which ensures a strong correlation to the (multi-periodically) creation of value.

II. Economic factor approach

I think that considerations and ideas from the general economic theory might help. In economics, input factors are necessary to produce an output. It is classic understanding that these factors are “land”, “labour” and “capital”. Interestingly, some opinions consider “entrepreneurial behavior” as another input factor. I will concentrate on the traditional three key factors. Depending on a very special composition of these factors, an economic output will be the result. It always takes years and a complex composition of “land”, “labour” and “capital” which might also dynamically change over time. Consequently, any economic evaluation requires a multi-periodical analysis and from any point in time, the historic accumulation of these input factors does result in today’s economic output which is expressed by the annual profit (or loss) reported.

In more common words, it starts with capital (machinery etc.) and labour provided by people (employees) plus any ongoing operational expenses (what also can be indirectly labour or capital). Depending on the industry, the factor “land” is more or less relevant, but e.g. in case “land” is rented, the paid rent is part of the operational cost. Both headcount- or non-headcount-related operational (and immediately tax deductible) expenses can also be considered over time as “economic investments”. These have been measured in monetary dimension by the accounting function since a company was initially started. Annual profit- and loss statements are the natural outcome.

In corporate practice, managers sometimes talk about “marketing and sales investments”. This message refers to the same entrepreneurial and economic mindset. Cumulated expenses in marketing and sales will create over time a brand or market reputation. The same happens with ongoing R&D work or continuous activities and initiatives which result in annual expenses (cost) to improve the product’s quality or performance. Bringing a service or a product to a “premium” stage is a multi-period process, “the financial payoff” is just the long term result but reported and taxed year-by-year. It is well known that the cumulated cost for a dedicated R&D project are the totally invested amount for creating an IP (patent). This view...
should be broaden up further to a more macroeconomic view when it comes to integrated value chains. There is no reason to fragment complex value contributions artificially into “parts” when it is against its nature and each “part” could not exist alone.

III. An universally applicable key allocation framework
In any time, these cumulated “entrepreneurial corporate investments” combined with the cumulated labour will result in an annual profit or loss out of the total value-chain. This amount will have to be split every year between the MNE’s different legal entities which are involved. The most interesting question addresses frequently the same problem, so in the discussion draft and the given examples as well: what allocation key would be reasonable and how to deal with multi-periodical issues, in particular when specific setups and a mix of cross-border transactions does change year-on-year and doesn’t allow a clear year-by-year analysis? This is in particular given in scenario 1-5 but similar with 7 and 8 of the discussion draft.

The question “what is a good allocation key to assign cost to several business lines” is very common for experienced individuals who work in Financial Planning and Analysis (FP&A) departments. They are continuously challenged by top managers who have profit responsibilities for a specific global business line. No manager would like to have allocated cost in his/her P&L, so everyone is pushing back. Similar pattern can be identified for the transfer pricing problem with the profit split method. Instead of allocation to business lines (representing an integrated value chain), now the allocation of cost and income to legal entities/countries has to be solved. For such problems, FP&A experts sometimes prepare and apply a “MACRO key” mechanism, which weights a number of KPIs to come up with a transparent, fair and stable rule to allocate e.g. overhead cost. This approach and mindset should also be the basis to determine a reasonable profit split.

IV. Example for a multi-periodic MACRO key in line with value creation
The following example should make the approach transparent and comprehensive. The profit for an existing complex value-chain has to be split between 3 companies of a MNE group (GER / USA / FRA). Every year, the annual profit requires a percentage key to allocate the profit between the three countries.

It is assumed and validated by management interviews that economic contributors for the profit of the value chain is the capital stock (cumulated CAPEX incl. acquired IP) and total operational cost with cost for “labour” separated (total salaries and wages):

35% MACRO weight: cumulated CAPEX since start of the transaction (xxx-2015)
50% MACRO weight: cumulated labour cost (20xx-2015)
15% MACRO weight: Other cumulated operational cost w/o depreciation (20xx-2015)

Based on group accounting standards, original 3rd party expenses only, no direct material cost, intercompany transactions/purchases excluded, in group currency.

Assets, for instance, are reflected in the CAPEX weighting, any production, R&D, marketing and selling cost are either part of labour cost or part of other operational cost. These amounts are collected and calculated every year in a cumulated way for the period since the transaction started first.

As a first advantage, such a structure to calculate an allocation key for the profit split will change only slightly over time and incorporates an “aging element”. Second, it does reflect contributions from history when the value chain was initially created. Third, it does not depend on any past or future profitability levels.
(any allocation key based on profitability could deliver useless results when a loss occurred) and becomes more and more robust as time goes by. Even later in time, if any new countries become part of an existing value chain or if other countries do “leave” a complex and integrated value chain, they will “get” a weighted share of the total profit which also factors in the dynamic of the business.

The MNE needs to define the weighting of the economic input factors analyzing facts and circumstances, as some businesses are more labour-(people)intense than others. The weighting factor could be different, but once set and backed-up with competent global management estimations, it should not be changed year-on-year. This approach also works in cases where expenses for “labour” will decrease because CAPEX is replacing the “labour’s contribution over time. The first calculation of the key should cover the period of time since the transaction was started. The following table demonstrates the “economic factor” key allocation approach.

<table>
<thead>
<tr>
<th></th>
<th>annual CAPEX</th>
<th>cumulated annual CAPEX</th>
<th>annual CAPEX</th>
<th>cumulated annual CAPEX</th>
<th>annual CAPEX</th>
<th>cumulated annual CAPEX</th>
<th>annual CAPEX</th>
<th>cumulated annual CAPEX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>20</td>
<td>15%</td>
<td>30</td>
<td>25%</td>
<td>40</td>
<td>15%</td>
<td>50</td>
<td>15%</td>
</tr>
<tr>
<td>USA</td>
<td>5</td>
<td>15%</td>
<td>10</td>
<td>15%</td>
<td>15</td>
<td>15%</td>
<td>20</td>
<td>15%</td>
</tr>
<tr>
<td>France</td>
<td>10</td>
<td>15%</td>
<td>15</td>
<td>15%</td>
<td>20</td>
<td>15%</td>
<td>25</td>
<td>15%</td>
</tr>
</tbody>
</table>

A test of changing the input values (marked in red) confirms that the outcome will be robust. A simulated change in factor weightings, in CAPEX as well as cost figures does change the MACRO key to split a global profit in a smooth way, it reflects the MNE’s “big picture” changes over time and looks pretty meaningful.

Certainly, it could be also a “rolling time window” in case there is a proof for the industries’ typically IP/technology lifecycle period. For CAPEX, the average depreciation period also could provide an indication.

### Conclusion

Instead of commenting all given scenarios separately, I was looking for a more general approach and framework which can universally applied for most of (or even all) scenarios in discussion. So my comment answers question 22, 23 and 25 in particular. Based on the economic input factors theory, I came up with framework and an example how to calculate a MACRO key based on multi-factors and weightings.

It could be a reasonable next step to analyze the given scenarios with the MACRO key approach, as explained here. I encourage further discussions and appreciate if my comments would be considered in the process of the BEPS project.
Introduction

The OECD released its latest draft on the public discussion of the use of profit splits in the context of global value chains on 16 December 2014 with comments invited by 6 February 2015. The comments provided below are prepared by the author as representative of Gazprom Marketing & Trading Ltd.

General Overview and High Level Thoughts

The paper has highlighted the many areas of difficulty which all taxpayers have undoubtedly experienced in general when trying to select an appropriate transfer pricing methodology. Traditional operating models where each party in the value chain operates in isolation do still exist but this is becoming increasingly less common and particularly for any MNE groups operating regionally or globally. The usual split of functions, assets and risks has become much more blurred.

In the Oil and Gas sector, and the same is likely true for other industry sectors, businesses are operating in a much more integrated manner to optimise the value along the global value chain. We agree that such integrated supply chains make one sided comparables difficult and in those cases profit splits can be the most reliable and appropriate method. Profit splits are also in line with one of the key BEPS objectives, aligning profits with substance (as a proxy for where value is created).

Profit Splitting Factors

As the paper notes, global value chains are heterogeneous across industries, companies, products and services and therefore the evaluation of value drivers and profit splitting factors also need to be assessed on a case by case basis. Whilst guidance on general factors which may be considered in determining appropriate allocations and weightings may be helpful as a starting point, we would recommend that such allocations are not overly prescriptive. Prescriptive allocations would actually result in profit splits which are not reflective of the true value contributions and economic substance and can become a “numbers game” which can also be manipulated. Instead, allocations and weightings should be based on the relevant and appropriate factors to that particular industry or business which results in an arm’s length allocation. We would not want to see any development of the profit split methodology that prescribes a specific allocation of profits that would not be consistent with the contributions that the profit share participants made to creating value.
Dealing with *ex ante / ex post* results

There is an expectation that taxing authorities will expect to see profit split calculations to be trued up to actuals and this can significantly increase the compliance burden on companies. In a (non-related party) commercial JV arrangement, parties would negotiate and agree on their respective contributions and relative share of the benefit from the outset. The relative split of profits would be set for a period of time and subject to revisions from time to time (or perhaps when there are exceptional circumstances). The same principle is true in normal trading where the supplier will make its assessment of costs and relative profits and once a price has been set apart from exceptional circumstances the arm’s length price would remain unchanged.

An ex ante approach makes sense for the scenario that is set out in the paper but as with the profit splitting factors such an approach would need to be considered on a case by case basis. The move to accept operating on an *ex ante* basis without the need for true-up calculations as a business simplification measure would be welcomed. We do recognise however the challenge for taxing authorities on preventing artificial diversion of profits through inaccurate or deliberate manipulation of assumptions to arrive at the profit split. We do not have the answer but the key is to ensure that the profit split factors are properly defined and are appropriate for the specific scenario.

Dealing with losses

Unless there are exceptional circumstances that may point to the cause of a combined loss being attributable to a specific party then the presumption must be that parties would be expected to take a share of combined losses in the same way they would share combined profits. If losses are not split then this would alternatively need to be factored into the profit splitting ratio as any party facing a disproportional share of losses would require a higher share of the profits to reflect a fair risk and return trade-off, which in itself becomes difficult to calculate. However, we do agree that there are cases that allocations in a loss situation may need to differ from in profit situations but these also need to be considered on a case by case basis.

These comments have been prepared by:

**Tim Branston - Director of Global Taxation**
Gazprom Marketing & Trading Ltd
20 Triton Street
London, NW1 3BF

E-mail: tim.branston@gazprom-mt.com
Web: www.gazprom-mt.com
Dear Andrew,

**OECD Discussion Draft BEPS Action 10: Draft on the use of profit splits in the context of global value chains**

Grant Thornton International Ltd welcomes the opportunity to comment on the OECD public discussion draft on the use of profit splits in the context of global value chains issued on 16 December 2014. We appreciate the work that the OECD has undertaken on the wider BEPS project and would like to make the following comments on the guidance released on transactional profit split methods.

Application of the transactional profit split method to test an intercompany transaction is a subjective and complex area, and we fully appreciate the acknowledgement for further guidance in this area and the interrelations with the other BEPS Action Points. If increasingly more reliance is going to be placed on the use and application of the profit split method, then further guidance on how to apply this method under different scenarios would be helpful. We would welcome further guidance through the use of more examples in the guidance that are akin to real life practical scenarios. We feel strongly that taxpayers should take a pragmatic, rather than formulaic, approach in applying the transactional profit split method. We would prefer the guidance to present considerations and examples, but not be a series of mechanical steps that need to be followed rigidly in the application presented.

We have documented our comments on the existing guidance on transactional profit splits (Part III, Chapter II) in Appendix A. Our responses to the OECD’s questions in regards to profit splits are included in Appendix B.

We appreciate the opportunity to contribute our comments and sincerely hope that our remarks will help Working Party 6 (WP6) move the guidance forward to a point of consensus. We would be pleased to expand on any of the points enclosed in this letter. Please contact Elizabeth Hughes, Director for Grant Thornton UK LLP (Elizabeth.hughes@uk.gt.com) or Glen Haslhofer, Principal for Grant Thornton LLP Canada (Glen.Haslhofer@ca.gt.com).

Yours sincerely

[Signature]

Global head - tax services
francesca.lagerberg@gti.gt.com
Appendix A
Comments on the existing Part III, Chapter II

We recognise the discussion draft on the use of profit splits in the context of global value chains is interrelated to other OECD BEPS Discussion drafts that have been released, namely, Action 1 – Address the tax challenges of the digital economy and Action 8 – assure that transfer pricing outcomes are in line with value creation: intangibles. With tax authorities increasingly looking at where, and by whom, value is created in a business' global value chain through the use of risk assessment techniques and requirement for taxpayers to complete a country by country reporting (CbCR) template, it is evident there is a common theme that the use of the profit split method will increasingly be applied to test transactions where parties involved are for example highly integrated, and or where they both own/fund intangible assets. More specifically, Action 8 – assure that transfer pricing outcomes are in line with value creation: intangibles discussion draft places a high importance on the profit split method for intangible related transactions (over the other transfer pricing methods). We would welcome and appreciate further guidance on the application of the use of profit split methods to help taxpayers in implementing and applying profit split analyses, especially if businesses are increasingly expected to move towards using the profit split method to test intercompany transactions. We discuss the specifics of where we would welcome further guidance below.

The application of the profit split method in practice can be subjective and complex. We appreciate that the selection of the 'most appropriate methodology' should be used when testing intercompany transactions but historically the profit split method has been treated as a method of 'last resort'. This appears to be associated with the ambiguity that lies around applying the profit split method and the limited examples available. We would welcome any wording to be removed in the guidance which could potentially act as a deterrent from using this methodology and our suggestion of further practical examples in the form of an Annex could help encourage the use of this method where it is considered most appropriate. In the same light the profit split method should not unduly be favoured or used as a first port of call where other methods could be appropriate.

Profits splits, particularly those applying a contribution analysis, are not always more difficult to apply reliably than one-sided methods. We have found them to be a practical solution for businesses of all sizes in certain circumstances, as they are quite scalable with respect to analysis time and cost. They can be applied to multilateral transaction chains, in the appropriate circumstances, where the alternative could be several applications of one-sided methods and extensive benchmarking.

We have noted increased consideration given to profit splits in tax authority examinations and competent authority settlements. Profit splits can also sometimes serve as a ‘reasonableness’ check against the outcomes of one sided methods or of proposed tax authority adjustments. A profit split analysis can be useful for explaining why it may be reasonable for an entity to achieve a result above or below a range of comparables, for example if profits are lower due to extensive discounting required to obtain or maintain a significant customer in a given market and it may be expected that the discount be shared by both a manufacturer and a distributor. We would caution though against making these kinds of corroborative checks the norm simply because the costs of compliance would be too burdensome.

In addition to being a ‘sense check’ of the results obtained under other methods in certain circumstances, in our experience the profit split method is an appropriate methodology to use in scenarios where both parties bring to bear valuable intangibles and we can easily identify the strengths behind using this methodology.

As mentioned above further guidance would be welcome, more specifically the following:

- More examples where multi factor/allocation keys are applied and where the two or more parties involved in the transaction have different functional and risk profiles. We appreciate the current examples stated in Annex II of Chapter II as they clearly show the application of the profit split
method, but we recognise they are simplistic and do not represent the true complexities seen with practical cases. By adding in additional examples it would also give further insight into applicable allocation keys. Based on our experience the value drivers [of a business] and competitive advantage of a Group are normally attributed to multiple factors. We would like to see more detailed examples on how to apply such a complicated method to such a complex issue and believe that the inclusion of typical case examples may prove helpful in illustrating the concepts of this method and its application. We have commented further on this point in Appendix B.

- Industry specific examples - as the profit split method is used in more integrated business models, for example the financial services industry, industry specific guidance would be welcome. We think the 'application of profit split methods to the global trading' in Part III, Section C of the Report on the Attribution of Profits to Permanent Establishments example is helpful in that it walks through different factors that could be used to measure relative contributions of the different value drivers in the industry; whilst appreciating that individual facts and circumstances need to be considered for each case. We think this would be particularly helpful for those taxpayers applying the profit split method for the first time and could increase alignment within industries. We are not suggesting industry norms should be definitive, but that they could provide useful context for taxpayers in some industries.

- Choose/implement one methodology for the application of accounting standards. In the absence (as is the case with current guidance) of standard tax accounting rules where the profit split application considers different entities in different jurisdictions it can be difficult to align different year ends, currencies and accounting treatments. Guidance on choosing/implementing one methodology for tax accounting standards on a global basis which is agreed in advance by tax administrations and applied consistently would be welcomed. Also in the event of an enquiry, tax authorities may ask for financial data to be provided in a different way to that in the document where the profit split analysis is set out, for their own ease and understanding. The determination of a standard approach to providing/applying financial information, before the profit split is carried out, could prevent further questions being raised by tax administrations and reduce any unnecessary administrative burden.

Further guidance on the above may help with solving some of the practical difficulties in applying the profit split. Whilst we have suggested further guidance would be helpful, we recommend this is balanced without making the profit split method application a mechanical step-by-step process. We respect the arm's length principle and believe this is still the underlying principle to adhere to. We also want to avoid adding to taxpayers' administrative burden further. As the profit split method is a subjective area, we strongly consider it would not be appropriate to have too mechanical an approach for its application.

We think the application of the profit split method should be consistent year on year (assuming the facts and circumstances have not changed) and it should generally not change in the event that in one year the analysis results in a split of losses rather than profits in a given year. Additionally, we suggest consistency should ideally be maintained with the source of financials used in a profit split analysis and the Country by Country Reporting (CbCR) template (ie whether this is applying the statutory accounts, using the statutory methodology for tax accounting standards on a global basis which is agreed in advance by tax

We note there are many references in the current guidance to look for comparables and comparable uncontrolled prices (CUPs) in the first instance for a transaction where the profit split method may be deemed appropriate (even though the hierarchy of methods was removed when the 2010 Guidelines were finalised). The current wording of the guidance almost suggests this is the first step before starting a profit split analysis. If this is expected to be the case, guidance on sources of information of where to find suitable comparables would be helpful. We recognise this information is sensitive as it will tend to involve complex transactions and business models. The guidance refers to joint-venture (JV) agreements being a source of comparables, and whilst there are JV agreements available in the public domain eg through royalty databases, they are heavily US-centric. By nature of the complexities and highly integrated nature of businesses that require a profit split analysis we think it is difficult to find suitable comparables without making major adjustments. We also appreciate this is sensitive information and understand the limited availability in the public domain.
In our experience undertaking a contribution analysis has proved useful for complex circumstances (we have provided examples in Appendix B). We note there are no examples of the application of the contribution analysis in the current guidance. However the current guidance does have two examples in Annex II of Chapter II of the residual profit split analysis and this suggests bias towards the application of the residual profit split analysis method. We suggest an example(s) is also provided on the application of the contribution analysis (eg from one of the examples in the questions).

We also recognise that taxpayers and administrations should not lose sight of the fundamental principles of 'substance over form' and ensure where the profit split is used, the rationale is consistent with the contractual arrangements. The allocation keys/factors used to determine relative contributions should map the function and risk profile of the entities, and those functions and risks are determined, in the first instance by the contractual arrangements.

Where other methodologies should be considered, especially in the case where there are intangible assets, we suggest a further section is included within the guidance on application of discounted cash flows and other valuation techniques.
Appendix B
Responses to OECD Questions

Questions 1–4
Regarding value chains and Scenario 1

We find Scenario 1 may place an inappropriate focus on the importance of joint-leadership boards in the context of a transfer pricing analysis. All multinationals have joint leadership boards to some degree, and in our experience it is nearly always the case that the critical decisions affecting subsidiaries and related entities in foreign jurisdictions make their way up to an over-arching body for influence or approval. The scenario, as presented, may paint the picture that joint-decision making is an exceptional circumstance to which a profit split method may apply, rather than the every-day norm for multinationals. We are concerned that the scenario may create controversy between taxpayers and tax authorities in cases where there is some joint-leadership or decision making, but where one-sided methods could nevertheless reliably be applied.

Further, the scenario may be somewhat internally inconsistent in that it does not address the European group in the context of the global business. The European joint-leadership team would likely report into or participate in global leadership for the Parent company. In which case, would it be reasonable to consider a profit split on global profits? The scenario mentions the European business is largely independent- and if that wording is intended by OECD to represent a threshold then additional description and guidance regarding what is meant by largely independent would be helpful.

Scenario 1 also does not consider whether other types of profit split (other than the residual profit split) could be reasonable, or explain why the residual profit split was chosen in the circumstances.

It appears that this group can come together and share data and information effectively, but in our experience not every group is cohesive enough to be able to share the required financial detail in order to apply the profit split. We find accessing data in financial systems is a recurring issue with profit splits, particularly when what is needed is country rather than divisional data.

Finally, there is no discussion regarding profit drivers and it would be helpful for OECD to continue with the example and provide commentary regarding how the residual (profit/loss) would be allocated.

Questions 5–6
Regarding multisided business models and Scenario 2

Our immediate reaction is that the subsidiaries in Scenario 2 seem to be performing simple activities: advertising, translation, local market adaptation, and technical support services, and one can easily imagine Company R outsourcing these activities to independent parties. If it were to do so, it would likely structure a contract ensuring it retains all intangible rights, and any residual profits. A one-sided method application may therefore be a reliable approach, providing comparable transactions or companies can be identified.

Nevertheless, if an application of one-sided methods is not reliable because the contribution of the subsidiaries is substantial and difficult to benchmark, a profit split approach may be appropriate. We do frequently apply profit split methods to multisided business models, including in the internet, recruitment agency, and advertising agency industries. One particularly similar example involved an internet advertising business with three primary profit drivers: a) the underlying technology platform, b) the user network, and c) the advertiser network.

Another important consideration is that companies operating in the internet/advertising industry tend to be small to medium-sized enterprises (SMEs), and it can be a challenge to reliably apply any transfer pricing method due to the materiality of the business or transactions. Practical application guidance would be very helpful for these taxpayers because of the significant trade-off that companies operating in this industry face regarding cost/reliability of analysis vs. materiality.
Questions 7 – 10
Regarding unique and valuable contributions and Scenario 3

Based on the facts presented in Scenario 3, our preference would likely be for a one-sided method applied with the distributor as the tested party, unless there was clearly a compelling evidence for the distributor’s extraordinary contribution in the value chain. If a functional and benchmarking analysis were to identify that Company S undertook some functions over and above those of the comparable, as seems to be the case in Scenario 3, we might quantify an adjustment or perhaps simply target the higher end of the distribution range. However, in such cases it would be rare to apply a profit split method - there is rarely much evidence to suggest distribution activities warrant high returns. We also note that there are often internal comparables available in these cases, which may be used to apply the CUP, RPM or TNMM methods.

For illustrative purposes, we can present an alternative scenario where the application of a profit split method may be (more) appropriate: Company S enjoys a dominant position in Country S, and has a network of salespeople, customers, warehouses, and freight carriers that is by multiples larger and more efficient than its competitors. Through leveraging Company S’s infrastructure, Company P is able to instantaneously saturate the market with its new products, and for this reason Country S is one of the Group’s most profitable markets. This is a scenario where a profit split method may be relevant, as Company S’s contributions are significant and it is clear that the application of a one-sided method based on external benchmarks could be difficult because of the lack of comparables for Company S. However, we find scenarios like this are rare in practice. Most often the local distributor does not have a unique or dominant market position and there would be little reason to suspect it should earn more than a normal return for its activities, even if those activities are somewhat more substantial than (some) competitors.

Questions 11 – 13
Regarding integration and sharing of risks and Scenario 4

In Scenario 4, there appears to be a significant difference between Company A’s activities and risks versus those of Companies B and C. Company A appears to be the architect of the product- it is responsible for the overall product design/strategy/Offering. Companies B and C, although responsible for certain components, are not involved in the big picture. They appear to be providing a valuable service to Company A. This is a common case in the arm’s length market, and most standard outsourced research and development contracts share responsibilities and risks in this way. Based on the facts presented, we would likely look to a one-sided method focused on Companies B and C as the most reliable method here.

For illustrative purposes, we can present an alternative scenario where the application of a profit split method may be appropriate: Company A specializes in design and sophisticated fabrication of high-precision metal and plastic medical components. Company B specializes in design and manufacturing of printed circuit board and electrical components specifically for medical devices. And Company C specializes in software infrastructure design and programming, also with a focus on medical devices. The design process for the product involves all three capabilities equally, and takes many iterations and trial-and-error of components within each company. No single company can be identified as the ‘architect’ of the product- as it is a highly cooperative venture. A profit split in this context may be appropriate, as it would be difficult to apply one-sided methods to value any of the multi-faceted contributions of the parties, and in our experience few parallels exist in the arm’s length market.

Questions 14 – 16
Regarding fragmentation

We consider there should not be an automatic assumption that because activities are fragmented, profit split must necessarily be in point. In general, if certain activities (eg warehousing) can be, and are, outsourced, the working hypothesis should be that the (warehousing) entity could be the tested party in a one-sided method.

However, we have seen an interesting approach from the Canada Revenue Agency (CRA) when dealing with fragmented value chains: the co-distributor approach, which is a hybrid of one-sided method and a profit split method. In the case we observed, several legal entities in aggregate functioned as a distributor. Sales activities were conducted by one, warehousing by another (the one that recorded the product
purchase/sale), and marketing/management/administration by a third. The CRA treated all three companies as one and identified a target aggregate profit based on a set of fully-fledged distribution comparables, then effectively split that profit amongst the three entities. It was effectively an application of a one-sided method followed by a second-tier application of a profit split. This type of profit split application can perhaps be useful in other 'fragmentation' circumstances.

We also agree that there is a real issue with trying to find comparables for fragmented businesses, and the increasing digitisation of some processes only adds to the complexity. The idea of combining parts of a global business into measurable ‘chunks’ is appealing, but again there is likely to be difficulty in getting all the system profit information (especially if some of the entities are outside the enquiring tax authority’s country).

We do note that fragmentation happens often in the financial services sector. An example of how OECD recommends addressing fragmentation in the financial services sector would be very helpful. Finally, we note that addressing fragmentation requires a very detailed functional analysis, including granular global supply chain mapping and systems mapping. This would be an onerous task for all taxpayers, but perhaps a more feasible undertaking for certain industries, for instance financial services.

**Questions 17 to 19**

**Regarding the lack of comparables and Scenario 5**

Our preference in Scenario 5 would likely be to do some Profit & Loss statement segmentation of each company, then to consider one-sided methods first. A segmentation should be able to readily identify the profitability of each company’s segments (ie local distribution, order taking, and foreign fulfilment), and also highlight the profitability of each. A challenge of applying a profit split in this scenario is that there would be a danger of inappropriately compensating a company, or company segment, in the event of non-normal contributions. For instance, if a particular company or company segment were particularly profitable, or unprofitable, because of strong, or poor, management (or for whatever reason) for instance, those facts could be lost in a profit split unless they happened to factor into the contribution/residual split analysis. A segmentation and one-sided method application would have a better chance of identifying the issue, as the starting place would be the actual profit of that company/segment.

If one-sided methods would not be reliable because of the lack of comparables, a profit split method could be helpful here. Thought would have to be given to the contribution/residual split analysis to ensure it would address important issues such as: effectiveness of local management, value of local intangibles (customer networks, relationships), order volumes and referrals, local market characteristics, etc.

We also very much welcome the reference to looking at comparables flexibly before precluding an application of a one-sided method. In many cases, we prefer to use profit splits as corroborating methods or methods of last resort, simply because profit splits can be quite subjective and are not well understood by groups or tax authorities.

**Questions 20 – 21**

**Regarding the use of profit splits to adjust one-sided method results**

We agree with the approach in this paragraph, and would suggest that an application of a one-sided method should take into account such ‘sensitivity’ considerations. It is rare to work with a fact pattern that perfectly matches benchmarks, which is why transfer pricing practitioners operate with ranges in the first place. It is also generally a 'rule of thumb' that when industries are squeezed, everyone’s margins get squeezed, including the materials supplier, manufacturer, logistics provider, distributor, after-sales service provider, etc., and in the opposite, during boom times everyone makes a little more money. Our transfer pricing approaches must recognize this reality and be sensitive to the fact that often our benchmarks are not perfectly synched with the tested party’s actual industry and business cycle.

A general example of a scenario where such considerations can apply is presented for illustrative purposes: An extremely profitable manufacturer (25%+ operating margin) is selling to a foreign related-party distributor. The taxpayer’s one-sided method application suggested that a 5% operating margin for the distributor was appropriate, effectively providing a relatively minor split of the consolidated profits to the distributor. An analysis of the market and industry circumstances demonstrated that the taxpayer was
operating in a highly profitable stage of the industry and business cycle, whereas the ‘comparable’ distributors were operating in a slightly different industry which was in a significantly less profitable stage of the industry cycle. Based on that analysis, the taxpayer adjusted the target distribution margin upward to reflect the unique market circumstances in the market and corroborated the result using a profit split applying a contribution analysis.

We do note that such an approach would necessitate frequent monitoring and adjustments to targets, and so may require a high level of compliance costs and a lack of visibility. For these reasons it may not be a popular choice for taxpayers, particularly for SMEs.

Questions 22 – 23
Regarding aligning taxation with value creation

In our opinion, this area is where we need the most guidance from OECD. We believe the best way to present the guidance would be in the form of examples. The examples could present a fact pattern then comment on which allocation keys may be appropriate to consider. Taxpayers, practitioners, and tax authorities need some precedent or authority to base the choice of allocation keys, or contribution factors. This is the area of profit split method application that in our experience is currently generating the most controversy.

We also find weighting profit drivers to be a big issue. We observe that currently most practitioners default to an equal weighting in the absence of anything else, and so guidance from OECD with regards to weighting would be very helpful.

We also note that often several allocation keys could be reasonable, but if the taxpayer is applying a key prospectively, consistently, and in good faith- the application should not be challenged despite the presence of alternatives. The taxpayer should also not change allocation keys year-over-year unless there is a compelling reason that it would increase the reliability of the analysis. Commentary from OECD confirming this view would be very helpful.

In the case of financial services and asset managers, two common allocation keys are assets under management and remuneration costs (remuneration costs as a proxy for the value of a person’s contribution). Because remuneration costs are just a proxy, and people are not always paid the same for identical contributions, it is important to at least consider geographic purchasing power parity and cost of living. Failure to do so may, in our opinion, significantly under or over-remunerate certain legal entities for their contributions in the case of, say, asset management.

Question 24-25
Regarding approaches and factors to consider in applying profit splits to integrated global value chains

In Scenario 6, a RACI analysis is applied to each process contributing to a particular value driver in order to determine a split of total system profits. This example, however, does not suggest any weighting or enumeration for any of the specific ‘responsibilities’ undertaken. This type of RACI analysis appears to be highly subjective and it would likely be very burdensome to apply in practice. It would appear to be more reasonable to focus on factors such as bargaining power and options realistically available, which would more likely influence a split of profits amongst arm’s length parties.

Question 26
Regarding hard-to-value intangibles

We note that one of our Member Firms recently conducted an important valuation project that made exactly these considerations: they applied components of a profit split analysis in the context of an intellectual property migration and valuation of technology intangibles. The technology was in an early stage of development, and the purchase price allocation valuation indicated a nominal value for the technology in relation to the purchase price paid for the enterprise. There was effectively no recurring revenue in the business, and the purchase price was high simply because the buyer was willing to pay a high price due to the substantial synergy to be realized upon integration of the acquired technology into its
existing products, plus the substantial value of integrating the acquired workforce-in-place into its existing R&D operations.

To value the migrated intangibles, the project first forecasted and net-present-valued the direct and indirect benefits associated with the acquisition (to the buyer), then conducted a contribution analysis to determine how the target’s technology and workforce-in-place would contribute to the generation of that benefit. Based on that contribution analysis, the value of the benefit was split, and so effectively solved-for the value of the technology intangibles. In our view the contribution analysis and allocation key principles in the context of residual profit split analyses can be highly relevant in the context of intangible valuation.

**Question 27**

*Regarding dealing with ex ante / ex post results and Scenario 7*

Scenario 7 appears to assume that expected spend is an appropriate allocation key but does not present the value drivers of the business or an analysis regarding appropriate allocation keys. We would welcome further guidance from OECD regarding why expected spend was chosen in the example.

If an analysis of profit drivers were to identify that expected spend is an appropriate allocation key, then in that case we agree that Scenario 7 presents a good example of how a profit split could be applied prospectively at the outset of an intercompany arrangement. We do note, however, that in practice it can be very difficult for transfer pricing practitioners to appropriately perform ex-ante analysis, which is why there is such a focus on ex-post analysis in the community in the first place.

In Scenario 7, it would have to be the case that both parties expected both R&D activities to be equally risky. If one party was charged with the development of a high-technology and complex component, while the other was charged with simple routine design, the risk of cost overruns to the first would be significant, and expected cost would no longer represent an appropriate profit split allocator. When determining profit split allocation keys, it can be very difficult to understand the nuances and risks in a business even in cases where you have years of history, let alone in the case of a prospective (ex ante) analysis.

**Question 28**

*Regarding Scenario 8*

We agree that Scenario 8 presents a thoughtful method to price the royalty, and we do agree that profit splits can be used to determine a price rather than just split actual profits. We have some concern, however, regarding the appropriateness of the payment structure. Company P, having contributed 80% of the development efforts, is agreeing to ‘lock-in’ a rate based on uncertain forecasts, and we do not think this would be likely in an arm’s length context. Having contributed 80% of the effort should entitle Company P to some sort of option to adjust the rate in the event of development overages, issues, etc. We may be more comfortable with a plain-vanilla profit split, or at least a variable royalty based on some sort of development cost or sales waterfall to mitigate Company P’s risk.

**Question 29-31**

*Regarding loss Splitting*

In the application of profit split methods to the global trading example (Scenario 9), several allocation keys have been outlined to show how to measure the relative contribution of each location and function. The example showed the use of an allocation key around compensation of staff who are involved in the trading and risk management function (people functions) used to determine relative contributions. The problem around using people functions arises when taking into consideration comparability factors such as location savings and considering what is involved in an individual’s salary package ie benefits, bonus, different taxes and other local market specific factors. The role of capital, risk and other important factors which contribute to value should often be considered in on profit split, as well as people factors. We appreciate the importance of significant people functions (SPF) and the role they have in creating or managing intangibles but suggest other factors such as purchasing power parity etc. must be considered.
This example presents a scenario where the splitting factors may need to be adjusted in the case that losses are incurred. In terms of where it may be appropriate under the arm’s length principal to vary the application of splitting factors depending on whether there is a combined profit or combined loss, we believe the application of the profit split should be consistent on a year by year basis and that its application should generally not change in the event of losses. Consideration, however, should be given to the underlying risks borne by the parties and any extraordinary circumstances that may have created the losses. This might suggest a modification to the splitting factors and/or circumstances where it might not be reasonable for certain parties to share in the losses.

**Question 31**  
*Concerns regarding availability of financial data*

In our experience, the concerns summarized in this section regarding Accessing Foreign Data, Measuring Consolidated profits and Segmented Operating expenses continue to be valid concerns for many companies.
VIA E-MAIL

Mr. Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
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France
TransferPricing@oecd.org

Re: Comments on Discussion Draft on BEPS Action 10: The Use of Profit Splits in the Context of Global Value Chains

Dear Mr. Hickman:

The International Alliance for Principled Taxation (IAPT or Alliance) is a group of major multinational corporations based throughout the world, and representing business sectors as diverse as consumer products, media, mining, telecommunications, oilfield services, transportation, computer technology, energy, pharmaceuticals, entertainment, software, IT systems, publishing, and electronics. The group’s purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally.

The Alliance appreciates the opportunity to provide input to the OECD with respect to its Discussion Draft on BEPS Action 10: The Use of Profit Splits in the Context of Global Value Chains released on 16 December 2014. Our comments are set forth in the Annex to this letter.

We look forward to the opportunity to participate in the consultation to be held on 19-20 March 2015 with respect to this topic and would appreciate an opportunity to speak at the consultation. We also

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1 The current membership of the IAPT is made up of the following companies: Adobe Systems, Inc.; Anheuser-Busch InBev NV/SA; A.P. Møller-Mærsk A/S; AstraZeneca plc; Baker Hughes, Inc.; Barrick Gold Corporation; BP plc; Chevron Corporation; Cisco Systems, Inc.; Exxon Mobil Corporation; Hewlett-Packard Company; Johnson Controls, Inc.; Microsoft Corporation; Procter & Gamble Co.; Reed Elsevier plc; Repsol S.A.; Sony Corporation; Texas Instruments, Inc.; Thomson Reuters Corporation; Tupperware Brands Corporation; and Vodafone Group plc.
stand ready to respond to any questions or to provide further input as the work of the OECD on this item continues.

Sincerely yours on behalf of the Alliance,

Caroline Silberzein
Baker & McKenzie SCP
Counsel to the Alliance

Annex
ANNEX

INTERNATIONAL ALLIANCE FOR PRINCIPLE TAXATION

COMMENTS ON DISCUSSION DRAFT ON BEPS ACTION 10: THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAINS

6 FEBRUARY 2015
IAPT Comments on Discussion Draft on BEPS Action 10: The Use of Profit Splits in the Context of Global Value Chains

I. Introduction

1. We are pleased to provide hereafter our comments on the 16 December 2014 Discussion Draft on BEPS Action 10: The Use of Profit Splits in the Context of Global Value Chains (hereafter “the Draft”). This document touches upon some very fundamental aspects of the arm’s length principle and guidance for application in the OECD Transfer Pricing Guidelines (hereafter “TPG”) and we much welcome the OECD inviting public comment at an early stage of the process, based on hypothetical scenarios rather than on draft guidance.

2. We fully appreciate that this Draft was prepared in the context of the BEPS Action 10, to develop “rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties” and “clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains” and have kept these objectives in mind when reviewing the proposed Scenarios.

3. At the same time, we understand that the OECD and member countries continue to support the arm’s length principle. While special measures may be needed and legitimate to deal with abusive scenarios and structures which lack economic substance, our working assumption is that a principled application of the arm’s length principle should prevail in other cases - i.e. in fact in the vast majority of cases.

4. We would therefore be very concerned if the OECD were to confirm that the profit split method becomes the most appropriate method in cases of integration, cooperation, collaboration, or fragmentation, i.e. in fact in most if not all situations involving associated enterprises. This would in substance mean that one-sided methods would become the exception as cases where a contract manufacturer, distributor, or service provider within a group is not coordinated or does not act collaboratively with other parts of the group to which it belongs are exceptional.

5. In arm’s length transactions between independent parties, the sharing of profits (and losses) is not the norm and we do not see any compelling reason why it should become the norm between associated enterprises, if the arm’s length principle is to remain the standard.

6. Furthermore, we note that generalizing the application of profit splits would lead to extraordinarily complex compliance and enforcement. It would also create unprecedented uncertainty, given the lack of any clear and reasonably detailed consensus guidance about how to measure the profits to be shared and how to split them. Taxpayers and competent authorities would face the practical impediments linked to insufficient administrative resources to effectively resolve in a timely manner the wave of multilateral APA and MAP requests which would inevitably follow. This would possibly pave the road for some form of Global Formulary Apportionment as a fallback for an overly complex and subjective system requiring the systematic measure and sharing of profits of MNEs based on criteria other
than comparables. We think that this risk is not theoretical as already reflected in questions 22 and 23 of the Draft.

7. If however the OECD did confirm that it now regards the profit split method as the most appropriate method to deal with some of the proposed scenarios irrespective of whether the parties contribute unique, valuable intangibles to the transaction, this would be a significant change in the guidance and would raise complex questions about the timing and modalities of implementation.

8. It is not neutral that the Draft only contains two questions in relation to loss splits. We suggest that the OECD ensure that any final guidance appropriately reflect that wherever the profit split method would be regarded as the most appropriate method to the circumstances of the case, loss splits would be accepted in loss-making years. Our experience is that tax administrations are often very reluctant to accept loss situations, even in cases where the local affiliate is appropriately characterized as a full-fledged risk-taker entrepreneur.

9. Finally, we find the wording of several of the questions posed in the Draft troubling (e.g. questions 1, 5, 1, 15, 17, 20, 27, 28). We believe that the question to be asked is not whether a profit split method “can be used”, or even “may be appropriate”, but whether it is the most appropriate method to the circumstances of each case, based on the guidance at TPG 2.2.

II. Value chains

10. As noted in the OECD report, *Interconnected Economies: Benefitting from Global Value Chains*,

    A value chain is the full range of activities that firms engage in to bring a product to the market, from conception to final use. Such activities range from design, production, marketing, logistics and distribution to support to the final customer. **They may be performed by the same firm or shared among several firms.** [emphasis added]

    […] Global value chains involve different types of firm: MNEs and their affiliates abroad as well as independent suppliers, including small and medium-sized enterprises (SMEs), in both domestic and foreign markets. **Transactions in GVCs include arm’s-length transactions between companies and independent suppliers as well as intra-firm transactions.**

11. In effect, there are many examples of independent parties being part of a Global Value Chain: independent logistic service providers working closely with their large clients, independent part manufacturers working closely with their large automotive clients, independent engineering service providers working closely on large projects with clients, etc.

12. With this background in mind, we do not think that “the integrated nature of many MNE groups and the ways in which they interact with each other” pose such comparability challenges that the profit

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2 Synthesis report; OECD 2013.
split method should be generalized. We think that the profit split method has an important role to play in situations where two or more associated enterprises contribute valuable, unique intangibles to a transaction, because in such cases parties make contributions which are not reflected in the benchmarks, thus making the use of a one-sided method alone inappropriate. On the other hand, we do not think that the profit split method is appropriate to compensate routine activities taking place within a Global Value Chain, where such routine activities (i) involve no valuable contribution susceptible of warranting a share in the residual profit (or loss) and (ii) are reasonably reliably comparable to uncontrolled transactions. Furthermore, we do not think that a limitation in the availability of public data, or of perfect comparables, is a sufficient reason to select a profit split in cases where this method is not the most appropriate to the nature of the transaction and the functional analysis of the parties (see more detailed comments on lack of comparables under Scenario 5).

13. We support the statements at paragraph 6 of the Draft that there can be no assumption that a particular transfer pricing method is more appropriate in determining arm’s length prices for transactions between associated enterprises within that global value chain. Instead Chapters I-III of the Guidelines and in particular the guidance on method selection in paragraph 2.2 apply in analysing global value chains. […] The fact that an MNE group disseminates its value chain amongst a number of enterprises in different jurisdictions does not imply that transactional profit split methods will be necessary or appropriate to benchmark arm’s length returns for those enterprises. In many cases, the structure of the MNE group’s value chain will allow the identification of relatively discrete, stand-alone elements which can be reliably priced using one-sided methods.

Scenario 1

**Q1. Can transactional profit split methods be used to provide a transfer pricing solution to this scenario? If so, how?**

14. In our view, a profit split method would not be the most appropriate method between the three associated OEMs unless each of them makes unique, valuable contributions (such as unique, valuable intangibles) to a transaction taking place among them, or are so closely integrated that a one-sided method would not be appropriate.

15. In Scenario 1, the facts of the case indicate that arm’s length royalty payments, compensation for contract manufacturers and distributors can be reliably determined using one-sided methods. We understand that Question 1 relates to a situation whereby a transaction among the three OEMs would be hypothesized in order to split their combined profits among them.

16. In our view, hypothesizing such a transaction would require much more than the mere existence of a regional board or coordination body, or of a value chain, for the reasons described in Section I above. It is very common to have coordinating bodies within MNEs. If the TPG were amended to make the mere existence of such coordinating bodies a sufficient criterion for selecting a profit split method as the most
appropriate method, this would mean a very broad generalization of the profit split method, not aligned with market realities. In effect, at arm’s length, only parties who make valuable, unique contributions to a transaction are generally in a position to share in the profits (or loss) derived from the transaction.

17. The facts under Scenario 1 provide that the technology IP is licensed from a non-EU parent. It is unclear to us what other valuable, unique intangible the three OEMs may contribute which would warrant their earning a post-royalty residual profit to be shared among themselves.3

Q2. What aspects of Scenario 1 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?

18. The key factor to be elaborated is whether there is a transaction among the three OEMs to which each of them would make unique, valuable contributions such as unique, valuable intangibles, and/or what are the precise circumstances that make them so closely integrated that a one-sided method would not be appropriate.

III - Multisided Business Models

Scenario 2

Q5. Can transactional profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how?

19. In our view, a transactional profit split method would only be the most appropriate method in Scenario 2 if both parties make unique, valuable contributions such as unique, valuable intangibles. Whether the local subsidiaries would develop / own / contribute unique, valuable intangibles is a highly factual question which cannot be determined based on the limited information available on the factual pattern of Scenario 2. We note however that the performance of promotional activities does not suffice to create a valuable, unique intangible.

20. Furthermore, even in the case where activities lead to the creation of valuable, unique intangibles, there should be no assumption that the party performing such activities necessarily owns the intangible. At arm’s length there are many cases of activities contributing to the creation of a valuable intangible on behalf of a principal, whereby the intangible which may (or may not, depending on success) result from the activities does not belong to service provider performing the functions. This is true for contract R&D activities as well as for promotional and marketing activities.

21. Therefore, there should be no assumption under the facts of Scenario 2 that the mere performance of the services described at paragraph 16 should generally lead to the local subsidiaries owning or contributing a valuable, unique marketing intangible, and as a consequence that a profit split method would be the most appropriate method.

IV - Unique and valuable contributions

3 We understand the term “OEM” to refer to an entity which “makes a part that is marketed by another company, typically as a component of the second company’s own product”, see http://en.wikipedia.org/wiki/Original_equipment_manufacturer.
Scenario 3

22. We disagree with the suggestion that building a strong relationship with customers would generally give rise to a unique, valuable contribution and entail the dismissal of one-sided methods and selection of a profit split method as the most appropriate transfer pricing method. This would amount to suggesting that comparables are always unsuccessful operators. It is generally the responsibility of a distributor to build, maintain, and develop a strong relationship with its customers. Well-performing distributors benefit from their strong customer relationship as they are able to grow in volume. There are distributors who perform better than others in this respect, whether members of MNE groups or independent parties, and this might be one of the reasons for the TPG endorsing the notion of an arm’s length range. In summary, there is no theoretical rationale to suggest that well-performing distributors who do not own the key intangibles (technology, trademark) would be entitled to a share in the residual profit above the arm’s length range of profits for their distribution activities.

Q7. Does the way in which “unique and valuable” is defined for intangibles assist in defining the term “unique and valuable contributions” in relation to the transactional profit split method?

23. We believe that the phrase “unique and valuable” is appropriate both in relation to intangibles and to profit splits in that it aims at capturing two important concepts:

- First, only unique contributions, including unique intangibles, should be taken into account to assess the need to reject one-sided methods based on comparables and select instead a profit split method. The reason is that comparables are deemed to also own or employ non-unique intangibles, so that their presence does not jeopardize the reliability of the benchmarks. For instance, all distributors have a customer list and commercial know-how, otherwise they would not be able to operate. It follows that the arm’s length range determined on the basis of comparable uncontrolled distributors already captures the arm’s length compensation for such non-unique intangibles. Therefore, a distributor which is part of an MNE group should not be compensated based on a profit split just because it owns a non-unique customer list and commercial know-how.

- Secondly, only valuable intangibles or contributions should be taken into account. In effect, “to be comparable means that none of the differences (if any) between the situations being compared could materially [emphasis added] affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.”4 Taking into account insignificant intangibles or contributions would make the arm’s length principle unworkable in the real world where perfect comparables rarely exist. Minor intangibles which do not materially affect the comparability or can be reliably adjusted for should not lead to the rejection of a comparable based method.

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4 TPG 1.33.
V - Integration and sharing of risks

Scenario 4

Q11. In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks?

24. In our view, a transactional profit split method would only be the most appropriate method in Scenario 4 if A, B, and C all make unique, valuable contributions and share the risk of failure in the development process. The facts of the case do not give any indication as to whether B and C are sharing the risk. The circumstances that “the development of the components is a lengthy and complex process” and that “the components are highly specific to the equipment under development and unlikely to be useful in other types of products” do not give any indication as to which party(ies) among Company A, Company B, and Company C bear(s) the risks associated with the development.

25. At arm’s length, there would be situations where A, B, and C would set up a joint-venture because each of them makes unique, valuable contributions and because their business decision is to share the risks and profits (or losses) from the development. There would be other situations where A is the sole risk taker, while B and C operate as contract service providers. There would also be situations where A and B share the risks and profits (or losses) while C operates as a contract service provider. All these situations are found between independent parties and have fundamentally differing contractual and financial implications. Under the arm’s length principle, there is no economic foundation for the OECD to impose a joint-venture type sharing of profits between A, B, and C irrespective of the contractual terms and functional analysis of the parties. From a governance process point of view, we support the guidance at paragraph 9.26 of the TPG.

26. We believe that the OECD should clarify that its intention is not to disregard contract R&D scenarios and impose the profit split method just because an entity is performing development services with a certain level of autonomy.

VI - Fragmentation

Q14. Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how?

27. In a situation where one entity “holds the legal ownership of intangibles while another performs important functions relating to the development, enhancement, maintenance, protection and exploitation of those intangibles, and another party provides funding”, we think that the following questions should be addressed:

- What are the contractual terms between the parties, in particular in relation to the allocation of the risk associated with the funding and ownership of the intangibles?
- Do the contractual terms reflect the actual conduct of the parties?
• Does the transaction lack economic substance?
• Is the contractual allocation of risks arm’s length?

28. At arm’s length, the provision of funding to finance costly R&D programs is generally associated with investment risk and there is no reason, if the arm’s length principle is to be retained as the norm, for ignoring the value of the investor’s contribution in other than abusive situations.

29. At arm’s length, the performance of “important functions relating to the development, enhancement, maintenance, protection and exploitation of those intangibles” will not necessarily lead to a joint venture type profit sharing (see our comments under Scenario 4 above).

30. We believe that the interim OECD guidance on intangibles should be amended to clearly differentiate between abusive situations, where recharacterisation and risk (and profit) reallocation can be legitimate, and other situations, where the arm’s length principle should prevail.

Q15. Can transactional profit split methods be used to provide reliable arm’s length transfer pricing solutions for fragmented functions? If so how? Can other methods address the issue of fragmentation, and, if so, how?

31. Fragmentation has nothing to do with tax planning. It does not only concern parts of MNEs, but also their suppliers, subcontractors and service providers. As noted in the above-quoted OECD report,

The fragmentation of production in GVCs is a means of increasing productivity and competitiveness.⁵

32. The same report highlights the growing “specialisation of firms and countries in tasks and business functions”, noting that

The fragmentation of production across countries is not a new phenomenon. What is new is its increasing scale and scope. Firms today can disperse production across the world because trade costs have decreased significantly, mainly owing to technological advances. Cheaper and more reliable telecommunications, information management software and increasingly powerful personal computers have markedly lowered the cost of coordinating complex activities within and between companies over long distances. Rapid advances in information and communications technologies (ICT) have increased the tradability of many goods and services. Moreover, containerised shipping, standardisation, automation and greater inter-modality of freight have facilitated the movement of goods in GVCs, although distance still matters. […]

These developments have enabled companies to look at relative costs and factor endowments and build an efficient value chain across firms and locations. Sourcing inputs from low-cost or more efficient producers, domestically or internationally, and

⁵ Ibid, p. 8.
within or beyond the firm’s boundaries, can mean important cost advantages. Outsourcing production also enables firms to benefit from the economies of scale and scope that specialised suppliers can provide. [emphasis added] ³

33. While “MNEs play a major role in these networks, including through their control of foreign affiliates”,

The fragmentation of production has created new opportunities for relatively small firms – including in developing and emerging economies – to enter global markets as components or services suppliers, without having to build a product’s entire value chain. New niches for the supply of novel products and services continuously emerge and may allow SMEs to exploit their flexibility and speed. Certainly, the on-going fragmentation of production combined with the development of ICTs has created new entrepreneurial possibilities for SMEs. ICTs have eased access to markets beyond national borders and have led to a new category of micro-multinationals, i.e. small firms that develop global activities from their inception.⁷

34. Accordingly, while we agree with the statement at paragraph 26 of the Draft that

In some cases, it may prove difficult to find comparable uncontrolled enterprises that are similarly specialised in their activities and carry out just the narrow activity conducted by the controlled enterprise,

we do not think that fragmentation poses systematic comparability challenges which would warrant generalization of the profit split method. To the contrary, fragmentation is often a case for more reliable comparability analysis, as its helps retain the transactional focus of the OECD recognized transfer pricing methods.⁸

Q16. What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?

35. For the reasons explained above, we do not think that any aspect of fragmentation needs to be further elaborated in the TPG in relation to the selection of the transactional profit split or another method.

VII - Lack of comparables

36. We generally support the statement at paragraph 29 of the Draft that where reliable comparables are not available,

reliable arm’s length solutions can often still be found through the application of one-sided methods, for example, by broadening the search for comparables to other markets

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⁴ See TPG 3.37.
with similar economic conditions, and by making reasonably accurate comparability adjustments.

37. We however suggest that this statement should be amended for two reasons:

- First, to acknowledge that where reasonably accurate comparability adjustments are made to uncontrolled data, the resulting adjusted data consist in reliable comparables, so that situations where reliably accurate comparability adjustments can be made should not be presented as situations where reliable comparables are not available.

- Secondly, searching for data from other markets is one of the available options. Other possible options are discussed at TPG 3.38. However, as noted at TPG 3.39, a transactional profit split method might in appropriate circumstances be considered without comparable data, e.g. where the absence of comparable data is due to the presence of valuable, unique intangibles contributed by each party to the transaction (see paragraph 2.109). However, even in cases where comparable data are scarce and imperfect, the selection of the most appropriate transfer pricing method should be consistent with the functional analysis of the parties, see paragraph 2.2. [emphasis added]

38. Paragraph 29 of the Draft broadens the cases for profit split methods to cases “where a lack of comparables is such that it poses a serious impediment to the reliable application of one-sided methods”, irrespective of whether in effect both parties to the transactions make unique, valuable contributions to the transactions, and without any consideration as to the reason for comparables not being available. This, in our view, is unfounded. For instance, in a situation where there are arguably no reliable comparables for a contract manufacturer in a particular country because of the lack of publicly available information on independent contract manufacturers in that particular country, it should not follow that a profit split method should be used, if the contract manufacturer does not make any unique, valuable contribution. Otherwise, the revised guidance would put an extraordinary pressure on the reliability of comparables, and create an incentive to reject reasonable comparables in order to dismiss the use of a one-sided method including in cases where a profit split method would not be the most appropriate to the functional analysis of the parties, e.g. because one of them performs only routine, benchmarkable activities. In a world where perfect comparables rarely exist, this would mean increased uncertainty and generalization of profit split well beyond what is warranted under the arm’s length principle.

Scenario 5

Q17. How can comparables be found and applied in scenario 5? What method is likely to be appropriate for determining an arm’s length remuneration for the activities of the group companies?

39. In Scenario 5, each operating entity has three functions:

- selling to local customers,
agreeing terms and taking orders from local customers buying on behalf of their regional organisation, and

fulfilling orders placed with other group companies.

40. It follows (subject to a review of the actual facts of the case) that three controlled transactions likely need to be analyzed and tested and three comparability analyses performed: one for the selling activity (the fact pattern is silent as to whether the stationery supplies are sourced from third parties or associated enterprises), one for a commissionnaire type activity (which is often similar to a distribution activity, subject to a working capital adjustment to reflect the absence of inventory on the books of the commissionnaire), and one for a fulfillment activity (typically a low value-adding service).

41. We do not see Scenario 5 as a case for applying a profit split. We are in fact very surprised and concerned that this simple case could potentially be considered for a profit split.

**Q18. How can comparables be found and applied in scenario 3 (or to any other relevant scenario in this discussion draft)?**

42. In Scenario 3, Company S is responsible for sales and local marketing. As indicated above, we do not think that the circumstance that Company S is successful building a strong relationship with customers “poses a serious impediment to the reliable application of one-sided methods”. We think that an arm’s length range of uncontrolled sales and marketing transactions will naturally include well-performing and less well-performing comparables, each of which aims at developing and maintaining customer relationships.

43. Again, we are very surprised and concerned that this simple case could potentially be considered for a profit split.

**VIII - Selecting a point in the range based on a profit split approach**

**Q20. In what circumstances, if any, might an approach described in the last sentence of paragraph 32 be appropriate?**

44. This is potentially a novel approach, and in order to be able to better frame the concept we suggest that the OECD should clarify what it seeks to achieve with it, e.g.:

- To impose the use of a profit split method whenever there are comparability defects (a solution which we would strongly disagree with); or

- To design a new hybrid transfer pricing method, in addition to the five OECD recognized methods in the TPG, which in substance would still be a one-sided method but would contain an element of profit split, noting that such element could not lead to exceed the boundaries of the arm’s length range determined for the application of the one-sided method; or
• To amend the guidance on determining the arm’s length range when applying a one-sided method, by requiring that the range of comparables be further “refined” depending on the profits of the controlled transaction; or

• To amend the guidance for selecting the most appropriate point in the range, noting that in the latter case it should be limited to cases where the taxpayer’s controlled transaction is outside the range. In effect, no adjustment by tax authorities is warranted if the taxpayer’s controlled transaction is within the range.10

Q21. More generally, in what circumstances would a transactional profit split approach be useful in supporting the application of other transfer pricing methods, and what guidance would be useful to develop for the supporting use of such approaches?

45. We reiterate our view that a profit split method should be used where and only where both parties to the transaction make unique, valuable contributions. Lacking any such valuable, unique contributions, a mere comparability defect should not legitimate the recourse to a profit split method, whether as the primary method or “to support the application of other transfer pricing methods”.

46. Furthermore, we support the existing guidance at TPG 2.11 and think that the use of a profit split method to “support another method” should be reserved for complex cases.

IX - Aligning taxation with value creation

Q22. In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?

47. As noted under Scenario 1 above, we believe that a profit split method would not be the most appropriate method between the three associated OEMs unless each of them contributes valuable intangibles or unless they are so closely integrated that a one-sided method would not be appropriate., which would require more than the mere existence of a regional board or coordination body, or of a value chain. Assuming this would be the case so that a profit split among them would be the most appropriate method, further guidance would be needed both on how to measure the profits to be split and how to split the profits. The OECD is inviting comments on the latter question; we note that the former is also a very complex one.

48. We find that the facts of the case are insufficiently detailed to determine what splitting factors would possibly be the most appropriate. For instance, as already indicated, given that OEMs in this case are not the technology IP owner, it is unclear from the facts of the case what other valuable intangible they contribute to the transaction or value chain which would warrant their earning a post-royalty residual profit and could form an appropriate basis for sharing such residual profit, if any.

9 TPG 3.55-3.59.
10 TPG 3.60.
49. Furthermore, we think that the OECD should clarify at paragraph 37 of the Draft that it is not sufficient to identify the key value drivers to the business. It is also necessary to fully understand what the contributions of each of the parties to the transaction are. For instance, it is possible that one OEM only contributes production capacity and no headcount, even though it may have significant headcounts, while another OEM may only provide headcounts and no production capacity, although it may have production capacity. That is, the determination of the splitting factors should be made based on an analysis of the specific circumstances of the case.\footnote{See TPG 2.120.}

50. The proposed factors at paragraph 37 would not necessarily achieve the desired level of “objectivity” or “fairness”. For instance, headcounts may not reflect the differing levels of contributions to the value creation of various categories of staffs; production capacity may or may not be a relevant factor, depending on whether the three OEMs manufacture interchangeable goods; etc.\footnote{These issues were extensively discussed, among other arenas, by the European Commission as part of its work on a Common Consolidated Corporate Tax Base (“CCCTB”). We understand that the EC is currently re-launching work towards a CCCTB, see Commission Work Program for 2015, “A new start”, COM(2014) 910 Final.}

51. We understand that identifying splitting factors for types of transactions or industries can be seen by some as a means to improve the objectivity of the profit split method, but we do not think that it would be effective. In our view, this would amount to proposing some form of Global Formulary Apportionment. In this respect, we respectfully submit that there should be more clarity as to the policy direction of the OECD transfer pricing work.

**Scenario 6**

**Q24. How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for example approaches based on concepts of bargaining power, options realistically available, or a RACI-type analysis of responsibilities and decision making)?**

52. Under the 2010 TPG, options realistically available are already part of the analysis in relevant circumstances (see TPG 1.34-1.35, 9.59-9.64 and 9.175-9.176).

53. We think that the notion of bargaining power is extremely difficult to quantify especially in the context of intragroup transactions, so that introducing it would likely result in more uncertainty. That being said, we also think that only a party which makes valuable, unique contributions to a transaction would have the bargaining power to claim a share in the profit (or loss) resulting from the transaction.

54. With respect to RACI-type analyses, we consider that the starting point for allocation of risks should be the transaction as structured by the taxpayer as evidenced in contractual arrangements unless the actual conduct of the parties does not match the contractual terms or lacks economic substance. A detailed analysis of the functions performed in relation to who is responsible, accountable, consulted or informed about a risk can provide a picture of who performs those functions, but will not provide any
indication as to the capacity in which the functions are performed (e.g. as a risk taker or as a service provider).

**X - Hard to value intangibles**

**Q26. What specific aspects of transactional profit split approaches may be particularly relevant in determining arm’s length outcomes for transactions involving hard-to-value intangibles?**

55. We understand the phrase “hard-to-value intangibles” to refer to situations where the projections used in valuing an intangible, e.g. using a discounted cash flow approach, are highly uncertain. This can be the case where an in-process intangible is transferred at a point in time where the risk of failure of the remaining R&D steps is still significant, and/or where the commercial prospects are still very uncertain. We believe that hard-to-value intangibles raise two main issues:

- First, the determination of what party(ies) (transferor, transferee, or both) bears the risk associated with the uncertain valuation of the transferred intangible;
- Secondly, the question of a potential information asymmetry between tax administrations and taxpayers in relation to the determination of the projections used to support the valuation.

56. In our view, the first issue should be resolved following the general guidance on risks in the TPG. The second question may possibly lead the OECD to adopt a Special Measure, as described in the discussion draft on Revisions to Chapter I of the TPG (Including Risk, Recharacterisation and Special Measures).

57. We do not think that profit split methods are a response to the above two issues. Rather, we think that the most appropriate transfer pricing method to the circumstances of the case should be selected based on the guidance at TPG 2.2 and Chapter VI. In cases where the most appropriate method is a profit split, then the issues listed above could be dealt with by applying the profit split on actual outcomes rather than projections.

**XI - Dealing with ex ante / ex post results**

**Scenario 7**

**Q27. How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?**

58. Where the most appropriate method to the circumstances of the case is a profit split, applying the profit split on actual outcomes rather than projections mechanically deals with unanticipated results. Depending on the allocation of risks between the parties,

- The profit to be split will generally be the actual result, thus mechanically reflecting unanticipated results; in some specific cases, however, a contractual mechanism may be put in place to insulate one of the parties from such risks / opportunity;
Similarly, the split will generally be based on the actual costs incurred by the parties, thus achieving a sharing of the risk of overrun; however, depending on the allocation of risks and responsibilities, there can be cases where the 70/30 split agreed upfront will be used to insulate each party from the risk that the other would not effectively monitor its own costs.

Scenario 8

Q28. Is the application of a transactional profit split method to calculate the royalty in Scenario 8, or in other circumstances to set a price, helpful? What are the advantages and disadvantages?

59. In practice, we think that all the development would generally take place in P rather under a license to an affiliate S; but we agree that based on the proposed fact pattern as set out in Scenario 8, the application of a profit split method to derive a royalty or set a price is possible under a license.

60. However, it should be noted that other structures of compensation are also possible including upfront payments, milestone payments, etc., as evidenced in third party licences. Such multi-part structures are more prevalent between unrelated parties but can deliver similar splits of expected returns (eNPV) as a royalty. For example, a royalty of 10% can be eNPV equivalent to an upfront payment of say 100 plus a royalty of 5%.

61. The advantages are that these methods are used in business in arm’s length licence situations and relevant data and compound specific probabilities of success are available in order to calculate risk weighted shares of intangible related returns between licensor and licensee. We would not necessarily recommend using industry average data as risk is very compound specific; for example, by reference to therapeutic class, degree of innovation, synthetic compound versus biologic, etc. If this information is available it should always be used in the first instance.

62. The potential disadvantage is that profit splits are imposed where they are not warranted, for example in the case of contract R&D, also widely evidenced in third party arrangements. The OECD should be clear that the profit split approach should only be applied in joint IP development or licence situations and when service cost arrangements and CUT’s are not appropriate.

63. It should also be noted that in third party licence situations there are often different views on expected revenues and returns as well as assumptions, for example discount rates and probabilities of success. Ultimately third party licences are only concluded if the parties’ views as to expected outcomes overlap to some extent. In a related party situation equal information and assumptions, e.g. discount rate, can be imposed to narrow the range even to a single shared eNPV. However, any assessment of relative bargaining positions is of course subjective in arriving at the residual split.

XII - Dealing with losses

Scenario 9

Q29. In what circumstances might it be appropriate under the arm’s length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss?
64. We support the guidance at TPG 2.117, including the following:

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

65. We believe that Scenario 9 correctly points to a situation where the correlation between bonus compensation and losses would not be the same as that between bonuses and profits, and therefore where the splitting factor would differ between profit and loss making years.

Q30. Are there circumstances under the arm’s length principle where parties which would share combined profits, would not be expected to take any share of combined losses?

66. While there may be specific circumstances where parties at arm’s length would share combined profits but not combined losses, we think that these are exceptional and are appropriately captured by the existing guidance at TPG 2.117. We would be very concerned if the TPG endorsed profit splits with no loss split as a matter of principle. Many transfer pricing disputes arise today whereby tax authorities refuse loss-making situations on the grounds that local affiliates are “only affiliates” which should not bear losses which arguably derive from the global strategy decided at parent level. We would find it very unfortunate and unfounded if the same tax authorities could claim a share of the residual profit in profitable years and a guaranteed, one-sided method in loss-making years: this is not a theoretical concern but is based on various real life examples of recent and ongoing transfer pricing audits.

XIII - Final questions

Q31. Paragraph 2.114 of the Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?

67. We think that there are multiple difficulties in applying a profit split method:

- Accurately delineating the profit to be split, especially in the cases where it is not the total profit of the participating entities, so that segmented Profit and Loss accounts need to be established, typically involving information system constraints and subjective decisions as to the allocation of indirect expenses.
- Agreeing on the most appropriate splitting factors.
- Effectively determining the splitting factors.
- Agreeing on how to reflect unanticipated events which may affect the amounts of profits to be split and/or the splitting factors.
• Dealing with changes over time, e.g. changes of relative contributions by the parties, new entrants to the transaction, mergers or acquisitions, etc.

• Putting in place year-end adjustment mechanisms (given that the actual outcomes are typically known a few weeks or months after the year-end), including transfer pricing determination, contractual support, accounting and invoicing, as well as any withholding tax and/or indirect tax consequences.

68. Last but not least, a broader use of profit split would in our view require significantly more administrative resources and much streamlined multilateral APA and MAP procedures.

Q32. Finally, what further points would respondents wish to make about the application of transactional profit split methods not covered by previous questions?

69. As indicated in the introduction, we fully appreciate that this Draft was prepared in the context of the BEPS Action 10, but we would be very concerned if the OECD were to confirm that the profit split method is to become the most appropriate method in cases of integration, cooperation, collaboration, or fragmentation, i.e. in fact in most if not all situations involving associated enterprises. If the guidance is to remain consistent with the arm’s length principle, it should only view a profit split as the most appropriate method in cases where independent parties would have agreed to it, e.g. where both contribute unique, valuable intangibles to the transaction.

XIV - Conclusion

70. The IAPT thanks the OECD for this opportunity to comment and especially welcomes the process consisting in sharing a very early draft with stakeholders. We believe that the issues raised in the Draft and proposed scenarios are of paramount importance to the future of the arm’s length principle and to the business community.

71. We therefore express our strong interest in further consultation on these questions, and would very much appreciate the possibility to speak at the March 19-20 public consultation.
Comments to the OECD Discussion Draft on BEPS Action 10
On the Use of Profit Splits in the Context of Global Value Chains

The International Chamber of Commerce (ICC), as the world business organization speaking with authority on behalf of enterprises from all sectors in every part of the world, welcomes the opportunity to provide comments on the Discussion Draft on BEPS Action 10 on the Use of Profit Splits in the Context of Global Value Chains which sets out scenarios to facilitate modifications to Chapter II of the OECD Transfer Pricing Guidelines (the “Guidelines”) and to clarify circumstances in which the application of a transactional profit split method may better align profits and value creation.

ICC commends the efforts of the OECD in providing further guidance on the application of profit split methodologies. The alignment of value creation and profits, if truly representative of arm’s length outcomes, may be an important step in eliminating BEPS and enhancing certainty for tax administrations and taxpayers alike by reducing the likelihood of tax disputes and double taxation. Such outcomes, in turn, advance the fundamental principles of enhancing cross-border trade, foreign direct investment and economic growth.

ICC would equally note that the increased application of the transactional profit split method introduces additional subjectivity and complexity for taxpayers and tax administrations alike. Its inappropriate application may result in a departure from the arm’s length principle, an increase in uncertainty and the compliance burden, and contribute to an increased incidence of double taxation and disputes; ultimately undermining the fundamental principles noted above.

In certain circumstances, the application of a transactional profit split method over a one-sided method does not result in improvements or additional certainty but only in the substitution of the specific matters under dispute. Often, in the case of one sided methods, such as the transactional net margin method, disputes center around whether a selection of imperfect comparable transactions results in an arm’s length determination of the transfer price. In relation to profit split methodologies, disputes focus on whether a subjective and complex determination of, and measurement of, value creating activities gives rise to an arm’s length distribution of profits. The risk is that the substitution of one area of difficulty for another may not produce a significant improvement in the reliability of the results. Where governments may differ on the presence of value drivers and their measurement, the use of the transactional profit split method, especially with limited, or no, reference to direct evidence from third party transactions, may only exacerbate the risk of tax disputes and incidence of double taxation.

In many cases, Multinational Enterprises (MNEs) strive for consistency in the application of the transfer pricing methods over multiple years and in their dealings with similar related parties in multiple jurisdictions. This consistency is an important factor in achieving predictability, efficiency and certainty in terms of compliance efforts and financial statement reporting. The higher propensity of any one jurisdiction to require a transactional profit split method could result in significant increases in compliance requirements and reduction in financial statement certainty for MNEs.

In transactions, involving multiple related parties, in multiple jurisdictions, where a significant difference exists between the parties in respect of intensity of value creation (and magnitude of risk bearing), the over-utilization of the transactional profit split method may result in a
cumulative attribution of profit to the incremental creators of value (and bearers of risk) that significantly understates the final residual profit attributable to key value creating and risk taking activities. Such an outcome would not be consistent with the arm’s length principle and its ultimate resolution may require the collective concurrence of multiple tax authorities.

To safeguard the fundamental principles of enhancing cross-border trade, foreign direct investment and economic growth, ICC strongly believes additional emphasis on the selection of the ‘most appropriate method’ is imperative. Such emphasis should additionally require the consideration of the potential for improved reliability and be tempered against factors such as the additional compliance burden placed on MNEs and the potential increase in the disputes and incidence of double taxation.

Further, an expressly stated preference that every effort be made to establish transfer prices with direct reference to arm’s length transactions, with the use of appropriate adjustments and judgment, may help to ensure the transactional profit split method is applied in extreme cases and, in a manner which acknowledges the facts and circumstances, as opposed to a more formulary approach.

Where imperfect comparables impede the determination of an acceptable transfer price, the development of practical solutions would help to protect against the arbitrary and excessive application of profit splits. Practical guidance on the manner in which the results under a one-sided approach may be varied or applied would reduce the potential for disputes and simplify compliance for all parties.

Where transactional profit split methods are to be applied, the use of a residual profit split approach, by virtue of its first reference to the arm’s length transaction, may reduce the degree of subjectivity and uncertainty and protect against gross mismatches in the alignment of value creation and profits.

The requirement that transactional profit splits be first considered in the context of the multilateral instrument, may help to prevent double taxation and strengthen principles of enhancing cross-border trade, foreign direct investment and economic growth.
The International Chamber of Commerce (ICC) 
Commission on Taxation

ICC is the world business organization, whose mission is to promote open trade and investment and help business meet the challenges and opportunities of an increasingly integrated world economy. Founded in 1919, and with interests spanning every sector of private enterprise, ICC’s global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments.

The fundamental mission of ICC is to promote open international trade and investment and help business meet the challenges and opportunities of globalization. ICC conveys international business views and priorities through active engagement with the United Nations, the World Trade Organization, the Organisation for Economic Co-Operation and Development (OECD), the G20 and other intergovernmental forums.

The ICC Commission on Taxation promotes transparent and non-discriminatory treatment of foreign investment and earnings that eliminates tax obstacles to cross-border trade and investment. The Commission is composed of more than 150 tax experts from companies and business associations in approximately 40 countries from different regions of the world and all economic sectors. It analyses developments in international fiscal policy and legislation and puts forward business views on government and intergovernmental projects affecting taxation. Observers include representatives of the International Fiscal Association (IFA), International Bar Association (IBA), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe and the United Nations Committee of Experts on International Cooperation in Tax Matters.
By Electronic Delivery

6 February 2015

Andrew Hickman
Head of the Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2 rue André-Pascal
75775, Paris, Cedex 16
France

RE: The CIV Industry and the Use of Profit Splits

Dear Mr. Hickman:

ICI Global,¹ on behalf of our collective investment vehicle (CIV)² industry members, submits that the arm’s length method is the most appropriate basis for determining global value chain profitability within the CIV industry. The profit split methodology should be used only as a last resort, when no other measure can be applied fairly. Moreover, the profit split methodology should never be applied as a “check” on pricing determined under the arm’s length standard; arm’s length pricing is the most accurate measure of the value created by parties to a transaction. As we support the comments being submitted today by BIAC, this letter summarizes a few issues of particular concern to our industry.

First, we submit that the final report on BEPS Action 10 must stress that the benefits of using the profit split method can vary significantly across industries and within an industry. The financial services industry in general, and the CIV industry in particular, present factual issues that are very different from those presented by other industry sectors. The Report on the Attribution of Profits to Permanent Establishments approved in 2010 by the CFA and the

¹ The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$19.1 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

² A CIV is defined for this purpose consistently with the OECD’s Report entitled “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles” (the “CIV Report”). Specifically, paragraph 4, page 3 of the CIV Report defines CIVs as “funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established.”
Council illustrates this point. The Report addresses general considerations and then specific considerations for various aspects of the financial services industry. While banking, global trading of financial instruments, and insurance all are addressed specifically, asset management in general and the CIV industry in particular are not analysed separately.

Second, for similar reasons, we are concerned that over-inclusive use of the profit split method effectively will lead to formulary apportionment. We strongly oppose formulary apportionment as the various activities performed by an asset manager in the CIV industry create different types of risks and do not contribute equally to the manager’s success. Risk management and profitability considerations are different for actively-managed funds that “pick” stocks, for example, than they are for indexed-based funds that seek to mirror the performance of a basket of stocks.

Finally, we reiterate our previously-expressed strong support for including mandatory binding arbitration in the BEPS Action 14 recommendations. The use of the profit split method, because the results are so heavily dependent on the factors used and the relative weight given to each factor, may increase substantially both the number of tax controversies and the difficulties of resolving them. Without the possibility of mandatory binding arbitration, the result surely would be more cross-border disputes and greater double taxation of income.

* * *

Please feel free to contact me (at lawson@ici.org or 001-202-326-5832) at your convenience if you would like to discuss this issue further or if we can provide you with any additional information. My colleagues Karen Gibian (at kgibian@ici.org or 001-202-371-5432) and Ryan Lovin (at ryan.lovin@ici.org or 001-202-326-5826) also may be called upon for assistance.

Sincerely,

Keith Lawson
Senior Counsel – Tax Law

cc: Transfer Pricing@oecd.org

Attachment
Overview of the CIV Industry

ICI Global’s recommendations on BEPS Action 10 are informed by CIV industry experiences in the global marketplace and the resulting tax controversies. In this context, it is instructive to consider the nature of a CIV, the reliance on third-party service providers, the roles and responsibilities of these service providers, and the organization of the CIV manager.

The Nature of a CIV

A CIV is a pooled investment vehicle widely used by individuals to cost-effectively access the securities markets. The important advantages provided by CIVs include professional management, asset diversification, liquidity, and robust governmental regulation and oversight.

All functions of the CIV, which does not have employees of its own, are performed by third-parties. The asset manager that has created the CIV often will perform many of these services. A CIV’s officers typically will be employees of the asset manager. The typical CIV is overseen by a board of directors or trustees responsible for ensuring that the CIV is operated in accordance with its organizational documents, local law, and the best interests of its investors.

A CIV’s investment objective (e.g., stocks or bonds; country-specific, regional, or global; etc.) is prescribed in its offering document. Most CIVs disavow any interest in exercising any control over a company in which they invest. The CIV’s portfolio management team decides which specific securities to buy and sell and initiates the securities trades.

Investors’ interests in a CIV are acquired either directly from the CIV (with the purchase reflected directly on the CIV transfer agent’s/recordkeeper’s books) or through a third-party distributor. All CIV investor transactions are effected at the CIV’s net asset value (NAV), which is determined each day by calculating the CIV’s assets and liabilities and dividing by the number of outstanding interests. Because of this precise calculation requirement, certainty regarding a CIV’s tax liabilities is essential.

CIVs may be organized for distribution to one or more specific types of investors (e.g., individuals, pension funds, corporates, etc.). Depending on the type of targeted customer, different methods will be utilized for promoting the CIV and distributing CIV interests. Intermediaries (e.g., banks, broker dealers, financial planners) typically are heavily involved in the distribution process.

The tax treatment provided to CIVs effectively recognizes that CIVs do not carry on business activities. To ensure that CIV investors receive tax treatment comparable to that provided to direct investors, for example, countries typically provide some mechanism to exempt a CIV’s income from tax; the exemption mechanism may be an express tax exemption or a targeted tax deduction for amounts distributed to investors. The only tax borne by the typical CIV on its portfolio transactions is any withholding tax that may be imposed when the CIV is a nonresident investor.
A CIV is separate and distinct from the asset manager that created it. The CIV and the asset manager have different owners, their assets are totally separate, and they bear no responsibility for each other’s liabilities (including tax liabilities).

**Management Companies and Other Service Providers to CIVs**

The typical CIV asset manager offers its customers a wide range of financial products and provides them with an array of valuable services. The products may include CIVs, other investment pools (e.g., hedge funds) that are not widely-held, insurance, and banking services. The services provided, in addition to offering these products, may include distribution, investment education, investment advice, wealth management, and/or estate planning.

The services that an asset manager may provide to a CIV could include:
- portfolio selection (which may involve portfolio managers (PMs), analysts, and research assistants);
- asset acquisition and disposition (often through multiple securities dealers);
- assistance in arranging asset custody (typically through a global custodian and regional/local subcustodians);
- regulatory compliance;
- investor recordkeeping (through a “transfer agent”); and
- investor communications (including transaction confirmations and periodic account statements).

Many asset managers create separate entities to distribute CIV interests. These distributors may contact investors directly or work through unrelated third-parties (e.g., broker-dealers). Because the global CIV industry is highly intermediated (i.e., CIV interests typically are acquired through third parties), arm’s-length pricing comparables are available for “in-house” distribution activities.

Many management companies operate globally – although their specific activities may vary widely. Companies may distribute their products locally, regionally, or globally. Some may invest globally – even if they distribute only locally or regionally. Still others may consolidate various functions in one (or more) locations to achieve economies of scale.

The manner in which a management company is organized and/or structures its operations also may vary widely. Even within one country, a company may create separate entities; different business lines subject to different regulatory regimes and/or supervised by different regulators frequently will be placed in separate entities. Operations in multiple countries likewise often will be performed by separate companies.

Particularly within the heavily-regulated financial services industry, regulatory considerations often will be the primary (if not exclusive) driver for structuring decisions. Local regulatory requirements, for example, frequently require that a locally-organized CIV be managed by a local management company. To the extent that one country’s regulatory regime applies to an entire entity, companies often will establish separate subsidiaries so that the applicable regulatory regime will apply only to the relevant business activities. When different jurisdictions have different, and potentially inconsistent, regulatory
requirements, it often is necessary to set up separate entities (e.g., distributors) in each jurisdiction. Separate entities become even more important when country-specific securities licenses or other permissions are required.

CIV Industry Competitiveness

The CIV industry is extremely competitive. CIVs routinely advertise their performance (investment return) both in real terms and relative to their competitors. Independent research firms (e.g., Morningstar) often are a primary source for the data required to make these comparisons.

Performance and reputation are key for CIVs and their asset managers. CIVs that generate strong returns and outperform competing investment products are rewarded with shareholder investment inflows. CIVs that underperform face shareholder redemptions. Because an asset manager’s fees are calculated based upon assets under management (AUM), managers are incentivized to generate strong performance.

Perhaps the biggest driver on performance (other than portfolio management) is the fee paid by a CIV to its manager. Because all fees paid by a CIV come directly from the CIV’s assets, fees have a direct and negative impact on performance. The more a CIV pays in management fees, the lower its investment return. The CIV industry, therefore, is extremely price-sensitive.

Management companies also are incentivized to keep fees low. The lower the CIV’s expenses, the higher the returns, and the greater the investor demand for the CIV. The larger the CIV, the higher the gross management fee.

Management Company Expense Considerations

Management companies seek to control all of their expenses. Business efficiency, including consolidating functions operationally and/or geographically, play an important role in cost containment. Costs between related parties are charged by applying the arm’s-length standard.

All management company operations, importantly, do not have the same impact on profitability. In the CIV industry, a management company’s reputation and success are driven largely by the attractiveness of the CIVs it offers to investors. Developing innovative products (e.g., exchange traded funds) or identifying new investment opportunities (e.g., micro cap stocks) can generate growth. Because performance is key, however, portfolio management (e.g., stock picking) is a key profitability driver. Administration and infrastructure costs (e.g., regulatory compliance such as legal services and accounting, transfer agency, custodial, and information technology costs) are very important to a successful operation and may constitute a significant portion of a CIV’s operating costs – but they have less impact on a CIV’s performance.
Dear Mr. Hickman,

On behalf of IFA Grupo Mexicano, A.C. (Mexican Branch of the International Fiscal Association) kindly find below some comments on the “Public Discussion Draft on Action 10 of the BEPS Action Plan on the use of profit splits in the context of global value chains” (the “Draft”).

1) General remarks

First we acknowledge the effort made by the OECD in analyzing the existing guidance on the profit split method as part of the BEPS project. As the draft states it is important to gain knowledge about the existing experience and best practices in applying the transactional profit splits.

In general terms, we strongly agree with the reference made to the proposed revision to section D of chapter I of the Transfer Pricing Guidelines (TP Guidelines), as we believe that delineating the transaction is essential for it to be adequately priced. We also stand by the current wording of paragraph 2.2 of the TP Guidelines, given that even with the context of integrated value chains we consider that the selection of the transfer pricing method has to be a comprehensive process that takes into account the advantages (and disadvantages) of each method, the nature of the controlled transaction and a deep and detailed functional analysis as well as the existence of reliable comparable operations and related adjustments.

Having said that, we would like to recommend the inclusion of language that states that the application of a profit split method in a global value chain context should not be identified with a global apportionment approach. It is important to establish that there is no intention to suggest that the profit split method is an adequate way to redistribute income among related parties in a multinational group. We consider that the fact that a company is part of a global value chain should not be taken as a situation that calls for an immediate application of a profit split method.

...
split method. There are several cases where an appropriate functional analysis will be enough to establish an arm’s length return for the operation using an adequate method. A strict analysis on the functions performed, the assets involved and the risks assumed is the best way to establish the arm’s length remuneration of a transaction and the objective that the OECD has established for assuring that the TP outcomes are in line with value creation can be fulfilled with the adequate application of any method, in particular with the most adequate method for each case.

Although the draft states that there are some situations where the interdependence of key functions and risks makes it difficult to apply another method, or that the existence of risks and benefits derived from an integration may appear, it would be advisable to add language that states that those key functions or benefits / synergies have to be proven and not assumed that they exist only due to the fact that the company is part of a global value chain, as defined by the Draft.

We understand that the scenarios are designed to cover a broad range of points of view, but we should aim to the creation of more detailed scenarios, given that in general terms, if we leave as an open ended question the split of the profits, it is clear that the application of the method will rely on a subjective weighting of the parties applying the method, if it is in a prospective basis, or the tax authorities views, if it derives from a TP review. This could lead to an increase in double taxation, given that all tax authorities could misinterpret the application of a profit split method as a way to “increase fairness” from their point of view and they will place subjective valuations to the respective contributions of their own residents.

2) With the previous considerations in mind, we would like to make some specific comments:

Regarding Scenario 1 more attention should be devoted to the way the Leadership Board is structured, the overall functions it performs and also proper consideration should be given to the risks derived from the decisions taken by the board.

We consider scenario 2 will benefit if more details about the functions performed by each of the parties is added as well as the contribution that local teams make to the overall business. We have to consider if a second method can be used to verify the results.
In Scenario 3 when we read the Proposed Draft of Chapter 6 of the TP Guidelines we see the definition of “unique and valuable” as a useful tool to define “unique and valuable contributions”. The existent guidance on profit splits already captures this kind of situations, specifically where the contribution of both parties is considered as significant.

For Scenario 4 we think that it is not clear the risks that each party is assuming and also if the fact that each party controls its own research, development and manufacturing process has a direct impact in the possible allocation of profits among them. In a BEPS analysis we are assuming they are all situated in different countries, so more detail should be provided regarding the contractual terms used to establish the profits.

As for Scenario 5, we think that the lack of comparables and the fact that such lack of comparable operations may pose serious impediments for the application of a one sided method remains as the best example where the application of a profit split method is advisable.

In general terms the scope of the BEPS project emphasizes the need of aligning the outcome of the TP analysis with the value creation. We think that the weighting factors such as production capacity, headcount and value of production depicted in Scenario 1 amended has to be carefully used and we would strongly recommend adding language that assures that the application of such allocation keys does not result in outcomes that are not consistent with the arm’s length principle.

In general we welcome the effort in trying to design rules that clarify the use of profit split methods in the context of global value chains, however we have to highlight the fact that the existent guidance on the application of the other TP methods, adequately reflects a lot of circumstances of current businesses and can be used to establish an arm’s length result in a transaction.

It is important to stress the fact that the integration of an operation in a multinational entity by no means implies the immediate application of a profit split method and also that the existence of a profit split method should not be interpreted as a redistribution tool, given that the more important part in our TP analysis is the adequate reward for the functions performed, assets involved and risks taken in the operation, not if the split of the global profits is made using a subjective criterion that could lead to double taxation in several cases.
The participation of IFA Grupo Mexicano, A.C. is made on its own behalf exclusively as an IFA Branch, and in no case in the name or on behalf of Central IFA or IFA as a whole.

We hope you find these comments interesting and useful. We remain yours for any questions or comments you may have.

Sincerely,

IFA Grupo Mexicano, A.C.
To: Andrew Hickman,
Head of Transfer Pricing Unit,
Centre for Tax Policy and Administration.

(sent via email to Transfer Pricing @oecd.org)

2nd February 2015

Dear Andrew,

**BEPS ACTION 10: THE USE OF PROFIT Splits IN THE CONTEXT OF GLOBAL VALUE CHAINS**

IHG welcomes the opportunity to submit comments on the above paper ('The Discussion Draft').

IHG is supportive of the BEPS Action Plan in general and of the specific Action 10 objective of developing 'rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to ...... clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains.'

We have had the benefit of seeing the submission which is being made by BIAC and support the overall comments being made by BIAC, including the detailed responses made to the questions raised in The Discussion Draft. These primarily concern matters of practical or other detail concerning the use of profit splits. The purpose of our submission is to provide some broader background comment concerning key business concerns and issues based on our experience.

In our view it would be helpful for there to be greater, or updated, guidance to help develop some of the principles set out in The Discussion Draft and help taxpayers and tax authorities determine and agree, for example:

1) Where a profit split approach is likely to be the only appropriate (i.e. acceptable) method;
2) Where the application of the principles set out in The Discussion Draft may add support to the use of alternative one-sided methods which contain profit split type features but fall short of a full profit split methodology [for example, because there is significant integration of revenue generating functions but not cost functions-or vice-versa]; and
3) What role a high level profit split review of value chains might play in sense checking the appropriateness of alternative one-sided approaches [i.e. on the basis that the most important aspect is whether outcomes bear a reasonable correspondence to value creation rather than, within bounds, the precise route by which that outcome is arrived at].

Our primary concern is that the use of profit split methods, in particular multi-sided profit split methods, is likely to be exceptionally problematic for taxpayers where that deviates significantly from the attribution bases used in the underlying accounting. In particular, where the profit-split methodology deviates significantly from the underlying attribution bases used for management reporting, we would
suggest that that is likely to be a strong indicator that the proposed profit split basis is inappropriate. We do however also have a concern that significant ambiguity or uncertainty concerning acceptable methods will lead to insoluble disputes between jurisdictions and resultant double taxation.

About IHG

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

IHG manages IHG® Rewards Club, the world’s first and largest hotel loyalty programme with over 82 million members worldwide. The programme was re-launched in July 2013, offering enhanced benefits for members including free internet across all hotels, globally.

IHG franchises, leases, manages or owns over 4,700 hotels and 697,000 guest rooms in nearly 100 countries, with almost 1,200 hotels in its development pipeline.

InterContinental Hotels Group PLC is the Group’s holding company and is incorporated in Great Britain and registered in England and Wales.

1. General Comments on The Discussion Draft

1.1. We note that the preliminary comments to The Discussion Draft provides some important comments which set the context of the work in The Discussion Draft as to help develop rules ‘to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties and scenarios where it may be more difficult to apply one-sided transfer pricing methods to determine transfer pricing outcomes which are line with value creation’. As indicated above, if this leads to the conclusion that there are certain categories of transactions or circumstances where the only appropriate method is a profit split method, then we consider that it is essential that as clear as possible guidelines are given to help identify where that conclusion applies.

1.2. We welcome and support the emphasis given in paragraph 3 of The Discussion Draft concerning the need to find the most appropriate method for a particular case, and the need to consider that in the context of a thorough factual and functional analysis. We also welcome the clear caveat given in paragraph 4 that the examples given should not be taken as implying that a profit split method is necessarily the most appropriate method in examples such as those given. We understand the examples to be intended instead to bring out some features and hallmarks which may lead to profit split being considered as a potentially appropriate method, and consider the issues which might arise if the method were used.

1.3. We understand a key hallmark for such consideration to be the extent of integration. We suggest that a useful distinction here might be between sequential integration of functions or activities (which may signify little more than the fact that those functions or activities form part of a single, coherent, value chain) and parallel integration. The latter is intended to signify functions or activities which either occur at the same point in the value chain, or in parallel across the whole value chain, and occur in a way which means that their attributable revenues or costs (or both) cannot be segregated other than by some form of allocation using an appropriate key. We understand the multisided business model/structural cross subsidy type of circumstance in Scenario 2 to provide an example of this type of circumstance.

1.4. We can understand that where there is this type of integration across both revenues and costs
there is, in effect, a form of partnership and a profit split may be an appropriate, or perhaps even the only appropriate, methodology. We feel that it may however be helpful to bring out what are (perhaps) more frequent circumstances which arise, where the parallel integration concerns only revenues, or only costs, and how the principles in The Discussion Draft may then support alternative types of method.

1.5. For example Scenario 8/question 28 considers circumstances where the use of a royalty may be appropriate (thus giving rise to a need to compute an appropriate rate). A royalty is of course a route for sharing revenues, in the same way as a commission based payment method does. In each case the entity earning the royalty or commission is however (after the development phase in the context of the relevant intangible property) likely to have its own separable cost base.

1.6. The converse may of course apply with respect to common cost bases from, for example, shared specialist service centres or regional or global functions. It seems consistent with the principles of The Discussion Draft that an allocation of costs using an appropriate key as part of, say, a Transactional Net Margin Method may form an appropriate method.

1.7. We note that even where there is a form of parallel integration across both revenues and costs, there may not be a precise (or even significant) correspondence between the entities which are integrated in terms of revenues and those which are integrated in terms of costs. One of the biggest concerns of business relates to the possibility of multi-party profit splits being required – as these are seen as likely to be unworkable in practise (for example because of the difficulty of achieving agreement between multiple tax authorities). It is however noted that the overlay of methods such as those described in 1.5 and 1.6 may achieve a similar result.

1.8. Whereas taxpayers will not want to conduct complex profit split calculations unnecessarily we do recognise that a high level sense check of profitability across the value chain can play a useful role.

1.9. We have drawn the distinction above between sequential and parallel integration and suggested that the latter is more likely to have integration features which require some form or revenue, cost, or profit split. We think it is also important however to draw a distinction between operational integration and strategic oversight of the type which regional or global management may perform. The latter will exist in all organisations and is a form of common due diligence, advisory and support service, of the type which may in appropriate circumstances be charged for in different ways (including under methods such as those described in 1.6 above). We are therefore concerned if normal strategic oversight and management structures might be seen as hallmarks suggesting some form of broader profit split might be appropriate. For example, the Leadership Board functions described in para 11 of The Discussion Draft seemed to comprise normal strategic oversight rather than indicators of more substantive and inseparable operational integration.

We hope that these comments are of constructive assistance to the OECD’s considerations. We would be pleased to expand on them further as necessary.

Yours faithfully,

C.P. Garwood
Head of Tax
Mr. Andrew Hickman  
Head of Transfer Pricing Unit,  
OECD Centre for Tax Policy and Administration  
2, rue André Pascal  
75775 Paris  

Submitted by Email to transferpricing@oecd.org  

6 February 2015  

Dear Mr. Hickman  

Submission in response to OECD Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains  

Please find enclosed our submission in response to the Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains that was released on 16 December 2014.  

The global business models addressed through the Discussion Draft broadly cover multinationals from all industry sectors. The future of the OECD guidance on the use of the profit split method has the ability to greatly affect Irish business with international operations. On behalf of our members, we submit comments in response to the commendable effort by the OECD to address a complex technical area of transfer pricing.  

We would like to thank Warren Novis and the Transfer Pricing team from KPMG Ireland for their assistance in preparing our submission and gathering input from members in the Irish Tax Institute.  

We are available for further discussion on any of the matters raised in our submission.  

Yours truly,  

Andrew Gallagher  
President  
Irish Tax Institute
Irish Tax Institute

Response to OECD Discussion Draft: Use of Profit Splits in the Context of Global Value Chains

February 2015
About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland’s AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.
Our response

The Irish Tax Institute is writing in response to the Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains, which the OECD released on 16 December 2014. We prepared this submission with consideration and input from a number of our members.

Introduction

Base Erosion and Profit Shifting (BEPS) Action 10 is broadly for the purpose of “assuring that transfer pricing outcomes are in line with value creation in the context of other high-risk transactions”. The Discussion Draft on profit splits was introduced as a consultation paper, with the objective to clarify the application of the transactional profit split method for globally integrated value chains. The draft primarily cites characteristics of global value chains, illustrated through nine scenarios. The OECD has asked for input on 32 questions linked to the issues and scenarios.

Each scenario invites tailored input on the application of a transactional profit split to the brief facts identified. It is understood that feedback on the Discussion Draft would be considered in revision of Chapter II of the OECD Transfer Pricing Guidelines for Multinational Enterprises (“the Guidelines”) and would help to clarify the application of profit split method in the context of global value chains. The OECD has emphasised the scenarios are illustrative on the points raised, and not meant to imply the profit split method is most appropriate.

We have chosen to provide both general comments and more tailored comments to the Discussion Draft that will address many of the specific questions raised on the scenarios.

A. General comments

There are core principles to selecting and applying the most appropriate transfer pricing method. A change to any core principle that may bias one method over another carries the risk of resulting in increased controversy. By featuring the profit split method apart from others in developing guidance for global value chains may be unreasonably interpreted by tax authorities to convey support by the OECD for increased use of this method. Greater controversy and double tax is a likely outcome where tax authorities apply methods that are not the most appropriate or apply profit split methods in unique and uncoordinated fashions. It should be the objective of this work to provide greater guidance that will result in greater consistency.

Scenarios to reflect real business models including risks and assets

The Discussion Draft provides examples of global business models to solicit guidance on how to determine if the profit split method may be the most appropriate solution. We consulted with business leaders across various sectors, and suggest that the brief facts in the nine scenarios illustrated are unlikely to occur in practice as currently drafted. It would be most helpful to represent illustrative facts on functions, risks and assets that reflect real business models. In particular, the scenarios should describe how the companies interact with each other.

An example of our concern is Scenario 4 where three companies research and develop products (two being components) seemingly with no co-ordination or common oversight amongst them. This might occur if the companies were to develop independent products, though highly unlikely in an integrated business. Within a globally integrated multinational, and between third parties, we would expect one of the parties to take lead responsibility (and risk) for the overall research and development.
Appling the arm’s length principle to any transaction, including global value chains, should follow the functions performed, risks borne and assets owned by each affiliate taking into account how third party transactions would be arranged. The Draft says (in para 7) “...where there is significant integration, involving parties to a specific transaction or transactions within that value chain, for example in the effective sharing of key functions and risks, the reliability of one-sided methods may be reduced”.

In this regard, the Draft limits the facts to functions performed with no mention of risks borne or intangibles assets owned in the value chain. The types of risks and intangible assets are often the most critical facts to select the most appropriate transfer pricing method, and particularly in order to select the transactional profit split method over other methods.

If consultations on transfer pricing of global value chains are to be beneficial, we recommend developing scenarios that reflect real business activity, address potential risks borne and assets owned in the value chain, and describe the interaction of the companies. We recognise the importance of providing greater certainty to taxpayers on circumstances where the profit split method might be appropriate, and welcome the guidance.

**Profit split consultation to co-ordinate with other Actions (Intangibles and Risk)**

Current business operating models and the allocation of income within some of those models have led to government concerns that have driven the BEPS Actions. A broad objective of the OECD is to ensure that transfer pricing outcomes are in line with “value creation”. In this case, the output of this initiative is to create enhanced guidance where the profit split method may be regarded as most appropriate to match income allocation in accordance with value creation.

The profit split method seeks to evaluate relative values that related parties contribute to a specific transaction, and allocate profit on that relative value. Such an approach corresponds with the BEPS objective that profit should be earned and taxed where the economic activity driving profit is undertaken. BEPS Action 8 (Transfer Pricing Aspects of Intangibles) seeks to refine the definition of intangible assets and to attribute the intangible return in accordance with the place where the economic activity takes place. Further, the work on Risk and Capital (Actions 8-10) is evaluating the proper allocation of risk, ensuring risks are appropriately attributed to the parties responsible for managing and controlling those key business risks.

We noted earlier that the Discussion Draft only describes scenarios identifying limited functions performed without covering risks or intangibles assets. It is clear that this Discussion Draft and any resulting recommendations should closely align with the work on Intangibles and Risk (above). The current language in the Guidelines note that contributions of unique intangibles and risk allocation may suggest the profit split method as most appropriate (paras 2.108-2.117). We suggest future draft papers focus specifically on providing clear guidance on the use of profit split methods to value chains where multiple parties contribute unique and valuable intangibles or share in the assumption of entrepreneurial risks.

**Expectation of consistent and fair application**

A key outcome of this initiative to revisit Chapters I-III of the Guidelines should be to ensure there is guidance that can achieve a consistent and fair application of the profit splits method in the context of globally integrated value chains or any multinational business model. An individual function that is valuable to a multinational business should not by itself suggest the party performing that function is entitled to share in a large pool of profits or to absorb losses.
Therefore, we strongly recommend the next phase of this initiative is to provide clearer guidance related to the selection of profit split methods, in order to ensure that tax authorities will fairly and consistently select, interpret and apply the most appropriate method based on the complete facts. Not achieving consistency or fairness will increase the level of international double taxation and place increased burden on Competent Authority resources.

B. Technical comments

Selection of the most appropriate method

The intent of this work is to provide guidance for the application (or not) of profit split methods in the context of global value chains. The Discussion Draft refers to the most appropriate method principle where the transfer pricing method applied must be the one that provides the most reliable measure of an arm’s length result for a particular case. The Draft re-iterates there should not be any implied change in this principle. While this is an important and useful comment in the Discussion Draft, we believe future papers need to include clearer, consistent and practical guidance to taxpayers and tax authorities on how the Guidelines might be evolving.

The selection of the most appropriate method should equally evaluate the five prescribed methods, and determine the most appropriate method using the framework described in the Guidelines. The Discussion Draft or other work should not be seen to favour profit splits against the application of other approaches, especially when it seems there are challenging comparability issues with other transfer pricing methods. If, however, the profit split method is most appropriate after full consideration of the strengths/weaknesses of the methods, then another method should not be chosen in its place.

Scenarios where profit split might not be appropriate

The purpose of the Draft focuses on identifying facts and circumstances in global value chains in order to clarify the application of profit split methods in those cases. There is risk in only providing direction about when and how taxpayers might apply profit split methods. It may lead certain readers to suppose a bias towards profit split methods, supported by the BEPS project. The exercise to generate guidelines needs to strike a balance so not to bias the analysis toward the use of the profit split but to a fair evaluation of the most appropriate method.

In order to provide fair guidance, the OECD should consider issues, and scenarios of business models, where the profit split method might not be appropriate or where it might not be reliably applied. Therefore, we recommend the scenarios are balanced to include a detailed discussion of facts (functions, risk and assets) where a profit split is likely most appropriate, and contrast with slightly different facts where a profit split is not likely most appropriate.

Data reliability to apply profit split method

The selection and application of any transfer pricing method is guided by the availability and reliability of data on how arm’s length parties conduct business. The Discussion Draft should clarify the relevant importance of data reliability as a critical factor to applying the profit split method to global value chains, in a manner that is both practical and consistent. Comparability issues generally exist in all methods. When there are comparability or data issues to apply other transfer pricing methods, there will likely be similar data availability or comparability issues to apply a profit split method. Therefore, the absence of reliable and comparable data for other transfer pricing methods should not imply a default choice to profit split as the most appropriate method for integrated value chains. The relative
reliability of the comparable data for the different methodologies needs to be simultaneously considered when selecting the most appropriate method.

Hence, we believe it is particularly important for the OECD Guidelines to ensure that the selection of a profit split method as the most appropriate method is not dissociated from an evaluation of whether the profit split method can be reliably applied. In other words, this evaluation should not be based on the absence of reliable or good comparables for other approaches and then default to using allocation keys which may not reflect the best indication of arm’s length pricing.

Subjectivity in allocation keys increases likelihood of disputes

If the profit split method is most appropriate to select, the method requires a formula, an allocation key, to share the profits between the parties. A critical step is the determination of the most reliable allocation key(s), in line with relative value contributions or observations of independent parties. In practice, it can be challenging to finding suitable allocation keys to reflect value contributions. The OECD Guidelines and certain tax authorities recognise and prefer objective data, such as headcount or compensation, as reliable and readily available. In our view, this data does not regularly provide reliable measures of value contributions because they largely represent functions or certain types of assets. It becomes a subjective exercise if the parties’ valuable contributions are a combination of functions, risks and assets.

Introducing subjectivity to the allocation of profits can foreseeably lead to bias views by interested parties, e.g. tax authorities. Consistency is certainly needed for the profit split method to be reliably implementable and accepted. It is critical to predict and find ways resolve potential disputes between taxpayers and tax authorities, as well as between tax authorities, on the allocation of profits.

Double tax relief can generally be available to taxpayers when there is a dispute on a transfer price between two jurisdictions. When profits are to be allocated to more than two companies in a global value chain, an adjustment by one tax authority may require double tax resolution with more than one counter party. An increase in the use of profit split methods to multi-party transactions may place significant complexity and strain on Competent Authority processes.

One sided methods

The Discussion Draft regularly refers to “one-sided” methods and how they may not be the most appropriate method for globally integrated business models. While a profit split is considered as a “two-sided” method and the transactional net margin method (TNMM) is a “one-sided” method, it is not clear what is more broadly meant by a “one-sided” method.

The Draft seems to imply that any method different from the profit split method is presumably “one-sided”, indicating where a one-sided method is not reliable, a profit split approach is likely to be most appropriate. In particular, paragraph 7 of the Draft frames the “one-sided” methods as inferior, lacking the ability to attribute reliable arm’s length outcomes to characteristics of a global value chain.

It would be helpful for the OECD to clarify its reference to “one-sided” method and acknowledge that potentially reduced reliability of “one-sided” transfer pricing methods does not imply that a profit split approach will be most appropriate.
Multiple-year issues

A section of the Discussion Draft highlights the possibility to use a profit split approach as an appropriate way to deal with situations where there may be significant differences between \textit{ex ante} and \textit{ex post} results or scenarios where losses arise. Multinationals may be concerned that profit splits, if viewed appropriate to the transaction, will be applied by tax authorities in a biased manner to tax profitable periods while disregarding loss-making years. Specific guidance would be welcome on the appropriate allocation of losses and treatment of loss-making companies when applying the profit split method.

Guidance should be developed in relation to the period(s) when and how profit split methods should be applied. In most business models, a profit split considering a single year is unlikely to achieve reliable results to measure business investment, e.g. intangible property development. Since most entrepreneurial actions and costs are undertaken for future gains, appropriate periods should be part of the profit split analysis.

C. Scenarios

The Discussion Draft outlines several conceptual issues related to the application of transactional profit split methods, furthered by nine scenarios in order to raise public input. Rather than provide specific commentary on each scenario and respond to each question, in this section we provide general comments.

- **Additional facts** - Several scenarios ask whether a profit split approach is most appropriate in the circumstances presented. A recommendation for all scenarios is to provide enough information (i.e. functions, assets and risks involved) for a relative evaluation of the different transfer pricing methods. In addition, the scenarios should also discuss considerations of fact that lead to the profit split approach as most appropriate over other methods.

- **Remove bias from scenarios** - The Draft notes the scenarios “\textit{have been provided to illustrate points for discussion only and should in no way be taken to imply that transactional profit split methods will be the most appropriate method in the circumstances outlined in those scenarios.}” However, it is not clear from the scenarios as drafted, if these were so phrased as not to illustrate facts where the profit split method will be viewed as most appropriate.

- **Relationship of parties** - Certain scenarios are unclear in distinguishing the relationship between the companies from a mere principal-contractor relationship and a joint venture/partnership arrangement. While many third parties render value added services, they are not automatically entitled to share in the residual profits of the principal entity. For example, in Scenario 2, the services provided by the subsidiaries of RCo might be valuable to the RCo Group and still be viewed as support services depending on the arm’s length allocation of risk.
Mr. Andrew Hickman,
Head of Transfer Pricing Unit,
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development

Accounting & Tax Committee
Japan Foreign Trade Council, Inc.

Comments on the Discussion Draft on
Action10 (the use of profit splits in the context of global value chains)
of the BEPS Action Plan

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. (JFTC) in response to the invitation to public comments by the OECD regarding the "BEPS Action 10: Discussion Draft on the use of profit splits in the context of global value chains," released on December 16, 2014.

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

General Comments

The transactional profit split method (PS method) is useful for highly integrated operations for which a one-sided transfer pricing method such as the transactional net margin method (TNMM) would not be appropriate, and we basically support the OECD's action with regard to evaluating complex high-level functions and risk-bearing relationships between MNE groups in such operations, and determining appropriate arm’s length prices.

But it would be a rush decision to conclude that the PS method should be applied proactively simply because activities between associated enterprises are
integrated or some functions that comparable companies do not have are performed. The TNMM or the other transfer pricing methods could be applied with a high degree of reliability even in such transactions. Taking into account that there is a difficulty in application of the PS method which has been pointed out in paragraph 2.114 and the other paragraphs of the current OECD Transfer Pricing Guidelines (difficulties such as inadequate calculation of combined revenue and selecting appropriate split factors) and large administrative burden on taxpayers, it is not appropriate to apply the PS method extensively to cases in which other transfer pricing methods could be applied.

Therefore, the PS method should be applied in cases in which related parties use the assets, undertake the functions, and assume the risks in a highly integrated and complex manner, and consequently it becomes impossible to find appropriate comparable transactions, or more specifically in cases in which parties to transactions between associated enterprises each possess key intangible assets that are unique and valuable. Care must be taken when applying the PS method in other cases. If the opinion of the tax authorities differs from that of the taxpayers, the burden of proof should be borne by the tax authorities.

In addition, whether or not the PS method is applied should be determined after considering the functions performed and risks assumed by the parties in MNE group in a comprehensive manner.

Specific Comments

Concerning Scenario 1

- It seems not to be necessary to apply the PS method in a way of splitting the profits between three OEMs simply because of their integrated activities. If the activities of each OEMs are similar to the one of comparable company, it may be appropriate to allocate each party the profit calculated by the TNMM.

  It is necessary to perform the functional and risk analysis of the whole parties including the Non-EU parent company, the contract manufacturing company and the distributing company, and to consider the activities of comparable when deciding whether the application of PS method is appropriate.

- Regarding Question 4, guidance would be necessary with regard to the method
for specifying the profits and losses (gross profit or operating profit) to be subject to profit splitting, and with regard to the method for selecting the key for profit splitting.

Concerning Scenario 2 (questions 5, 6)

- If the technologies developed and acquired by Company R produce non-routine return, the functions performed and of the risks assumed by its subsidiaries may be relatively insignificant. In such a case, we would consider it is appropriate to apply the TNMM testing subsidiaries’ profits and losses.

- Even in cases where technologies acquired initially by Company R have already become obsolescent, if subsidiaries only support Company R’s development activities to some extent, do not to generate their own new technologies, or do not assume development risk, we would consider it is appropriate to apply the TNMM testing each subsidiary.

- The profit split method would be appropriate only in the case where 1) technologies acquired initially by Company R have already become obsolescent, 2) subsidiaries undertakes development activities of new technologies at the same or similar level compared with Company R, which successfully achieves new technologies, and 3) subsidiaries assume the related development risk.

Concerning Scenario 3

- (regarding question 7) we support the use of "unique and valuable" as it is defined for intangibles for the term "unique and valuable contribution" in relation to the PS method.

- It could be interpreted that the profit split method is more appropriate as transfer pricing method in this transaction, but the judgment as to whether Company S is "not merely a routine distributor" and is a key source of competitive advantage for that company is quite difficult. If taxpayers recognize its role as “merely a routine distributor”, nevertheless tax authorities insist different argument, tax authorities should bear the burden of proof.

In deciding whether to apply the PS method in this scenario, the contributions of company S which sells high technology industrial equipment is highly
appreciated, but it is also necessary to consider from the aspect of the value creation in the Group whether the activities of company S are important compared with the value of equipment itself. It is described that customers place high value on the reliability and performance of the equipment also in this scenario.

If the contribution to value creation is relatively low, it is not always necessary to apply the PS method even though the activities of company S are not “merely a routine”. Moreover, if the information about the other company which operates similar activities is available, one-sided methods such as the TNMM could be applied.

Concerning Fragmentation

- It is not appropriate to apply the PS method based on the only fact of fragmentation. With regard to transactions in which no appropriate allocation key can be found, it would be appropriate to apply the other transfer pricing methods.

Concerning Scenario 5

- The potential lack of reliable comparables is referred to with regard to Scenario 5, but individual companies of the MNE group in this case are not considered to undertake unique and highly valuable activities which makes it impossible to select appropriate comparables. Therefore, we believe that it is possible to find highly reliable comparables for applying the other transfer pricing methods. Care should be taken not to reject the application of the other transfer pricing methods purely on the basis of there being a mix of local business and regional business.

- In view of this, the PS method should be considered only in cases in which it is impossible for reliable comparables to be selected.

- Profit splitting factors would have to be rational, objective, and quantitative. Since determining a standard split factor for all transactions would be difficult and extremely cumbersome from a practical standpoint, it would be appropriate to select them carefully for each transaction.

Aligning taxation with value creation
· It is difficult to determine the uniform profit splitting factors applicable to MNE because the process of its value creation varies from its industry or transaction. Eventually profit splitting factors have to be determined by transactions, and to avoid the conflict of view between tax payers and tax authorities, it is relevant that appropriate measures have to be determined with advanced mutual consultation between both parties by means of a process such as APA or more convenient one.

Concerning Scenario 6

· Since profit splitting factors vary according to the distinctive characteristics of industrial fields, it would be difficult to develop a common framework for conducting multifactor profit split analysis, and there is a risk that it could inadvertently give rise to double taxation. Given this, rather than conduct compulsory multifactor profit split analysis, it will be important to choose transfer pricing calculation methods based on considerations of transparency and simplicity.

Concerning Scenario 7

· If unanticipated results create circumstances that are not routine, the causal relationship between the residual profit split factors and the causes of the unanticipated results should be assessed and classified. If the relationship is close, there is no problem with using previously determined split factors, but if the relationship is weak, the split should be made in accordance with different factors.
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Toyota Tsusho Corporation
Yuasa Trading Co., Ltd.
To: Andrew Hickman, Head of Transfer Pricing Unit, Centre for Tax Policy and Administration
Date: 6 February 2015
Re: Comments to the OECD’s discussion draft on Action 10 of the BEPS Action Plan of 16 December 2014

Dear Andrew,

Here are my comments to the above draft. I will try to keep things brief, but will be happy to expand on any issues you require further information on.

My responses to the question posed in the paper are based on the following principles:

A. For transfer pricing purposes, I understand a value chain to mean the following. When following a supply chain from the setting up of a business strategy, through R&D, the acquisition of raw materials, manufacturing, marketing, distribution and sales, one tries to identify those functions which contribute most to the ultimate value of the product for the customer. A pair of jeans made by X may simply be seen as the hottest fashion item to wear; in that case those who have determined the design and marketing of those jeans are likely to have contributed most to the value of those jeans. Another pair of jeans made by Y, may be virtually indestructible, fire and water resistant, and yet comfortable to wear; here the R&D behind the jeans is likely to add the most value and – should the properties of these jeans be patented and unique – the jeans may require basic boiler plate design and little marketing to a very limited market (e.g. global fire departments) to achieve significant profits.

In addition, I assume a value chain for transfer pricing purposes to resemble a group of people knowing each other and deliberately deciding to cooperate with each other in an open, transparent fashion. I do not assume it to be e.g. a designer and a distributor deciding to cooperate, where they hire in R&D, marketing and sales functions from people whom they know very little of, and share no information with. In such a case, the TP value chain is created between the designer and the distributor, but it does not include the ones performing R&D, marketing or sales.

B. A profit split that is based on a (vertical) value chain analysis and referencing the full system profit created by that value chain (transparency), is more akin to the arm’s length principle, than the idea that cooperating unrelated parties would solely base their income expectations on the (horizontal) comparability studies described in chapter III of the guidelines (under the last example given under point A hereabove, this statement would apply to division of results between the designer and the distributor only).

In short, if a value chain generally creates an average system profit equal to a TNMM of 6%, an independent residual risk taker is unlikely to be prepared to compensate all low risk routine functions in that value chain a TNMM of 5%, just because that is what comparability studies say they should get: carrying virtually all the risk for a compensation that is 1% higher than the compensation of parties carrying little or virtually no risk, hardly seems worth the effort.

C. As stated, unrelated parties cooperating in a value chain will consider the system profit generated by that value chain when dividing the profit among themselves. Those who wish to take no risk, will have limited, if any, decision powers with regard to managing that risk; their share in the system profit will also be lowered down to the lower of the price for which their services can purchased in the market (the horizontal chapter III comparability analysis) or a share of the reasonably certain system profit of the value chain based on the prorated part of the value they contribute to the value chain. Should low risk takers in the value chain receive a higher compensation than would be expected from a chapter III comparability analysis, this will typically occur in higher than average profitably value chains where those low risk takers have a unique and valuable relationship with the residual risk takers.
D. The residual profit in the value chain will be split among the residual risk carriers in proportion to the risk they are prepared to carry. It is very unlikely to come across scenarios where a party accepting liability for 80% of the residual risk, will accept a compensation capped at 20% of the residual profit.

Outside of true principal structures, I believe that it will be the rule, rather than the exception, that value chains have more than one residual risk taking function and thus that the residual profit will be split over more than one function.

E. Residual profits and losses are not only split on the basis of the value of functions performed, but on the basis of the management of the risks created by those value creating functions. Taken to the extreme: it is not the people suggesting strategic decisions who are liable for and thus entitled to residual results. It is the people who hire the people making those suggestions and then deciding which of those strategic suggestions will be followed, who are entitled to the residual profit. The strategy deciders will base their decisions among others, on the risks they are prepared to manage and to bear which stem from these proposed and chosen strategies.

Based on the above, practically every value chain can be analysed into a residual profit split, where the low risk functions are compensated with a low, positive, value related, return for their contributions. These returns are based e.g. on CUP’s, cost plus, resale minus, or TNMM and the remaining results are split among the residual risk carriers based on the proportional risks carried and contributions made (in that order).

Answers to the paper’s questions

1. Yes. It can provide solutions to all scenarios, following the steps described above.
2. More information would primarily be required about the distribution among the OEM’s of the functions managing the residual risk.
3. Yes. That said, I see no reason why residual profit split should be limited to highly integrated value chains, as opposed to lowly integrated value chains.
4. Based on points A-E here above and on my answer to point 3, the question is whether there is a need for defining “unique and valuable”. I think the discussion ought rather to be if and when authorities can require a transactional profit split. In view of the administrative burden, the circumstances should be limited, e.g. to where it can be shown that a local tax payer is liable for residual risk. A party using a unique and valuable intangible but carrying no risk, or very limited risk only, may have no access to residual profits at all under arm’s length circumstances. E.g. as a hospital, I can hire the world’s best independent brain surgeon to perform an operation for a fixed fee without splitting the profits from charging for that operation with her or him.

12. Within a value chain, one sided methods would be more appropriate to i) those parties akin to the RandD, the marketing and the sales functions mentioned under the last example of point A above and ii) functions within the value chain which do not share in the residual risk.

14-16. I believe I provide answers to these questions under A-E hereabove: follow those who manage and bear the residual risk, and the extent to which they do so.

22. Identifying value can often be made a little more mechanical, using the following criteria. Compare the years of relevant experience, the level of compensation (adjust for geographical differences) and the relative position of persons within the chain of command. Value creating functions are more likely to be found in concentrations of a lot of relevant experience, high compensation and internal seniority.

25. I believe that the question is whether there is a need for a complicated, multi-factor analysis, or whether the predominant factor will always be the proportionate part of residual risk carried by a related party.

26. Risk assumed and managed.

27. Point D here above provides a first part of the answer (an ex-ante answer). Whether, and how that response will change in view of unanticipated results, depends on facts and circumstances, and the issues under point C may come into play as well. It would be necessary to know what caused those results, who was contractually
and actually responsible for the factors causing those results, whether and how those parties acted and whether they were hindered in their actions by other parties in the value chain. It would also be necessary to realise that unrelated parties will not wait until year end, or the time of preparing the tax returns, before taking action against the occurrence of unanticipated events/results. In addition the realistically available options to those unrelated parties would include continuing their activities with new unrelated parties or with products from unrelated parties. Such options would not always be available or explored by related parties and that lack of availability / action would require a separate pricing.

30. No, not that I am aware of. See point D here above.

Thank you for taking the time to read this. I am registering to attend the public consultation of 21 January 2015. Should you wish me to elaborate on any of my points at that meeting, I would be happy to do so.

Yours sincerely,

Johann H Müller

It is true that, in general, the transactional profit split (“PS”) method may be applicable to cases in which identifying comparable transactions is difficult and applying one-sided transfer pricing methods does not provide a solution. The PS method is one of the OECD-approved transfer pricing methods, and has been used by Japanese companies to deal with transactions in particular countries, including cases to which they have applied the method according to a mutual agreement obtained through a bilateral advance pricing arrangement. We have no intention of taking a position against the PS method per se, and basically welcome the refinement of the method.

The problem is that, as mentioned in paragraph 2.114 of the existing Guidelines, the PS method is difficult to apply, due partly to difficulty in accessing information on foreign affiliates and in measuring revenue and costs segmented by transaction. As MNEs’ value chains are increasingly complex and diverse, it is hard to determine the appropriate profit split factor, too. It should also be noted that, in the case of splitting profits generated in multiple countries, an adjustment by one country may affect other countries.

The Japanese business community is strongly concerned that the outcome of BEPS Action 10 may lead the application of the PS method to be readily expanded. Under the method, the prices of controlled transactions can be set from the perspective of value creation alone, without using comparables. If this approach prevails, the transfer pricing rules underpinned by the arm’s length principle will become ambiguous. Additionally, if tax administrations around the world unilaterally determine profit split factors at their discretion, double taxation will increase further. It goes without saying that formulary apportionment is unacceptable.
Accordingly, when considering the PS method, the following three points are of particular importance:

**Retain the most appropriate method approach**

It is overhasty to conclude, solely on account of the complexity of MNEs’ global value chains, that identifying comparable transactions is difficult and thus the PS method is the most appropriate method. For example, although the relationships among suppliers described in Scenario 5 of the public discussion draft appear intricate at first glance, not a few enterprises conduct their business in a similar fashion. In cases where reliable comparable transactions are available, the transactional net margin method (“TNMM”) and other one-sided methods still work effectively.

Suppose a clear determination cannot be made as to whether the TNMM should be used. Even in that case, if the taxpayer has taken into account the entire transaction value chain and other facts and thereby adjusted the range to a certain degree on the basis of the TNMM using additional factors, such an approach should be accepted. We believe that the application of the PS method should be considered only when the use of other possible methods has been examined and determined not appropriate.

We consider the following statement in paragraph 3 very important: “The separate discussion of the transactional profit split method in this discussion draft should not be taken to imply any change to this wider framework” (of paragraph 2.2 of the existing Guidelines that refers to the selection of the most appropriate transfer pricing method). This statement needs to be revisited.

It should also be noted that the most appropriate method referred to does not mean the one most appropriate for taxation. Therefore, the inconsistent selection of transfer pricing methods should be strictly refrained from. An example of such practice is, with regard to MNEs’ controlled transactions, applying the PS method to a case with combined profits for the purpose of levying taxes, while applying the TNMM to a case with combined losses for the purpose of artificially creating profits.

**Place emphasis on "unique and valuable" contributions**

Even if the role of the PS method is redefined, what is acceptable to us is the residual profit split method. In other words, core profits from transactions should be split only
among the parties who have made unique and valuable contributions to them; the parties
who have performed a mere routine function should be compensated only in an amount
commensurate with the level of that function. Another important matter here is that the
definition of the term “unique and valuable” in the context of profit splits should be
deemed the same as that in the context of intangibles, that is, being “not comparable . . .
and . . . expected to yield greater future economic benefits” as laid down in paragraph

Value intangibles in a right way

This is closely related to the second point. While the public discussion draft refers to
transactions involving intangibles as cases to which the PS method applies, we would
like to stress that, above all, importance should be attached to the legal ownership of
intangibles. In the process of analyzing functions performed for the development,
enhancement, maintenance, protection, and exploitation of the intangibles, the assets
used, and the risks assumed by the parties to the transactions, and the contributions
made in the development phase to the value of the intangibles should be clearly
distinguished from those made in the other phases. This is especially important to
manufacturers.

Suppose a parent company licenses intangibles it developed and legally owns to its
overseas subsidiary engaged in manufacturing end products. In that case, even if the
overseas subsidiary has enhanced the intangibles for purposes such as localization, such
enhancement constitutes nothing more than a mere ancillary activity, nor does it reduce
the original value of the intangibles. Even if new intangibles are created in ancillary
phases other than development, such enhancement should be required to satisfy multiple
conditions, including a unique and original contribution that can be seen in patents, the
possibility to be marketed as an independent product or technology, and the assumption
of product liability and other risks.

Due recognition should also be given to a difference in the level of contributions to
value creation between the development and marketing functions in the context of
operations of manufacturing companies. Basically, marketing is an activity that
produces a synergistic effect by building on development work and on the foundation it
has laid in the form of the product’s or service’s specifications, quality, price, and other
characteristics. As such, it is often the case that the marketing phase cannot be treated in
the same way as the development phase.
In connection with that, Scenario 3 of the public discussion draft warrants some comments. Although Company S may probably be said to make unique and valuable contributions to a certain extent by actively performing the marketing function, we cannot agree on valuing its contributions too highly. It is reasonable to think that a substantial portion of value creation in Group X stems from Company P’s extensive research and development activities.

Sincerely,

Subcommittee on Taxation
KEIDANREN
Comments on the Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

Professionals in the Global Transfer Pricing Services practice of KPMG welcome the opportunity to comment on the OECD’s Discussion Draft titled “BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains” (the “Discussion Draft”). KPMG commends the OECD for engaging the business community on the important and challenging issue of profit splits at an early stage.

General Comments:

KPMG has the following general comments on the Discussion Draft:

- The new guidance should not introduce an effective bias in favor of the transactional profit split method and against other methods, and in fact should recognize the significant difficulties that multilateral profit splits would create for resolution of double-tax issues, and the potential implications of contractual profit splits for other tax provisions;
- Examples of situations where profit splits might not be appropriate or where they might not be reliably applied will help clarify the application of profit split methods;
- The Discussion Draft should provide greater recognition to the fact that data reliability is an important factor in the application of a profit split method;
- The OECD should clarify what it means by “one-sided” approaches and also acknowledge that reduced reliability of such approaches need not imply that a profit split approach will be most appropriate; they still may be more reliable than profit split methods, especially if data reliability is a concern for the application of profit split methods.

Failure to clarify these fundamental principles related to the selection and application of the transactional profit split method will only lead to unnecessary increase in controversy, with tax authorities interpreting the scope and application of profit split methods differently.
Bias towards profit splits and against other methods:

The Discussion Draft intends to clarify the application of the transactional profit split method in the context of global value chains. It notes early on that the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case and that the separate discussion of the transactional profit split method in the Discussion Draft should not be taken to imply any change in this principle (paragraph 3). While this is an important and useful observation, KPMG believes that it needs to be clearly and consistently translated into practical guidance throughout the Discussion Draft.

The selection of the most appropriate transfer pricing method should carefully evaluate all recognized methods – profit splits and others. If a profit split method is the most appropriate then it should be selected, and if another approach is most appropriate, then that other approach should be selected. The Discussion Draft should not be viewed as being prejudiced in favor of the application of profit splits and against the application of other approaches.

For example, the Discussion Draft seems to suggest that an integrated supply chain should be analyzed under a profit split approach because individuals in various legal entities may contribute to business decisions affecting the business as a whole. It is very common for multinational organizations to take input from individuals geographically dispersed to ensure all interests and market conditions are factored into the decision making process. In its most extreme case, if a single individual who is based in Country B is part of an organization’s leadership team, otherwise based on Country A, which makes key decisions for the overall business, should this arrangement be priced under a profit split? If that individual is replaced with one in Country C, should a significant reallocation of profit be required? Or, alternatively, would pricing the individual’s contributions as a premium service be more appropriate and practical? Based on the Discussion Draft wording, tax authorities may try to apply profit splits to these type of situations, even when alternative methods may be more appropriate to deliver an arm’s length result.

The Discussion Draft also seems to introduce some ambiguity in distinguishing between a mere contractor relationship and a joint venture or partnership. Many third parties render high value added services in arm’s length dealings without being compensated based on the profits of the principal. For example, in Scenario 2, the services described, while certainly valuable to the parent company, could still be considered supportive in nature of the parent’s offerings. Alternatively, if the arrangement creates new demand for the parent, perhaps a commission-based compensation method would be more appropriate than a cost plus or a profit split. However, the Discussion Draft language may encourage tax authorities to apply the profit split method to many related-party subcontracting relationships without careful analysis of the services rendered. In contrast, the subcontracting arrangement described in Scenario 4 may better support a profit split approach given that the intangibles developed by Companies B and C are part of the core technology, and since Companies B and C do not merely perform R&D services, but each independently control their own research and development processes.
There are important practical reasons to avoid any bias towards profit split methods as well, notably the difficulties of resolving multilateral double-tax issues. Many scenarios in the Discussion Draft (such as the integrated supply chain) would imply that any profit split analysis be multilateral rather than simply bilateral. In such a case any double tax issue would be multilateral as well and require an effective multilateral mutual agreement procedure (“MAP”) process to resolve. Such a process simply does not exist, and the OECD’s efforts on dispute resolution do not promise to provide one in the foreseeable future. In addition, in a number of jurisdictions a contractual profit split arrangement with one or more related parties could be deemed to create a partnership under local tax rules, with resultant tax impacts and risks having nothing to do with transfer pricing.

**Examples of situations where profit split methods might not be appropriate:**

The objective of the discussion draft is to clarify the application of profit split methods – when they might be appropriate and how they might be applied. In order to provide the clearest guidance, the OECD should also provide examples of situations where profit splits might not be appropriate or where they might not be reliably applied. Not doing so will only provide a partial picture of profit split methods and may lead readers to presume a bias towards the application of profit split methods.

The Discussion Draft notes that the scenarios included in the Discussion Draft “have been provided to illustrate points for discussion only and should in no way be taken to imply that transactional profit split methods will be the most appropriate method in the circumstances outlined in those scenarios.” However, if not to illustrate circumstances in which profit splits will be the most appropriate, what is the purpose of the scenarios? If a profit split method may or may not be the most appropriate approach in the scenarios discussed, then the guidance will do nothing to further the cause of clarity in the application of transactional profit split methods unless the scenarios also include a clear discussion of circumstances in which a profit split approach might be the most appropriate and where it might not. Without the counterbalancing discussion of situations where a profit split might not be the most appropriate approach, the practical inference that interested parties are likely to draw from the scenarios is that they illustrate situations where a profit split method will be the most appropriate.

For example, Scenario 3 contemplates a situation where a distributor provides a significant competitive advantage to the manufacturer and therefore is not merely a “routine” distributor. The value of the distributor is primarily driven by its strong marketing efforts, connections with customers, proactive maintenance program (with the ability to detect problems before they arise) and its inventory of spare parts. The scenario seems to pit manufacturing IP and global marketing IP against local country marketing and customer-based intangibles. Notably, third party distributors often need to distinguish their services from those of their competitors in order to survive. Those distributors that have successfully distinguished themselves from the rest (e.g., having the strongest/largest distribution network in a particular region) are able to command a premium for their services. While these distributors may command a premium, they still typically are not viewed as splitting residual profits with the manufacturer. They may in fact provide appropriate comparables for a TNMM analysis. The concern is that there is no bright line between a “routine” distributor and a “non-routine”
distributor, such that tax authorities could easily latch onto any market differentiating activity to support a profit split approach, whereas a mere premium distribution return supported by appropriate comparables may be more appropriate. The Discussion Draft should provide guidance on distinguishing these situations.

**Importance of data reliability:**

The Discussion Draft should provide greater focus on data reliability as an important factor in the application of a profit split method. While good comparables might not exist for application of other approaches, data needed for application of a profit split method might not be reliably obtained either. Thus, lack of good comparables for other approaches should not imply that a profit split method will be the most appropriate method. The relative reliability of the data or comparables for the different approaches needs to be simultaneously considered.

Finding good allocation keys is critical for the application of a profit split method. While information on some commonly used allocation keys, such as headcount or compensation, may be relatively easily available, these may not be good measures of relative contributions. For example, the Discussion Draft seems to imply that a profit split may be the most appropriate method when both parties to the transaction make unique and valuable contributions, for which it may be difficult to find reliable comparables. However, the same factors that make it hard to find good comparables may make it equally hard or harder to apply profit splits. The only example in the draft, scenario 6, that provides a discussion of allocation keys defaults to a headcount-based allocation key (although it is not entirely clear from the example what exactly the allocation key is). Scenario 6 presents a RACI (Responsible, Accountable, Consulted and Informed) designation to assign responsibility to various people/entities, where the RACI designations themselves are subject to various interpretations (e.g., regarding the meaning of the different levels of responsibility). Once the RACI framework is made clearer, it may well be an appropriate framework for certain profit split analyses but is highly unlikely to be appropriate in all situations. With more heterogeneous contributions, finding good allocation keys might present an insurmountable challenge.

Hence, it is particularly important for the guidance to make sure that the selection of a profit split method as the most appropriate method is not divorced from an evaluation of whether the profit split method can be reliably applied. In other words, the presumption should not be to select a profit split method based on the absence of good comparables for other approaches and then default to using allocation keys such as headcount, which may provide an even less reliable indicator of an arm’s length result – and in fact if widely applied would be akin to a formulary approach. The selection of the most appropriate method should involve a relative evaluation of all the recognized approaches considering the reliability of information available to implement the approaches.
Clarification of “one-sided” methods:

The Discussion Draft makes references to “one-sided” methods and how they may not be relevant when there is interdependence of key functions and risks. While one could safely assume a profit split is a “two-sided” method and the transactional net margin method (TNMM) is a “one-sided” method, it is not clear what else the Discussion Draft means by a “one-sided” method. The Discussion Draft seems to imply that any method other than a profit split method is a “one-sided” method or, alternatively, whenever a one-sided method is not reliable, a transactional profit split method is likely to be most reliable. See, for example, paragraph 7, which states the following: “One-sided methods may not be able to account reliably for the interdependence of the key functions and risks, or for the synergies and benefits…In such cases the transactional profit split methods may be an appropriate means of determining an arm’s-length outcome, which takes into account the specific contributions of the parties to value creation.”

However, a product or royalty rate CUP is the result of negotiation between two sides, and is therefore “two-sided.” It is not a profit split method or a “one-sided” method. It may also be the most appropriate transfer pricing method when “one-sided” approaches that measure contributions of one party to the transaction only are not reliable. Similarly, an income approach that looks at the perspectives of the transferor and transferee may be hard to classify as “one-sided.” The OECD should clarify what it means by “one-sided” approaches and also acknowledge that reduced reliability of such approaches need not imply that a profit split approach will be most appropriate.

Comments on Scenarios and Questions Posed in the Discussion Draft:

The Discussion Draft considers several issues related to the application of transactional profit split methods, provides illustrative scenarios for each of the issues and poses some questions for public discussion related to the issues and scenarios. KPMG provides comments on the scenarios and questions in this section.

Several scenarios ask whether a profit split approach is the most appropriate one in the circumstances presented in the scenario. A comment that applies to all these scenarios is that the scenarios should provide enough information for a relative evaluation of the different recognized approaches. It is not sufficient to provide information that shows that a profit split method might be an appropriate method but the scenario should also discuss considerations that could lead to the conclusion that a profit split approach is the most appropriate one. The scenarios should, therefore, provide information needed to reach the conclusion that the other approaches would not lead to more reliable determinations of arm’s-length pricing.

We provide comments on each of the scenarios below:
Scenario 1:

Scenario 1 presents a case where there are three OEMs that share a Leadership Board and buy and sell components and finished goods among themselves. The example states that there is a high level of co-operation and interdependence between the OEMs and an effective pooling of entrepreneurial functions and risks. It also states that the alternative to a transactional profit split method in this case would involve pricing a complex web of transactions.

However, neither of these claims seems to be fully supported in the example. The complex web of transactions seems to refer to the purchase and sale of components and finished goods and the coordination of strategy at a high level – neither of which might constitute a complex web of transactions that would be difficult to price. Companies frequently buy from and sell products to each other and it might not be all that complex to price these transactions. Moreover, at arm’s length companies have complex and closely linked relationships without entering into profit split arrangements – as just one example automotive OEMS are often brought in by automotive companies at the very early stages of designing a new model as everything in the car has to work seamlessly together. But these is no expectation of sharing profits or losses and the independent OEMs could be perfectly appropriate comparables for similar related-party entities. Further, the “effective pooling of entrepreneurial functions and risks” seems to refer to the common Leadership Board. However, there is no mention of the functions performed by the OEMs outside of the Leadership Board, whether these are entrepreneurial in nature or involve risk-taking. Having certain high-level strategic functions in multiple entities should not in itself indicate that a profit split method will be most appropriate. It might be appropriate and not very complex to price the Leadership Board activities as premium services. While a profit split method may indeed be the most appropriate method under certain circumstances in scenario 1, other methods may be more appropriate under other circumstances.

Scenario 2:

In scenario 2, the parent company of a group provides a number of internet services (e.g., search engines, email services, advertising, etc.) to customers worldwide. It offers advertising services for a fee and other online services to customers free of charge. It has developed technology to collect and evaluate data obtained from its customers. The multinational group has local subsidiaries that promote the use of online services and advertising services to customers.

Given the facts in scenario 2, it is not clear that a profit split approach will be the most appropriate. The facts presented in the case could be consistent with the application of any of several approaches, including a CUP, TNMM or transactional profit split method. The parent company has developed and owns the technology intangibles. There is no discussion of availability of comparables to the transaction or to the function and risk profile of the local subsidiaries. The mere fact that the local subsidiaries provide value to the group does not in itself have any implications for the relative reliability of alternative methods.
The example should clearly state what facets of the activities or assets or risks of the local subsidiaries might increase the reliability of the profit split method and decrease the reliability of alternative methods such as the CUP or TNMM.

**Scenario 3:**

In this scenario Company P manufactures high technology industrial equipment and owns all the technology intangibles for the equipment. It also owns the global trademark and “provides broad guidance” to its subsidiaries on overall marketing strategy. Company S sells the equipment and undertakes marketing activities. It has developed close customer relationships and provides extensive advice to its customers, making it not just a “routine” distributor but one whose activities constitute a key source of competitive advantage for the MNE group.

This scenario is intended to illustrate the concept of “unique and valuable contributions.” The presumption in the example is that Company S is making unique and valuable contributions for which it needs a share of the group profits. We discuss several considerations related to “unique and valuable contributions” below.

First, should the contributions of Company S be considered unique and valuable? The example does not provide enough information as to why these are unique. The services listed in the example are not uncommon between third parties. Many distributors have close customer relationships and provide value-added services to their customers. The example should explain further why Company S’s contributions are so unique as to make it difficult to find reliable comparables. Based on the information provided in the example, the unique and valuable intangibles seem to be owned by Company P given the extensive R&D it performs to develop technology, its trademarks and its global marketing strategy.

Second, if the contributions are indeed “unique and valuable,” as defined in the Discussion Draft, is a transactional profit split method likely to be the most appropriate? Regarding the term “unique and valuable contributions” it is unclear how risk-taking fits into its definition. Does risk-taking contribute to the “competitive advantage” of the group as required by the definition of unique and valuable contributions? Risk-taking can lead to non-routine profits or losses, and thus provide a significant contribution to the overall group profits (or losses). The scenario is silent on the question of risk.

If contributions are indeed unique and valuable, other approaches might still be more appropriate. For example, if a contribution is “unique and valuable” and has a predictable expected cash flow, it could be priced using an income approach. If the unique and valuable contributions are difficult to price, then the application of a profit split method will also be hard since it will need a measure of the unique and valuable contributions which presumably are hard to measure.
Reiterating a point made earlier, the evaluation of the different methods is a relative one. While approaches other than the transactional profit split might be difficult to apply due to the difficulty of finding good comparables, profit split approaches might be even more difficult to apply in the case of unique and valuable contributions. The limitations on application of a profit split approach when contributions are unique and valuable may make it less reliable than other approaches. This is particularly true when contributions are very different in nature, for example, when one party controls risks whereas the other one contributes unique intangibles. It would be an oversimplification and not well founded in reality to imply that profit splits are likely to be the most appropriate method when both parties make unique and valuable contributions.

**Scenario 4:**

In this scenario, Company A manufactures and sells sophisticated medical equipment. It outsources the development and manufacture of certain key components to affiliates, Companies B and C. The components are highly specific to the equipment under development and unlikely to be useful in other types of products. Companies A, B and C each control and perform their own research, development and production processes.

If the facts in the example are true then a profit split method may indeed be the most appropriate. However, the facts of the example seem unlikely to occur in practice. Company A is the only one that manufactures and sells the finished product. In a multinational group (or in a third party situation, for that matter), it is highly unlikely that Companies A, B and C would go off on their own to develop products with no coordination or common oversight. That might result in a significant probability that the three parties would end up developing products, which while sophisticated in their own rights, wouldn’t function well together.

A likely scenario in the real world (and the one that we see in the case of automotive companies and first tier automotive OEMs as noted above) would be one where one of the parties is responsible for the overall development and contracts out the development and/or manufacture of components to others. If Company A is the entity responsible for the development of the complete product then it is more likely that Companies B and C would be viewed as contract service providers. A profit split approach would be unlikely to be the most appropriate method. There is a lack of reference to the contractual/business relationship among the various entities in this scenario. This is a case where a contract R&D arrangement could greatly simplify the transfer pricing analysis. Additionally, it should not have BEPS implications as long as the party that is bearing the risk has appropriate financial and decision-making substance.
**Fragmentation:**

The Discussion Draft notes that fragmentation of functions is common in an integrated value chain. It may involve, for example, the separation into different legal entities of logistics, warehousing, marketing, and sales functions into a value chain. Because of fragmentation, available data on similar independent transactions may generally not have a comparable mix of functions, assets and risks to the tested party or parties.

The discussion on fragmentation does not seem to add any clarity to the application of profit split methods and seems unnecessary. The example of fragmentation provided is one where logistics, warehousing, marketing and sales functions are separated into different legal entities within a value chain. However, none of these activities seems particularly unique or difficult to price in the market. The discussion makes no reference to valuable intangibles or key risks. If, for instance, a multinational group does have the fragmented functions mentioned above and certain unique and valuable intangibles, a profit split approach that splits profits between the intangibles and the fragmented functions would seem to be a clearly inappropriate method. The discussion on fragmentation does not seem to improve the general discussion of transactional profit split methods in any way. In fact, it might lead to greater uncertainty with tax authorities trying to impose profit split methods whenever there is fragmentation of functions in a multinational group – which is almost always.

**Scenario 5:**

In this scenario, an MNE group operates as a supplier of office stationary in a region. The activities of each operating company of the MNE involve selling to local customers, selling to regional customers with a local presence, and fulfilling orders placed with affiliates.

The stated objective of this scenario is to illustrate the potential lack of reliable comparables.

It is unclear why there needs to be an example solely for the purpose of illustrating the lack of comparables. The evaluation of whether (more) reliable comparables exist for the application of other approaches should be an integral part of the discussion of every example in the Discussion Draft. On the issue of potential lack of reliable comparables, the chosen example seems not to be a good example. The related party transaction appears to be cross-selling activities undertaken by the operating companies. It is not hard to envision finding comparables for the cross-sales activities undertaken. While there might be data-related challenges in isolating cross sales, those need not tilt the balance in favor of profit split methods. Without a much more detailed analysis of functions, assets and risks, it is hard to say what the most appropriate approach will be. For example, the cross-selling activities might be small or incidental to the local business of the operating companies. Pooling the profits of the different entities and splitting them up would likely not be the most appropriate approach in that case.
Reiterating a broader theme of this comments document, the OECD should be careful to avoid the implication that whenever there are cross-selling activities, a profit split approach will be the most appropriate. It should not allow tax authorities to conclude that if there are no good local comparables, something else must be used, without any real comparative analysis of reliability.

**Scenario 6:**

Scenario 6 describes a situation where Company A determines and controls the business and development strategy of the group, Company B determines and controls the global manufacturing strategy and Company C develops and owns the group’s IP.

The objective of the scenario is to illustrate the development of profit split factors such that transfer pricing outcomes are in line with value creation.

The scenario proposes an approach that splits the total group profits between Company A and Company B using a RACI responsibility matrix that considers which personnel were responsible for, accountable for, consulted in making or merely informed of relevant decisions. Companies A and B then provide arm’s-length remuneration from their shares to Company C for its IP, the local distributors and the manufacturing entity in country B using “one-sided” methods.

The following are several comments related to this scenario:

- The RACI matrix seems to include the entire universe of personnel in the two companies. Is the suggestion that all employees of the companies be included in the profit split determination? The accounts clerk who is merely informed of relevant decisions might not be a key value driver. The terms “responsible,” “accountable,” “consulted,” and “informed” can be interpreted in many different ways. As stated, the RACI framework in scenario 6 just looks like an arbitrary formulary approach. There is no particular economic reason to believe that these value drivers are all of equal importance in all cases. If the RACI matrix does indeed include the entire universe of employees, then a critical item in coming up with usable allocation keys is the weighting given to the different functions. The example is silent on the critical issue of weighting.

- While the scenario suggests a RACI framework, it does not discuss what the allocation keys are. Is it the number of people, somehow weighted, who are responsible for, accountable for, consulted in making or merely informed of “relevant decisions?” Or is it the compensation of those people? The scenario needs to discuss why the chosen allocation key is appropriate.

- While the allocation key is not explicitly specified, it appears to be based on headcount or something equivalent. Headcount is one of the most readily available allocation keys for
profit splits and this example is likely to simply reinforce the tendency of tax authorities and practitioners to default to simple headcount-based allocation keys. This is particularly troubling since another measure—compensation—is based on the same concept but often produces very different answers. To state the obvious, directing tax authorities to an allocation key that has two equally plausible measures that often leads to markedly difficult answers invites different tax authorities to take different positions, and thus encourages controversy. Moreover, the scenario treats the contribution of intangibles outside the profit split since reliable comparable transactions are available to price it. The example would be more illuminating in terms of demonstrating how objective allocation keys can be developed if the intangibles of Company C did not have reliable comparables and the scenario illustrated allocation keys other than headcount.

- The Discussion Draft notes that risks and assets are not considered separately because they are embedded in the processes that managed them. This statement seems to presume a particular—and extreme—ultimate outcome of the OECD’s separate effort on transfer pricing considerations related to risk and capital. This statement only serves to deflect the most challenging questions that arise in the application of profit splits—what are reliable allocation keys when the different parties make disparate contributions and how can those be implemented?

To conclude, for the profit split to have any relationship with the arm's-length principle, both the identification and the weighting of different drivers would have to be developed on a case by case basis based on the economics of the situation. Thus, a general comment on scenario 6 is that it would better serve the cause of clarity and certainty to discuss some important principles in developing objective allocation keys instead of coming up with a very specific framework that may not be practical to implement, which at best would be applicable in certain circumstances only and may lead to greater uncertainty through its misuse.

**Scenario 7:**

In this scenario two related parties jointly agree to share the development of a new product, with each party responsible for developing and manufacturing one of the two key components. At the outset, the parties estimate development costs to be $100 in total, with one party expected to incur $30 and the other $70. The parties manage their own cost overruns and agree that expected profits from the sale of new product will first be allocated to provide each party with a routine return on its manufacturing functions; with the residual profit and loss split 30/70 notwithstanding that the actual development costs may vary from what was projected.

The parties in this example seem to truly be in a joint venture relationship and a profit split approach seems appropriate. The scenario specifies how parties agree to share “expected” profits and we assume the scenario intends that the parties will share actual profits similarly.
Scenario 8:

In scenario 8, parent Company P licenses patent rights for a pharmaceutical product to its subsidiary Company S. Company S markets the product and contributes to late stage development. Company P performs all of the basic research and most of the development activities. The companies apply a profit split method using risk-weighted expenditures as the allocation key to determine a split of profits between Company P and Company S of 80:20. Company P’s expected profit from expected sales is then converted to a royalty rate on those sales. Thus, the transactional profit split method is used to calculate a royalty.

The use of a transactional profit split method to calculate a royalty can be reasonable. The OECD should also clarify why the royalty rate was not based on comparable agreements to start with since it is not uncommon to find third party licenses for pharmaceutical patents.

Scenario 9:

This scenario deals with a global dealing operation with three related participants. The companies share in the profits of the global dealing business based on a multi-factor allocation key, which includes trader compensation as one of the factors. However, while compensation may be a reliable indicator of contribution to profits, it is less reliable as an indicator of contribution to losses. The profit split approach, therefore, uses different mechanisms for allocating profits and losses.

In principle, it may be reasonable to split profits and losses using different mechanisms in certain circumstances although splitting losses in the same way as profits is a natural starting point. For example, there may be constraints such as the limitation of available funds to sustain losses or pharmaceutical licenses that explicitly shift risks for future R&D to another party. However, this does introduce a disparity in the risks assumed by the parties that has to be taken into account: if one party has the potential for incurring unlimited losses while the other party has its losses capped, the party bearing the unlimited losses would get a greater share of the upside than under an arrangement in which losses were shared equally. The mechanisms and the rationale behind the transfer pricing approach should be carefully explained upfront and there should be consistency between expected rewards and the risk of loss. The guidance should not add to uncertainty that tax authorities will disclaim losses but want a share in profits.

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About KPMG

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 155 countries and have more than 162,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.
Dear Mr Hickman,

We write in response to the request for comments on the Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains.

The comments that we have provided are answers to the questions the Discussion Draft poses to the reader. Please note for the comments we have provided to the scenarios, in relation to the selection of an appropriate transfer pricing method, our answers are based on the information provided in the Discussion Draft. However, in practice for each example a thorough functional analysis would need to be conducted to understand which transfer pricing method would be the most appropriate to select.

In general, we feel that the profit split method may be useful in the context of global value chains when the tested transaction has significant levels of integration which leads to the creation of synergies and/or sharing of sufficient levels of risk. In addition, the profit split method may be appropriate when a one-sided method cannot be reliably applied because of the lack of reliable comparables. In our opinion, the profit split should not be used as a default option, instead a thorough functional analysis should be conducted by analysing the functions, assets and risks of each of the parties in the controlled transaction before selecting an appropriate transfer pricing method.

The following comments are in relation to the questions posed to the reader in the Discussion Draft.

Scenario 1

1. For paragraph 9, it should be possible to find CUPs for the royalty payment because the European operation is largely independent from the parent. Therefore, the CUP method would be the expected choice for pricing the IP provided by the parent to the European operations. We also concur that a one-sided method would be the most likely way to price the contract manufacturing and distribution services.

For paragraph 11, the three Original Equipment Manufacturing enterprises (OEMs) interact in a highly integrated manner. The over-arching Leadership Board seems to be making the key entrepreneurial risk-taking (KERT) decisions. There seems to be a significant level of synergies and benefits between the three OEMs. Because the three OEMs are highly integrated, it seems unlikely that a suitable one-sided method can be applied to calculate the arm’s length price for the relevant functions carried out by the three OEMs. In this case, the profit split method may be a more suitable approach.
Across the value chain, the functions described in 9 would be carved out and remunerated using a suitable one sided method. For the functions described in 11, a suitable allocation key should be used to split the residual profit between the three OEMs.

2. A thorough functional analysis would help to understand the relationship between the different parties within the group. If suitable comparables are available then a one-sided method should be applied but if no suitable comparables are found then the residual profit split method may be appropriate. In this context the term ‘suitable comparable’ would encompass appropriately adjusted comparables within the terms of section A.6 (Chapter III: Comparability Analysis) of the guidelines.

3. The profit split method focuses on proportionally allocating the total value (measured by profits) created by a group into the respective areas that lead to the creation of value. This approach takes into account the synergies created by the interaction of different functions within a group. As such, it attempts to split the value created proportionally to the respective areas. Furthermore, if there are some functions that are exposed to a higher level of risk, the profit split method would allow a higher value to be allocated to such a function reflecting the principle that high risks would only be under taken when there is a high expected return. Consequently where functions are highly integrated or risks are shared in a commercial undertaking the profit split method is likely to offer a good solution for pricing controlled transactions at arm’s length.

4. When dealing with highly integrated functions, the total value created by the functions should be measured (for example profit would be a suitable measure of value). The total value created should be split proportionally according to the level of value created by each function by using a suitable allocation key. When analysing the risk functions in making a profit split calculation, careful consideration should be given to the nature of the risk, management of risk and the impact of the risk. Risk should not be considered on a standalone basis but considerations to the level of return should also be taken into account. The correlation between risks and the potential for diversifying risk overall, should not be ignored. In practice, one of the difficulties will usually be to find a suitable allocation key. For example, the number of employees is sometime cited as a suitable allocation key but this assumes that all employees contribute equally. Often this will not be the case, even within a set of employees all of whom perform ‘significant people functions’. The discipline of management accounting has much to say on the subject of keys for apportioning costs. The correlation between a possible key and the profile of respective value added may not always be clear. Some taxpayers will prefer to use the same keys as used in their management accounting systems, where available. For other taxpayers this may not be convenient, for example where the business perimeter of the profit split does not match that of management accounting profit centres.

Scenario 2

5. The services provided by Company R to the RCo Group seem to be unique and valuable. The RCo Group and Company R seem to be highly integrated and in order to account for the synergies created by the integrated activities a profit split method may be an appropriate method. In addition, the services provided by Company R are of a highly expert nature and it would be difficult to find suitable uncontrolled comparables. The profit split may be applied by splitting the advertisement revenues of the RCo Group by a suitable allocation key. An example of a suitable allocation key would be number of hours spent advertising versus number of hours spent by Company R on developing ideas. For the provision of services by subsidiaries to the RCo Group, there should be suitable reliable comparables for a one sided method to be considered.

6. To understand whether the profit split method is an appropriate method, the functions of Company R, the RCo Group and the subsidiaries should be analysed in great detail. The allocation of risks should be analysed in detail. Furthermore, functions should be analysed to determine the level of integration. A search on uncontrolled comparables should be carried to
find suitable comparables which reflect the relationships carried out by the tested parties. If the comparables do not reflect such functions and if suitable adjustments to the uncontrolled comparables cannot be made, a one sided method would not be appropriate.

Scenario 3

7. The “unique and valuable” definition in the Guidance on the Transfer Pricing Aspects of Intangibles report does help in defining the term in relation to the transactional profit split method. The key part of the definition is that “unique and valuable” contributions lead to difficulties in terms of finding reliable comparables. However, in our opinion “unique and valuable” should be defined to refer to intangible assets that give rise to returns over and above the normal returns associated with a given level of risk. Where a competitive advantage arises that gives rise to super-normal profits, beyond the short-term, then this element of the value chain may best be dealt with using a profit split.

8. To determine which method can be used to find the arm’s length price for the provision of services by Company S to Company P it is important to understand allocation of risk. The allocation of risk is useful to understand the degree of integration of the two entities. Furthermore, it is important to understand in greater detail the functions performed by the competitors of Group X and whether information on the marketing activities and R&D is available for the competitors. If the competitors are strong comparables and the entities within Group X are highly integrated, a comparable profit split may be an appropriate method.

9. In theory, a comparable profit split may be appropriate if the competitors to Group X are strong comparables. The comparable profit split should be applied to company P by splitting the profits in an identical manner to the profits of its competitors. For example, the provision of services by Company S could be determined by comparing the profit split in the competitor transactions for identical services. In practice, it is unlikely that information will be available in sufficient detail to produce a robust analysis.

10. An advantage of applying the comparable profit split method, if the comparable is identical, is that the method strongly reflects the value of Company S and therefore provides an accurate measure of profit. As stated above, a disadvantage is that finding strong comparables is difficult, this is because most businesses operate in a unique manner and it is difficult to calculate an accurate profit split for the controlled transaction using the comparable profit split method.

Scenario 4

11. In relation to scenario 4, it may be the case that even though the services provided by companies B and C are highly specific to the equipment under development, the functions it carries out are comparable to functions carried out by a comparable uncontrolled transaction. In such a case, the comparable uncontrolled transaction may provide to be a suitable comparable, perhaps by adjustment, even if the final product is significantly different. In addition to comparing the functions, the allocation of risk should be examined in the uncontrolled transaction and if the allocation of risk is comparable, a one-sided method may be more appropriate to determine the arm’s length price for the services provided by companies B and C to company A. If the allocation of risk is not comparable, using the transactional profit split may be a more appropriate method.

12. In our opinion, the profit split method should not be used as a default option. As noted above comparable uncontrolled transactions may provide suitable comparables. Even with adjustments the CUP method will often provide a more reliable result than a profit split, provided those adjustments are reasonable and can be made to eliminate the material effects of differences in comparability. The application of micro- and financial economics to provide such adjustments objectively should not be overlooked.
13. (See 11 and 12 above.)

14. In practice, it is common for a firm to have the ownership of intangibles in a singular location and develop, enhance, maintain, exploit and protect the intangibles in multiple locations. There may be cases where there is a high level of integration between the ownership entity and the other entities that make contributions to the intangibles in a unique and valuable manner. In such cases, it may be difficult to use a one sided method because reliable uncontrolled transactions may be difficult to obtain and therefore a transactional profit split method may be appropriate. Determining an appropriate allocation key for intangible transactions can be difficult and guidance should be given on appropriate allocation keys in relation to intangible transactions.

15. In our opinion, fragmentation does not necessarily imply that a profit split method should be used. A thorough functional analysis should be conducted to determine the functions, assets and risks of the various entities within the group. Using the functional analysis, a comparables search should be carried out and if only no reliable comparables are found, a transactional profit split method should be used to determine a reliable arm’s length price.

16. Care should be taken when assessing whether functions are actually fragmented. If functions are fragmented, an analysis should be conducted to determine the economic attributes of the fragmentation such as whether the fragmentation has led to lower synergies or a transfer of risk from one entity to another entity. These economic attributes should be analysed as part of the functional analysis. The functional analysis should be used to find suitable reliable comparable transactions. If no reliable comparable exists, the transactional profit split method should be adopted.

Scenario 5

17. Taxpayers may bifurcate their local and ‘global’ (or regional) business into two different transfer pricing policies. Transactions exhibiting a high degree of functional or risk integration may use a profit split. Those without such integration may use an alternative method, provided there is consistency in the treatment of common elements. For scenario 5, a functional analysis should be performed to analyse the assets, risks and functions of the transactions under examination. A comparable search should then be carried out by finding companies that carry out similar functions. A good place to start with comparables search would be to find industry competitors that carry out similar functions. The comparable search may be widened to include companies that are in different industries but carrying out similar functional activities. If financial/pricing information is available on comparable companies, it should be used to determine the arm’s length price using an appropriate one-sided method. In Scenario 5 it seems as though suitable comparables may be available, these comparables should be used to determine an arm’s length price using an appropriate one-sided method. Insofar as integration requires a profit split method this may be run separately. If the financial information is captured to enable such a bifurcation this may be a practical method. Where that is not the case taxpayers should not be required to develop reporting systems that are not commercially merited.

18. In Scenario 3, there are competitors to Group X that may have a similar functional profile. Since Company S provides services to Company P that are of highly integrated, leading to the creation of synergies, the comparable profit split method may be used to determine the arm’s length price. The comparable profit split method splits the profits of Group X in a comparable manner to its competitors. The comparable profit split method will take into account the synergies created in the transaction between Company S and Company P.

19. In Scenario 5, the functions performed need to be analysed in greater detail, in particular focusing on the allocation of risk and the integration of the functions. If there are companies that perform comparable functions to the tested transaction, they should be used as suitable comparables. If reliable comparables are difficult to find the transactional profit split method may be an appropriate method.
20. An example where such a method may be appropriate is where the operation margin of the tested transaction depends on another variable which is difficult to predict and is volatile. This may lead to several prices depending on the state of the transaction. An instance where such a pricing method may be appropriate is in the airline industry where the operating margin may vary significantly depending on the price of fuel.

21. A transactional profit split method may be used to support the approach used by a one-sided method. Suppose there is a transaction which is highly integrated and it is possible to find comparables that are reliable. The CUP method may be applied to find the arm’s length price in such a case. The transactional profit split method can be used to support the reliability of CUP method for the highly integrated transaction.

22. The guidance should be modified to help identify factors which reflect value creation. To determine value creation, the following should be considered:

   a. What are the risks involved in the transaction? Management of risk? Does taking high risk lead to creation of value for this transaction?
   b. How integrated are the entities in the transaction? Does the integration of functions lead to the creation of synergies?
   c. Does the transaction involve the creation of intangibles?
   d. Does the return arise more from the availability of risk capital, possibly at short notice, rather than the performance of labour functions?

23. To determine the weighting factor, consideration should be given to the value each factor contributes to the overall transaction. The weighting on each factor should strongly correlate with the value the respective factor contributes to the overall transaction. The economic analysis should show how any weighting factors used link back to the functional analysis, mapping to the respective functions, assets and risk and the respective importance of each. Matrices may be a convenient way of presenting this objectively.

Scenario 6

24. Using other approaches such as concepts based on bargaining power, options realistically available and a RACI (Responsible, Accountable, Consulted and Informed) type analysis of responsibilities and decision making can be used as part of the economic analysis to make suitable adjustments to comparables information or to improve the reliability of profit splitting factors. Other approaches help in providing a better understanding of the functions and should be used to provide a more accurate arm’s length price.

25. A framework within which to conduct an analysis is possible and would usefully serve as a standard approach. However this should in no way restrict the analysis itself nor the policy implementation. We agree that each global value chain is distinctive and the idea that a common approach may be expected, even within the same industry, should not be a priori assumption.

26. There will be many aspects here, but we would like to focus on one in particular. Valuable intangibles are likely to have a useful life and yield returns which will be uncertain. These may be assessed but outcomes can be volatile and therefore hard to predict. The degree to which keys in profit splits relate to exploitation functions (and to a degree maintenance, enhancement and protection functions, perhaps also development functions) may need to be frequently amended to align with commercial reality. Tax administrations usually prefer consistency between years and this is likely to create compliance tensions.
Scenario 7

27. The relationship between connected parties in a profit split should reflect the equivalent relationships between independent parties. For unanticipated result such as an unexpected gain or loss, the unanticipated result should be examined and if the source of the result is due to the behaviour of a specific party, the unanticipated result should be allocated to that particular party. This should be the case insofar as this reflects observable behaviour between independent parties. If the source of the unanticipated result is due to multiple causes, then the allocation of similar outcomes between third parties, where available, should be considered. Where it is not available then an analysis of rational commercial decision making between independent parties should be carried out using the principle of financial or micro-economics. In practice it is quite common for third parties to share profit and losses on the same basis.

Scenario 8

28. In Scenario 8 it is helpful to use the profit split method to calculate the royalty. It would seem unlikely that a CUP could be found to price the transaction between Company P and Company S. The advantages of using the profit split method is that the price is entirely based on analysing the controlled transaction since no comparison is made to uncontrolled transactions. Therefore using the profit split method takes into account the functions, risks and assets only of the transaction being analysed and the price determined is entirely based on these attributes. The disadvantage of converting to a royalty rate is that this may not result in the same outcome as applying a profit split outright. However this reflects the way that independent businesses set, or test, their prices. It is an inherent business risk that erroneous predictions used in setting prices may result in a loss. Clearly their (asymmetrical) information position is different. In practice taxpayers sometimes revisit an unexpected outcome and ‘true-up’ the result according to actual outcomes. While this can be a feature of third party agreements it is not very common. We are certainly not in favour of amending the current guidelines regarding the use of hindsight (e.g. paragraphs 2.11, 2.130, 3.74).

Scenario 9

29. As mentioned above, where the loss is caused by one party to a profit split in a manner that breaks the integrated nature of the business it may be appropriate to allocate the loss to that location. For example, where a trader has acted beyond his or her authority according to the integrated trading rules and local management have failed to apply appropriate controls.

30. In joint venture agreements where there is an unequal contribution of capital, or other resources, the expected financial outcome is sometimes rebalanced by the party contributing less to earn lower profits or bear losses disproportionately.

31. In our opinion, the points mentioned in relation to practical difficulties in applying the transactional profit split method in paragraph 2.114 of the Guidelines still remain relevant. We have outlined some of the other practical difficulties in applying the transactional profit split method above. In particular we emphasise the challenge of determining suitable allocation keys. Monitoring the allocation key leads to an increase in the compliance burden and therefore when selecting an allocation key, practicality of validating and monitoring the allocation key should be taken into account.

32. One further issue is the reward to capital in applying profit splits. This also lies in the scope of the risk consultation on revisions to Chapter 1 of the guidelines. The degree to which a return to capital, or a ‘funding charge’, is a legitimate expense in determining residual profit and how capital should be measured where it is used as an allocation key are subjects that warrant further guidance.
Should you wish to discuss any of our comments we remain at your disposal. Please contact the undersigned.

Yours sincerely

Martin Zetter
Head of Transfer Pricing and Senior Economist
on behalf of Macfarlanes LLP

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Comments on BEPS action 10: Profit Splits in the context of Global Value chains

Dear Andrew,

MEDEF is pleased to provide comments on the Discussion Draft “Profit Split in the context of Global value chains” issued on the 16th December (hereafter “the draft”).

French companies consider OECD’s work in general and BEPS Action Plan in particular as crucial if it is to provide a fair, competitive and coherent global fiscal landscape. The forthcoming changes are numerous and will have a gigantic impact on the running of their business. Companies are in the best position to identify difficulties related to implementation, to give feedback on the practical feasibility and to geographically and temporally assess the OECD proposals. They believe, however, that the operating mode, process and time-frame are inadequate to ensure a full and comprehensive analysis of the draft submitted for consultation. They regret the strengthening of this trend which will be detrimental to all: companies and Governments.

Our comments are mainly focused on the main concepts that are dealt with in the draft and on some scenarios that we have chosen according to their specificities.

We hope our contribution will give you a clearer insight into our expectations and remain at your disposal for further information.

Yours sincerely,
Vanessa de Saint-Blanquat
General Comments

On profit split

We agree with the mention that transactional profit split methods should not be regarded as the most appropriate method in the proposed scenarios. Far from being an easy method to adopt when other methods cannot be used, profit split is a more complex and subjective method in practice.

According to chapter II, profit split offers a solution “for highly integrated operations” and “cases where both parties to a transaction make unique and valuable contributions.”

Profit split is complex to use and heavy to document:
- It implies the analysis of two associated entities that are both entrepreneurs or whose activity is highly integrated
- The contribution analysis includes gathering a lot of non-accounting data and a large amount of qualitative information that could lead to discussion;
- This heavy work must be documented in voluminous descriptions and appendixes.

It must be reserved for specific cases with significant amounts at stake and result from a deep functional analysis.

On global value chain

Value chain is a very useful instrument for tax authorities to understand the way an MNE conducts its business. Indeed it facilitates the understanding business and industries specificities. However, it is hardly a tool for conducting a functional analysis on a particular transaction.

From a business perspective, global value chain:
- Is complex as it describes the activities of all the entities with the valuation of the role of each one;
- Is changing in time because the perimeter and the list of entities (acquisitions, mergers,..) varies, as well as the business model and organisation;
- Is more qualitative than quantitative: the value affected to the part played by each entity is of a qualitative nature and can be translated into figures mainly as percentages or expected returns for the routine functions;
- Besides, including ex-post financial accounting figures in the value chain has no meaning because those figures result from the actual activity depending on external factors and not from the mere strategy of the MNE.

Profit split in the context of global value chains
The use of profit split in the context of value chain in transfer pricing analysis should not lead to a type of formulary apportionment. Par. 7 of the draft mentions that: “one-sided methods may not be able to account reliably for the interdependence of key functions and risks, or for the synergies and benefits created by such integration”.

By construction the value chain presents the whole MNE as a set of interrelated functions and risks and some could be tempted to state that every entity of the MNE is entitled to the synergies and benefits created by such integration. If so, routine entities would receive a bonus remuneration that an independent entity would not receive in similar conditions.

Profit split should then be used only in the restricted cases as mentioned above and this usage must not be influenced by global considerations on the value chain.

Scenarios
Scenario 1
The scenario describes a case involving associated entities working in parallel (i.e. doing the same job in different regions) instead of the typical case of two entities assuming different functions along a value chain.

We believe residual profit split will not generally be the most appropriate method because the fields (regions) covered by each entity are different so that exchange of functions and risks will be limited and valuable.

We are concerned that the existence of co-operation, interdependence, pooling of functions and risks be considered as the main criteria for the potential use of profit split methods. MNEs do not usually like profit split methods since they are very subjective, difficult to document and easily challengeable by Tax authorities. So it would be absurd that Groups start limiting their co-operation or their pooling of interests to reduce the risks of having their TP policy challenged by tax authorities that could favor profit split methods. A profit split method should be used if the functional analysis justifies such method and not by default or as a method of last resort.

Scenario 3
A distributor of high technology equipment can be expected to offer premium quality service to its customers. However high is the quality of such service a distributor remains a distributor. Its competitive advantage will be that of a distributor separate from the competitive advantage of the manufacturer. A “unique & valuable” asset in that case would not apply. Therefore we see no necessity to opt for profit split.

Integration and sharing of risks (§22)
We share the position that (residual) profit split methods are usually more appropriate in highly integrated businesses (global financial trading operations) than in decentralised businesses. However it is key not to consider that the mere existence of “strategic risks jointly managed and controlled by more than one enterprise in the group, creating a strong interdependence of key functions and risks between the parties” justifies the use of a profit split method.
Indeed for risk management purposes, most MNE have a centralized risk management function and several entities can intervene in this management. Some entities can set up the risks policy (at Group, business lines, or regional’s level), others can effectively manage the risk on a day to day basis, others can control that the risks policy is well implemented. Since many key functions (like risk management) are managed at different levels of the organization, this cooperation should not be the criteria for applying a profit split method.

The profit split is more appropriate when several operational teams work together on the same product or vis à vis the same customer. When a sales/originator and a trader work together to sell a hedge to an end customer, a profit split can be appropriate because both are entrepreneurs and required to generate the same P&L. This is different from internal functions teams which intervene in the risk management process of a MNE but are not entrepreneurs and do not generate any P&L and are not supposed to generate any P&L but only to keep the risks under control either by setting up the necessary framework or by controlling the appropriate implementation.

Scenario 5
The case described is a very common case in business: global/regional manufacturers deal with global/regional customers on a global procurement agreement as local entities sell & purchase local quantities according to general conditions.
For us it is not a case of profit split as the activity of global buying and local procurement is distinct and can be assessed by traditional methods.

Aligning taxation with value creation
This statement is a basic principle of the BEPS exercise. It must be understood as a general principle disallowing profit shifting through declaring incorrect profit in some places.
It should not be regarded as a criterion to elect the most appropriate method. If so the method to be elected would be formulary apportionment, which we strongly contest.
Each of the five methods proposed in chapter II will meet the requirement of aligning taxation with value creation as long as it is the most appropriate and it is properly applied.
So we do not think that profit split should be mentioned as the first and only method to satisfy this principle as in § 34.
Discussion Draft on BEPS Action 10: Use of Profit Split in the Context of Global Value Chains

Comments by NERA Economic Consulting

Dear Mr. Hickman,

NERA is pleased to comment on the important question of using profit splits to “Assure that transfer pricing outcomes are in line with value creation” in the context of “other high-risk transactions” of the BEPS Action Plan. NERA wishes to thank you for the opportunity to provide comments on the Working Party No. 6 Discussion Draft dated 16 December 2014.

The Discussion Draft does an admirable job to identify and describe a broad range of potential situations where a transactional profit split method or some variant thereof might guide taxpayers and tax authorities in determining a transfer pricing outcome consistent with the arm’s length standard and the underlying economics of value creation. The “scenarios” identified in the Draft are wide-ranging and provocative, as are many of the hypothesized methods proposed to be applied in determining an arm’s length result based on applying the profit split method. This being said, whether they are called scenarios or examples, illustrations of this kind should always be recognized for what they are: simplified, hypothetical case situations. The challenge in judging the arm’s length character of related party transactions in a specific real-life situation is in the first place in establishing the relations between the parties of which the transactions are the expression.

We believe that profit split methods will play a critical role in OECD’s realization of its BEPS objectives and that the consequences of establishing a proper framework for profit splits consistent with the arm’s length standard and the principles of value creation are profound in terms of promoting both underlying tax principles and global economic efficiency. Accordingly, we applaud OECD in its ongoing review of the role of profit splits in future transfer pricing policy and their implications for the overall structure of global transfer pricing regimes, policies, methods, and documentation standards.

Historically, profit split methods have come to be recognized more prominently in transfer pricing guidance only recently, beginning with the revised US Section 482 regulations in 1994 and the subsequent OECD Guidelines published in 1995. The development of the residual profit split method (RPSM), in particular, which arguably was articulated initially in the 1988 U.S. Treasury White Paper1, provided the needed integration between “one-sided” transactional

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1 Treasury Department & Internal Revenue Service, “A Study of Intercompany Pricing,” October 18, 1988, pp. 99-102. Available at http://www.archive.org/stream/studyofintercomp00unit#page/n21/mode/2up. See also Eli Lilly & Co. vs. Commissioner, 84 T.C. 996, 1151-67 (1985), wherein the Tax Court applied RPSM to
methods to value functions and risks for which suitable independent transactions are available as comparators and inherently “two-sided” transactional methods for which such external evidence is absent or unreliable. And while the 2010 revisions to Chapters I-III of OECD’s Transfer Pricing Guidelines have upgraded the profit split method from a “method of last resort” to one of equal stature with other one-sided methods, depending upon the transactional circumstances and available alternatives, OECD’s guidance on its applicability and mode of application still remains relatively vague and tenuous. The BEPS initiative provides an opportunity to revisit these provisions and to strengthen them in light of what is referred to as the “digital economy” and in response to perceived abuses or ambiguities that may be addressed thereby.

In this regard, an important consideration is the degree to which tax administrations may need and indeed require consolidated value chain data in order to ascertain potential profit anomalies that are at variance with arm’s length principles and the economics of value creation. The underlying theoretical basis for such requirements is the economic theory of the firm, which recognizes the fundamental joint nature of collaboration between a firm’s participants in combining their talents and resources to create value in excess of what they are able to achieve as separate economic agents.\(^2\) The effect of the digital economy is the intensification and fragmentation of that collaboration, rendering integrated business models more prominent, entities more and more interchangeable, and the location of activities less and less fixed, permanent or even traceable.

Yet, country-by-country reporting of MNCs financial results, as proposed in the Discussion Draft in response to the BEPS Action Item 13, should not be viewed as a proxy or a substitute for value chain analysis. Value chain analysis focuses on the series of related-party transactions that lead to the ultimate arm’s length transaction at a given destination (e.g., specific geographical market, customer group, etc.) while country-by-country reporting provides financial results for one or several legal entities located in specific territories and will, in most cases, reflect a multitude of diverse and potentially unrelated transactions.

It should not be presumed, however, that application of the value chain analysis to intercompany transactions will inevitably lead to a broader use of profit split methods. One-sided methods do have their proper place in circumstances where the relationships between related parties are sufficiently proximate to independent third-party transactions for such transactions to be reliably probative as comparators (including the cases when sufficiently reliable adjustments can be made to account for the differences between related-party and arm’s length transactions). The pricing of intercompany transactions in accordance with the principles of value creation should take into account the joint venture nature of integrated

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undertakings within a firm whenever such joint venture relationships are evident, such as in cases when all parties to the transaction provide valuable non-routine contributions or create synergies through group activities.

OECD’s January 2014 *Discussion Draft on Transfer Pricing Documentation and CbC Reporting* would require disclosure of consolidated financial statement information together with country-by-country reporting of revenues, earnings, assets, employee headcount, and intercompany payments and receipts, although not necessarily at a segmented level for individual value chains or identifiable business segments. While one cannot predict with any certainty the extent to which such requirements may be implemented or enforced in the future, it seems clear that the role of profit splits will continue to expand under the OECD BEPS initiative. The immediate question is what additional guidance may be needed to facilitate proper application of profit split principles so as to avoid opportunistic profit allocations and tax incentives that are ultimately inefficient or counter-productive. The 1988 Treasury White Paper articulated in this respect:

“There are, therefore, two types of arm’s length transactions to consider - - one in which the parties remain independent and another in which the two parties make an arm’s length agreement to affiliate by merger, joint venture, acquisition, or simply through the hiring of local labor and capital within a subsidiary. Restricting attention to transactions between parties that remain unrelated can fail to accomplish the objective of allocating to each party its contribution to income, if such transactions do not accurately reflect the actual relations between the related parties.

“Another way of describing the arm’s length agreements that have to be considered is to say that they are the arrangements that would be made between unrelated parties if they could choose to have the costs of related parties - - i.e., to use the related party technology. In general, tax rules should distort business decisions as little as possible because rules that minimize such distortions will lead to the greatest possible production efficiency. Transfer pricing rules will allow the most efficient production technology to come to the fore if, holding the cost functions constant, they result in the same tax burdens whether or not the parties are related. In other words, if unrelated parties somehow had access to the technology available to related parties, their operations should not result in more or less total taxes than would be paid by a multinational using this technology. The difficulty, of course, is

\[3 \text{ Cf. Annexes I-III of the Discussion Draft.}\]
NERA proposes that the above observations are an appropriate lens for OECD in its examination of potential solutions to the numerous and varied scenarios presented in the December 2014 Discussion Draft. That implies taking as a starting point the relations between parties involved in a joint value creation (“cohesive business operations” in the wording of the discussion draft for BEPS Action 7) prior to mapping the role of individual entities and to identifying relevant transactions. We summarize the scenarios briefly as follows, with an understanding that considerably more attention is required as the Working Party No. 6 dialogue continues on this topic.

**Scenario 1** posits a multi-country trading situation wherein conventional technology intangibles have been licensed-in by all parties, and the trading partners create incremental value primarily through entrepreneurial decisions concerning their product portfolios, strategic marketing, and similar choices. Conventional entrepreneurial profit drivers like R&D and advertising are assumed to be relatively unimportant as success factors as compared with other business management factors that are arguably less self-evident or objectively measured. The question is whether or not transactional profit split methods are applicable in such situations and, if so, what allocation methods are most appropriate. One such method described later in the Discussion Draft (paragraph 37) suggests applying a three-factor formula based on production capacity, headcount, and value of production to divide the post-royalty residual profits of the parties. Viewed from the perspective of value creation and the arm’s length standard, such a three-factor formula approach might capture the relative entrepreneurial contributions appropriately, but this would need to be a finding of fact and not an *a priori* condition or safe harbor. A deeper understanding of the relevant success factors and their drivers is needed, again from a value chain and value creation perspective, to elucidate the relative entrepreneurial contributions within the group and to enable an objective determination consistent with RPSM principles. OECD guidance and examples concerning processes for evaluating and documenting the relevant weightings in such a contribution analysis (*i.e.*, the contribution to a joint value creation by each of the parties involved) would be welcome. These could include, for example, guidance on how to infer value contributions based on salary and bonus compensation arrangements that leverages evidence from labor markets. Another such area where guidance would be helpful is in establishing objective factors based on expert surveys and similar assessments by personnel with relevant knowledge and understanding of the value creation process within the given organization.

**Scenario 2** describes an internet services business that combines a sophisticated global technology platform with locally developed adaptations and demand generation activities. If a transaction profit split method is to be applied in this situation, the challenge is how to value the relative contributions of the parties, consisting of relatively long-duration investments in the overall global platform, on the one hand, and comparatively short-duration local marketing and

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local adaptations on the other. Unlike Scenario 1, the nexus between entrepreneurial investment outlays and their realization in terms of software functionality and sales revenues is visible and in principle measurable consistent with RPSM principles applicable in other industries. This would include, as with any RPSM application, a possible determination that the functions and risks undertaken by the local subsidiaries can be reliably benchmarked using one-sided methods in place of the RPSM. A comparable profit split method based on internal transactions with third-party local service providers may also be relevant if such transactions exist and are sufficiently comparable to the related party transactions.

Scenario 3 highlights the concept of “unique and valuable intangibles” as being an essential feature of bilateral (or even multilateral) transactional profit split applications, and it questions how such contributions are most appropriately defined. In practice, the conventional “litmus test” for determining entrepreneurial, non-routine contributions is whether or not the contributions in question can be evaluated reliably based on third-party evidence from one-sided transactions. This is a facts and circumstances test that is ultimately a matter of judgment based on the available evidence and the availability of suitable comparators. Future guidance could emphasize the significance of this distinction and factors to consider in establishing findings with respect to it.

Scenario 4 posits a similar situation in which the different entities within a multinational enterprise (MNE) share in development risks in an integrated value chain. A transactional profit split approach seems appropriate, based on the joint venture analogy and the entrepreneurial nature of the underlying risks undertaken by each party. The discussion following Scenario 4 goes on to pose a related question of whether or not a high degree of integration in terms of functions, assets, and/or risks in the context of a fragmented value chain structure within a MNE is not sufficient rationale to employ a transactional profit split method in lieu of one-sided transactional methods. The RPSM using a return on assets approach to evaluating “routine” or “functional” rewards prior to allocating the residual profits or losses attributed to entrepreneurial contributions is currently the leading paradigm for determining arm’s length results in such situations. Since all relevant value chain assets, functions, and risks are accounted for in this approach, it appropriately addresses “the broader context of the MNE group’s business operations… and their contribution to value creation” in a value chain context. It also takes into account the economies of integration, scale, and scope that are achieved by the parties and rewards each party in proportion to its value contribution, consistent with the underlying tax policy objectives outlined above. Future guidance should consider the appropriateness of establishing “routine” or functional returns based exclusively on localized country-by-country profit level indicators (PLIs) and associated arm’s length ranges or if these indicators need to be aligned across countries and under what circumstances such alignment is indicated to ensure an overall arm’s length result.5

5 See section 10.4 of “Profit Split Methods,” Chapter 10 in the Practical Guide to U.S. Transfer Pricing (Lexis Nexis) for additional perspectives on this.
Scenario 5 posits a similar problematic situation for potential application of a transactional profit split method where reliable comparators are not available for evaluating functions and risks that ordinarily might be treated as routine contributions. In the example given, a global supplier of stationary has a mix of local and regional business relationships in each of several countries, and the mix varies year to year making one-sided methods impractical or unreliable in application. Assuming, further, that the business operations are predominantly routine, so that entrepreneurial profits are relatively immaterial, can a profit split approach nonetheless be justified in place of one-sided transactional methods? Factors contributing to making such an approach more appropriate than other alternatives would include: (1) the significance of regional accounts whose servicing in effect creates a joint venture proposition for the entities selling to those accounts, and (2) considerations described above in connection with Scenario 4 concerning the integration of routine results across group members. Future guidance could address the tradeoff between interquartile ranges and similar regulatory prescriptions as “safe harbors” and the ultimate goal of achieving an allocation of group profits that is consistent with the value creation principle and the contributions and risks undertaken by the group members.

Scenario 6 suggests a framework for determining such an allocation based in part on an assessment of the multinational group’s key value drivers and the role of group personnel in achieving results through their individual contributions and accountabilities. As suggested above in connection with Scenario 1, compensation arrangements with key personnel may provide objective third-party evidence from the labor market that may be directly relevant to such determinations. Guidance could be developed further in terms of examples and illustrations, in addition to the regulatory context (e.g., Advance Pricing Agreements, Mutual Agreement Procedures, etc.) in which such approaches could be applied by tax administrations.

Scenarios 7 through 9 raise the question of whether, in the absence of a specific contractual relationship establishing the risks of the parties to a joint undertaking, ex post outcomes could be adjusted to reflect imputed ex ante risk assignments notwithstanding actual outcomes. Thus, for example, in the illustration posed for Scenario 7, the parties might be deemed to split the ex-ante combined profits based on their budgeted development cost contributions notwithstanding an actual variance in development costs vis-à-vis budgeted amounts. A similar example is when actual outcomes are affected materially by some unforeseen external event that is fundamentally unrelated to the entrepreneurial investments undertaken by the parties but which nonetheless significantly impairs the outcome achieved: while the entrepreneurial contributions of the parties might appropriately be rewarded based on the ex-ante contributions in the absence of the external event, the ultimate risk-taking vis-à-vis the external event may be more appropriately be viewed as an overall enterprise risk that is not directly shared based on entrepreneurial contributions. Unforeseeable enterprise risks are a similar category of risks that may require such exceptional treatment. Future regulatory guidance should recognize such exceptions and provide insights as to how to administer transactional profit splits in such circumstances. Scenario 9 provides an example of how independently determined group compensation arrangements may provide useful guidance concerning dealing differently with losses vis-à-vis profits in specific situations.
To summarize, we feel that the current Discussion Draft has done a good job of setting forth the scope of generic case situations and transactional circumstances within which the transactional profit split method can provide needed guidance consistent with the underlying premises of tax policy and value creation that are at the heart of the BEPS initiative. The RPSM in particular has promised to be a constructive and versatile framework within which to develop and administer transfer pricing policy effectively, and we welcome the articulation of further guidance that will provide insights to practitioners in its proper use and effective guidance to tax administrations in its application. For such guidance to be effective, OECD is encouraged to be more explicit than currently in Chapters I-III of the Transfer Pricing Guidelines in respect of the concept of value creation, which constitutes the core consideration for judging the correctness of intercompany profit attributions for tax purposes, and of the analytical metrics applied to establish the relevant relative relations within the MNE or other relevant business, i.e., the value chain analysis.

Harlow Higinbotham, Emmanuel Llianares, Pim Fris
Chicago / Paris / London
February 2015
February 5, 2015

Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration
Attn. Andrew Hickman
Head of Transfer Pricing Unit
2, Rue André Pascal
75775 Paris, France

Re: Comments on Discussion Draft on BEPS Action 10: The Use of Profit Splits in the Context of Global Value Chains

Dear Mr. Hickman:

The National Foreign Trade Council (the “NFTC”) is pleased to provide written comments on the Discussion Draft on BEPS Action 10: The Use of Profit Splits in the Context of Global Value Chains, published December 16, 2014.

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

This letter is divided into two parts. The first part provides general comments and observations regarding the Discussion Draft. The second part addresses the topics and scenarios identified by the Discussion Draft.

The direction of the work in the Discussion Draft, taken together with other elements of the BEPS project, represents a significant departure from longstanding applications of the internationally accepted arm’s length principle. The Discussion Draft seems premised on an assumption that a two-sided analysis should be applied in situations where a one-sided or comparables-based analysis would be more appropriate. Two-sided methods, such as profit splits, are necessarily more subjective and complex to apply, and are less based on data from comparable transactions or businesses. Fundamentally, much of the Discussion Draft is a move away from the arm’s length principle and toward a system of formulary apportionment. The NFTC is concerned that a greater reliance on two-sided methods and apportionment of profits
would create uncertainty for MNEs and would lead to a proliferation of tax disputes. The NFTC urges the OECD to reconsider its approach in the ways described below.

**General Comments**

The NFTC supports the efforts of the OECD to maintain a transfer pricing regime that reflects international tax norms and objective, commonly-agreed principles. The Discussion Draft, however, focuses too significantly on the potential application of a profit split method to allocate profits among parties that perform functions that likely can be reliably benchmarked against comparable businesses/transactions. As drafted, the scenarios suggest that a transactional profit split method may be the most reliable way to analyze the results of parties that do not make unique and valuable contributions and, therefore, that should be better analyzed with other methods. If countries adopt that position, tax disputes will multiply, with no adequate mechanism(s) to resolve them.

Most concerning, however, is the direction that the Discussion Draft could lead to in the future. By focusing primarily on the application of profit splits (based on relative functions performed), the Draft deemphasizes the role of arm’s length comparables and the importance of assets and risks. This represents a dramatic move towards a formulary apportionment approach. The current Guidelines discuss in sufficient detail why the arm’s length principle is preferable to formulary apportionment. We continue to believe that the theoretical alternative to the arm’s length principle represented by formulary apportionment should be resoundingly rejected.

The NFTC believes that the changes implied in the Discussion Draft are much broader than necessary to address the concerns identified by the BEPS project. By placing undue reliance on profit splits to allocate profits to persons performing benchmarkable functions, the Discussion Draft signals a radical departure from the internationally accepted arm’s length principle. The NFTC urges the OECD to reconsider the extent to which the concerns identified by the BEPS project can be addressed in ways that are consistent with the arm’s length principle.

**Specific Comments**

**Value Chains**

Scenario 1 posits a situation where three Original Equipment Manufacturing enterprises (“OEMs”) are licensing technology from a non-EU parent company. The Scenario states that there is a pooling of management between the three OEMs such that they are effectively managed as a single enterprise, and that a transactional profit split method could be applied to the residual profits achieved by them after the royalty payment and payments for the manufacturing and distribution services.
To determine whether a profit split is appropriate in this situation (and, indeed, how such a method might be applied), the Scenario would need to elaborate on the risks that each entity is bearing. It is possible that the relationship between the entities amounts to a kind of informal joint venture in which each entity plays an entrepreneurial role and, therefore, shares in the overall profits regardless of which entity is assigned which investment and other opportunities. But it is also possible that the relationship between the entities is such that, once those opportunities have been assigned, the profitability of one or more of the entities may be benchmarked against that of other OEMs operating in the same territories. It is not possible to determine the most appropriate transfer pricing method without taking into account the risks each entity has assumed and bears.

**Multisided Business Models**

Scenario 2 posits an internet services provider with local subsidiaries that, on the one hand, promote the use of on-line services free of charge to users and, on the other hand, generate demand for, and adapt advertising services to, clients for a fee. The Discussion Draft then asks whether a transactional profit split method could be used, and what aspects would need to be elaborated to determine whether a transactional profit split was the most reliable method.

Like Scenario 1, this Scenario focuses too heavily on the functions performed by the local subsidiaries and not enough on the risks they bear. Under the facts as presented, the local entities do not appear to be any different than cost-plus service providers that perform localization and customization functions. To determine whether a transactional profit split method is appropriate, the Scenario would have to elaborate on the extent to which the returns of these entities can be appropriately benchmarked against the returns of other service providers.

In addition, the most valuable aspects of this business appear to be the extent of the online services and the associated data. The technology used to provide the advertising services, along with the various algorithms used to collect and process the data, were developed and funded by Company R, the parent of the group. To determine whether a transactional profit split or another method would be appropriate, this scenario would need to elaborate on to what extent the subsidiaries were adding unique value rather than just localizing and customizing to their particular market conditions.

**Unique and Valuable Contributions**

Scenario 3 involves a situation where a manufacturer conducts extensive R&D activities, while its subsidiary is responsible for sales and marketing activities. According to the facts, the subsidiary is more than just a “routine” distributor. Instead, its activities constitute a “key source of competitive advantage” for the group.
As written, Scenario 3 is particularly problematic. First, the distinction between “routine” and “non-routine” is not particularly helpful. The relevant question is whether the returns for the functions performed by the distributor can be reliably benchmarked against those of independent and comparable distributors. Every independent distribution company will claim to allow its customers a competitive advantage in the markets in which it operates. Hence, before the results of such comparable companies are discarded, Scenario 3 would have to make clearer what sort of unique and valuable contributions the subsidiary is making and why those contributions cannot be benchmarked with a one-sided analysis. Such an analysis would also need to focus on the risks borne by the subsidiary as compared to independent distributors. We are skeptical that a profit split method is necessary or appropriate to evaluate the returns of a distributor bearing risks comparable to those of independent distributors.

Even if a transactional profit split method were warranted in this situation, the Scenario would need to provide more information about the relative values of the unique and valuable contributions being made.

Integration and Sharing of Risks

Scenario 4 presents a situation where one company outsources the development and production of certain key components to two associated enterprises. All three companies control and perform their own research, development, and production processes. The Discussion Draft then asks under what circumstances a transactional profit split method would be appropriate for dealing with the sharing of risks.

As drafted, Scenario 4 does not provide enough detail regarding the risks borne by each entity. To determine whether a transactional profit split is the most appropriate method, the risks borne by each entity would have to be taken into account and compared to the risks of independent companies engaged in similar functions. If the risks borne by one or more of the entities are comparable to that of independent companies that perform similar functions, then it may be more appropriate to apply a one-sided analysis to evaluate the returns of those entities.

Fragmentation

In the Fragmentation section, the Discussion Draft asks whether profit splits might provide solutions to situations such as those referred to in the interim guidance on intangibles. As with the other proposed changes discussed above, an application of profit splits to such situations would elevate the performance of functions, the returns on which likely can be benchmarked.

Lack of Comparables

Scenario 5 involves a group of office stationary suppliers with local operating companies that supply stationary products to local customers. Some of the group’s larger customers operate
across the region, and acquire goods from a local operating company for use on a regional basis. Accordingly, the mix of local and regional-use sales for each operating company varies from year to year and from company to company. The Discussion Draft asks how comparables can be found and applied to this Scenario.

We believe that the regional aspect to this business does not justify an abandonment of data from independent distributors. The relevant inquiry is whether such independent distributors perform comparable functions, bear comparable risks, and employ comparable assets. It is not clear that the extent to which customers of the related companies use the goods in one market or across a region would be particularly relevant to this analysis.

**Aligning Taxation with Value Creation**

In this section, the Discussion Draft provides a variation to Scenario 1 such that the post-royalty residual profits or losses are split between the OEMs on the basis of three factors: production capacity, headcount, and value of production. The Discussion Draft then asks how the guidance should be modified to help identify factors which reflect value creation in the context of a particular transaction and what guidance would be needed in weighting the factors.

The NFTC has three main concerns with this section of the Discussion Draft, especially the language in paragraph 37. First, the approach set forth here is a formulary apportionment rather than an application of the arm’s length principle and, as such, is inconsistent with the stated goals of the BEPS project. If all countries in which the OEMs operate could agree on the amount of aggregate profit (or loss) earned by the OEMs as a group and on apportionment factors in advance, then this approach could be a viable way of allocating the profits of the OEMs. Nevertheless, it does not reflect an application of the arm’s length principle. Second, we are skeptical that such an approach could be implemented on a broad basis so as to serve as a useful method for taxpayers or taxing authorities. Third, we are particularly concerned about the use of headcount as an apportionment factor. Low cost headcount is not comparable to high cost headcount. Headcount is not relevant to aligning transfer pricing outcomes with value creation, the stated goal of the BEPS project in this context.

**Dealing with ex ante / ex post results**

This section involves two Scenarios.

In Scenario 7, two associated enterprises jointly agree to share the development of a new product and to split the resulting residual profits and losses based on estimated costs. The Discussion Draft then asks how a transactional profit split would be able to deal with any unanticipated results. One way would be to employ a mechanism that would adjust the split of the residual profits and losses only in the exceptional circumstances where (1) the actual results turned out to be materially different than the estimated results, and (2) the difference is due to...
events that could have been foreseen but were not taken into account in the valuation, rather than reflecting the outcome of risks that were not possible to foresee at the time of the agreement.

Scenario 8 involves a parent company licensing patent rights to a subsidiary. The parent performs the research and most of the development, whereas the subsidiary contributes to the late stage development and marketing. A transactional profit split is applied to calculate a royalty and/or set a price that will be paid each year. The Discussion Draft then asks whether the application of a transactional profit split to calculate a royalty under these circumstances is helpful.

In our view, it is possible to apply a transactional profit split in a principled manner to determine a royalty rate in circumstances such as Scenario 8. This is the case if each party bears the risk with respect to its own intangible development activity. Each party’s relative contribution could be weighed and used to allocate residual profits.

Sincerely,

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Appendix to NFTC Comments on BEPS Action Item 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

NFTC Board Member Companies:

McKenna Long & Aldridge LLP
ABB Incorporated
AbbVie Pharmaceuticals
Applied Materials
Baxter International Inc.
British American Tobacco
Caterpillar Incorporated
Chevron Corporation
Chrysler Corporation
CIGNA International
Cisco Systems
Coca-Cola Company
ConocoPhillips, Inc.
Deloitte & Touche
DHL North America
eBay, Inc.
E.I. du Pont de Nemours & Co.
Ernst & Young
ExxonMobil Corporation
Fluor Corporation
Ford Motor Company
General Electric Company
Google, Inc.
Halliburton Company
Hanesbrands Inc.
Hercules Group
Hewlett-Packard Company
Johnson & Johnson
JPMorgan Chase & Co.
KPMG LLP
Mars Incorporated
Mayer Brown LLP
McCormick & Company, Inc.
Microsoft Corporation
Occidental Petroleum
Oracle Corporation
Pernod Ricard USA
Pfizer International Inc.
PricewaterhouseCoopers LLP
Procter & Gamble
Prudential Insurance
Ridgewood Group International, Ltd.
Siemens Corporation
Sullivan & Worcester LLP
TE Connectivity
Toyota
Tyco International
United Parcel Service, Inc.
United Technologies
Visa, Inc.
Walmart Stores, Inc.
COMMENTS ON THE 2014 DISCUSSION PAPER ON THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAINS

1 INTRODUCTION

I refer to the discussion draft on the use of profit splits in the context of global value chains issued 16 December 2014 (PSMDD). With this document I respectfully submit my comments on the draft.

I work as a research scholar at the Department of accounting, auditing and law at the Norwegian School of Economics (NHH). The comments below reflect my personal opinions on the matters discussed, and do not in any way purport to convey the opinions of NHH.

The structure of my discussion mirrors that of the draft. I will comment on:

- the appropriateness of the PSM in the context of value chains in Section 2,
- the scope of the PSM in Section 3,
- aligning taxation with value creation in Section 4,
- hard-to-value intangibles in Section 5,
- ex ante and ex post results in Section 6, and
- the relationship between losses and the PSM in Section 7.

Concluding comments are made in Section 8.

The 2014 interim guidance on intangibles will in the following be referred to as “2014D”.

2 ISSUE ONE: THE APPROPRIATENESS OF THE PSM IN THE CONTEXT OF GLOBAL VALUE CHAINS

2.1 Introduction
In the following I will tie some comments to the issue of whether the PSM is useful in contexts where the activity between the controlled parties is integrated, but where the parties do not necessarily contribute any unique inputs to the value chain. The discussion is divided into two sections purely in order to follow the structure of the draft.

2.2 Integrated functions and risks

The discussion draft recognises that the most appropriate method should be selected, but suggests that the PSM may be particularly useful in the context of global value chains. This must be seen in light of the draft’s assertion that the one-sided methods often suffer from a lack of reliable comparables, and that they do not reliably take into account synergies or the interdependence of functions and risks.¹

First, practically all transfer pricing pertaining to unique intangibles must be carried out within the context of global value chains. Thus, if the TPG were to establish a preference for the PSM in the context of global value chains, that would in my view be tantamount to disregarding the rule that the most appropriate method should be selected in each specific case.

Second, I find that the reservation with respect to comparability is largely valid for all OECD pricing methods. The problem is particularly pronounced for the CUT-method.

Third, I do not fully agree with the assertion that the one-sided methods do not take into account synergies or interdependence among MNE-entities. They do, but not through the allocation of income to the tested party. Operating profits due to such elements must be presumed to be included in the residual profits allocated to the other party to the controlled transaction. The one-sided methods therefore implicitly assume that the tested party is not entitled to such benefits, but only to the normal market return for routine contributions that is reflected in the arm’s length range of unrelated profit indicators.

In contrast, the PSM splits the residual profits, including profits from elements such as synergies, among both parties to the controlled transaction. Thus, the PSM has a more balanced approach to the distribution of income from synergies etc. relative to the one-sided methods, but it is not accurate that the latter methods do not take such elements into account.

The draft seeks to illustrate its point through an example that pertains to three controlled European entities (OEMs) that manufacture components for sale in their respective local markets and the European market.² The entities license manufacturing intangibles from a non-European parent. Their operations are described as integrated with a high level of interdependence. There is a common Leadership-Board that decides what, and where, new products will be built, strategic marketing etc. The entities buy and sell components and finished goods from each other. The draft poses several

¹ PSMDD, Para. 3 and 7.
² PSMDD, Para. 9-12 (Scenario 1).
question.\textsuperscript{3}

The example does not state whether the local OEMs own unique marketing intangibles. In light of the context, I assume that they do not. Thus, the manufacturing and marketing intangibles used in the value chain are likely owned by the non-EU parent. The OEMs seem to perform fairly routine functions. The draft states that “the alternative to a transactional profit split method in this case would involve pricing a complex web of transactions, for many of which, it may be difficult to find reliable comparables due to the very high degree of interdependence of the key functions, assets and risks of the associated enterprises.”\textsuperscript{4}

I agree with this, but the current TPG allow aggregation of closely-linked controlled transactions.\textsuperscript{5} Further, given that the controlled entities in this case are OEM’s, which typically operate in fiercely competitive environments, there should be profit data available from comparable third party enterprises upon which to base remuneration of the OEMs, typically through applying the TNMM. Given that the OEMs seem to be routine function providers, no residual profits should accrue to them. I do not see what can be gained by allocating normal returns to routine functions via the PSM.

I am therefore surprised by the statement that “a transactional profit split method could be applied to the residual profits achieved by the three OEMs (after the royalty payment and after payments for manufacturing and distribution services)” (underlining added).\textsuperscript{6} As indicated above, given the description in the example, the OEMs do not seem to contribute any unique inputs to the value chain and should therefore not be allocated any residual profits. If they are, that may indicate that the royalty paid to the parent is set too low. In light of the above, I do not see that the PSM is the most appropriate method.

2.3 Multisided business models

As an extension of the above, the draft discusses the application of the PSM in a “Facebook”-akin scenario pertaining to a MNE that provides internet services to customers worldwide.\textsuperscript{7} The business model is to offer online services for free to users, while charging firms to advertise on the platform. Through data collection, refinement, processing and analysis, the parent funds and develops technology that enables it to target advertisements to certain users. Local subsidiaries are established in larger markets to carry out marketing, localisation, support and provide feed-back to

\textsuperscript{3} The following questions are raised in the draft: 1) Can transactional profit split methods be used to provide a transfer pricing solution to this scenario? If so, how? 2) What aspects of Scenario 1 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case? 3) Is the application of a transactional profit split method more useful than other methods for dealing with particular aspects of value chains, such as highly integrated functions, and the sharing of risks? 4) What guidance should be provided to address the appropriate application of transactional profit split methods to deal with these aspects of value chains?

\textsuperscript{4} PSMDD, Para. 11.

\textsuperscript{5} TPG, Para. 3.9-3.12.

\textsuperscript{6} PSMDD, Para. 12.

\textsuperscript{7} PSMDD, Para. 14-16 (Scenario 2).
the parent with respect to its ongoing development. The draft poses several question.  

The example is ambiguous. It does not specify whether unique intangibles are employed in the value chain, nor which group entities are assigned ownership to such intangibles. These facts are decisive for determining the appropriate pricing method. I refer to Paragraph 6.201 of the interim guidance, which states that “vague assertions of the existence and use of unspecified intangibles will not support a reliable application of a profit split method”.

However, first, as the parent has carried out and funded the R&D connected to the main technology IP, it should be entitled to the residual profits from this intangible. The example however leaves doubt as to whether the local subsidiaries contribute to the ongoing development to such an extent that they should be deemed as co-owners.

Second, the example does not state whether the marketing intangibles employed in the value chain are owned by the parent alone or by the local subsidiaries. The example indicates that the subsidiaries are routine distribution entities. The PSM should not be applied, unless the local subsidiaries own unique manufacturing or marketing intangibles that are employed in the value chain. A one-sided method, likely the TNMM, should be applied to remunerate the marketing, localisation, support and feed-back functions performed by the local subsidiaries.

3 ISSUE TWO: THE SCOPE OF THE PSM

3.1 Introduction

The draft presents several problems that relate to the scope of application for the PSM. Most notably, it discusses a proposed definition of “unique and valuable” contributions, as well as whether the PSM can provide a sensible pricing solution in cases where there are comparability problems connected to the application of the one-sided methods. I will comment on this in the following, in the order that the topics are addressed in the draft. Issues raised in connection with:

- unique and valuable contributions are discussed in Section 3.2,
- integration and sharing of risk in Section 3.3,
- fragmentation in Section 3.4, and
- the lack of comparables in Section 3.4.4.

3.2 Unique and valuable contributions

This section of the draft first asks whether the definition of unique and valuable contributions contained in the interim draft is useful in the context of the PSM. The remaining questions pertain to

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8 The following questions are raised in the draft: 1) Can transactional profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how? 2) What aspects of Scenario 2 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?
an example. I will comment on this below.

First, the current TPG state that the PSM may be appropriate where both parties to a controlled transaction make “unique and valuable contributions”. The terminology “unique and valuable” is not defined in the current TPG.

The 2014 interim guidance proposes that “Unique and valuable intangibles are those intangibles (i) that are not comparable to intangibles used by or available to parties to potentially comparable transactions, and (ii) whose use in business operations (e.g. manufacturing, provision of services, marketing, sales or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible.”

As a point of departure, I think it is a difficult task to successfully define the notion of unique and valuable contributions. While I agree with the essence of the proposed definition, my impression is that the definition may cause problems in practice.

The first element of the definition appears too restrictive and may have a bearing on the selection between the CUT-method and the PSM. Both methods are two-sided and may be used to directly allocate residual profits in some scenarios. For instance, it may be that an uncontrolled licensing transaction is identified, that after comparability adjustments may be deemed to satisfy the comparability criterion set out in the TPG, but where the resulting comparability is somewhat questionable. Given the reliability issues connected with the uncontrolled comparable, it may be that the PSM should be given priority over the CUT-method as the most appropriate method. The proposed definition of “unique and valuable”, seen in light of the link to the current PSM-guidance which suggests use of the PSM in scenarios where both parties contribute “unique and valuable” contributions, seems to reject the PSM in these scenarios, as the intangible used in the uncontrolled transaction, even of questionable quality, is comparable.

The proposed definition may therefore potentially interfere with the rule that the most appropriate method should be selected. I therefore suggest that the first element of the definition is taken out.

That leaves the question of whether it is necessary to leave the remaining part of the definition that focuses on the economic aspects of the non-routine contributions. This part may have a side to profit

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9 The draft poses the following questions: 1) Does the way in which “unique and valuable” is defined for intangibles assist in defining the term “unique and valuable contributions” in relation to the transactional profit split method? 2) What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method? 3) Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm’s length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied? 4) What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3?

10 TPG, Para. 2.109.

11 2014D, Para. 8.17.
potential as a comparability criterion for uncontrolled transactions involving unique intangibles,\textsuperscript{12} and may therefore, in theory, be used as an argument that if a comparable uncontrolled transaction with similar profit potential to the controlled transaction does exist, the CUT-method, and not the PSM should be applied, regardless of the reliability of the uncontrolled comparable.

All in all, I question whether it is the right approach to include a positive definition of unique and valuable contributions in the TPG. Such an approach triggers a risk that important aspects are left out of the definition, while the parts that are included open for ambiguity, unintended interpretations and controversy.

Comparatively, the specified US PSM regulations define non-routine contributions negatively, simply as contributions that are not accounted for as routine contributions.\textsuperscript{13} In my view, this is the best approach also in the context of the OECD TPG. Not only does it avoid the difficult assessments mentioned above, but it also aligns with the residual character of intangible profits from unique intangibles, in the sense that these returns accrue to unique intangibles if, and to the extent that, there are operating profits left after routine contributions have been allocated a normal return pursuant to the one-sided methods.

Lastly, it would seem counterproductive to include a positive definition of unique and valuable contributions in light of the fact that the new intangibles guidance seems to seek to enhance the relative position of the PSM for allocating operating profits from unique intangibles, not restrict it.

Moving on to the next issue, the discussion draft describes a scenario pertaining to company P in country P, which manufactures high-tech industrial equipment, carries out self-funded R&D and provides guidance to local subsidiaries on the marketing strategy of the group.\textsuperscript{14} Several competitors offer products that are similar with respect to functionality, performance and reputation. Subsidiary S markets and distributes the high tech products to unrelated customers in country S. Subsidiary S has developed close relationships with local customers and provides proactive support. The example asserts that these activities provide a significant competitive advantage and that subsidiary S therefore should not be deemed a routine distributor.

The example clarifies that the parent owns the self-developed manufacturing intangibles and the global trademark employed in the value chain. Further, that the subsidiary is in possession of unique marketing intangibles, likely in the form of local goodwill or marketing know-how. Thus, both parties to the controlled transaction contribute unique and valuable intangibles. The PSM should be a candidate for the most appropriate method.

I note that the products are described as rather generic. Specifically, it is stated that there are similar

\textsuperscript{12} Confer 2014D, Para. 6.124.
\textsuperscript{13} Cf. Treas. Reg. § 1.482-6(c)(3)(ii)(B)(1).
\textsuperscript{14} PSMDD, Para. 20-21 (Scenario 3).
competing products available. This indicates that sales of the high tech product do not yield residual profits, and that the competing third party products are based on comparable manufacturing intangibles. It seems questionable whether the manufacturing intangible owned by the parent qualifies as a “unique and valuable” intangible. One could be inclined to assume that the residual profits from the value chain, if any, are due to the marketing intangibles. The example should clarify the relative value between the global trademark owned by the parent and the local marketing intangibles owned by the subsidiary.

In light of the above, there may be three unique and valuable intangibles in the value chain:

- The manufacturing intangible owned by the parent, if at all unique and valuable
- The global trademark owned by the parent
- The marketing intangibles owned by the subsidiary (goodwill, know-how)

In my view, the residual PSM should be applied to the combined operating profits of the parent and the subsidiary from sales of the high tech product. From this combined operating profit, a normal market return to the following routine contributions should be deducted:

- Parent: manufacturing & marketing
- Subsidiary: marketing

The normal return should be determined using a one-sided method, likely the TNMM, based on profit data from functionally comparable third party enterprises. The combined operating profits that remain after deductions for these normal returns, the residual profits, should be allocated among the parent and the subsidiary based on the relative value of their non-routine contributions to the value chain:

- Parent: (potential) manufacturing & marketing intangibles
- Subsidiary: marketing intangible

The relative value should be approximated through a concrete assessment that recognises that valuation is inherently uncertain and that the main purpose is to provide a sensible estimate of the real value of the specific intangibles employed in the value chain. The use of asset-, cost- or capital-based formulaic allocation keys should be avoided, as they normally will not provide a sensible indication of the relative value of the unique intangibles.

As it stands now, the example indicates that the marketing intangibles are the main value drivers. Thus, the marketing intangibles should likely command the lion’s share of the residual profits. For instance, one possible solution could be to split the residual profits with 20 % to the manufacturing intangible owned by the parent, 40 % to the global marketing intangible and 40 % to the local

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15 Confer 2014D, Para. 6.17.
marketing intangibles owed by the subsidiary.

In conclusion, only the CUT-method and the PSM are suitable when both parties to the controlled transaction contribute unique and valuable intangibles. Thus, in the absence of a CUT, there should be no alternative to applying the PSM in this case.

3.3 Integration and sharing of risks

The draft presents an additional example, where the main question is whether the PSM or a one-sided method should be applied. I will tie some comments to this.

The scenario pertains to company A, which manufactures and sells medical equipment to unrelated customers. Company A outsources the development and production of certain key components to group companies B and C. Companies A, B and C each carry out and control their own R&D and production processes. All third-party sales revenue from the equipment will initially accrue to A. The ultimate allocation of profits between companies A, B, and C is determined on a profit-sharing basis.

The example does not state whether the medical equipment sold is based on unique and valuable intangibles, or whether the sales generate residual profits. I will however assume that this is the case. Further, the example does not clarify which group entities own the intangibles. However, based on the information provided, I assume the following. First, since all sales are carried out by company A, any marketing intangibles will likely be owned by A. Second, since all three companies carry out and control R&D, important R&D functions seem to rest with each company with respect to the intangibles they develop. It is therefore likely that each company should be assigned ownership to the intangibles developed by it. This will result in the following assignment of ownership:

- Company A: self-developed marketing and manufacturing intangibles
- Company B: self-developed component manufacturing intangibles
- Company C: self-developed component manufacturing intangibles

One-sided methods should not be applied in this case, as all controlled entities contribute unique and valuable inputs to the value chain. Company A’s operating profits should be allocated as follows:

- A normal market return (likely TNMM-based): to the R&D, manufacturing and sales functions of A, as well as to the R&D and manufacturing functions of B and C.

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16 The following questions are posed in the draft: 1) In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks? 2) Would a one-sided method produce more reliable results? 3) What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?

17 PSMDD, Para. 24-25 (Scenario 4).

18 Confer 2014D, Para. 6.56.
The residual profit: allocated among A, B and C pursuant to the relative value of the unique intangibles that they presumably contribute to the value chain.

The example does not offer much information that can be used to form an opinion of the relative values of the unique intangibles contributed to the value chain.

3.4 Fragmentation

3.4.1 Introduction

The draft raises two rather fundamental questions pertaining to the application of the PSM under the headline “fragmentation”. The first issue is whether the PSM can be used to allocate normal returns among routine group entities. This proposal touches upon the general comparability debate that has relevance in particular for the CUT-method and the one-sided methods, especially the TNMM. I will discuss this in Section 3.4.2.

Second, the draft asks whether the PSM could be applied to split residual profits between a group entity that holds legal ownership to an intangible, an entity that performs R&D and a funding entity. I will present my view on this in Section 3.4.3.

3.4.2 “Aggregation” approach

As touched upon above, the draft is of the view that the one-sided methods do not account reliably for the interdependence of functions and risks, or for synergies. The draft observes that MNEs tend to separate functions into different legal entities, for instance with single entities devoted to logistics, warehousing, marketing etc., making it difficult to find similar unrelated enterprises, as well as to account for the high level of interdependence between the functions performed. In light of this, the draft asserts that pricing could be based on a profit split approach, in the sense that a comparable unrelated enterprise could be identified if the controlled fragmented activities are aggregated. 19 I interpret the suggestion of the draft to in reality pertain to whether the PSM could be used to allocate normal market returns among routine group entities.

Several questions are posed in the draft. 20 I will tie some comments to this.

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19 TPG, Para. 2.119-2.120, confer 2.132-2.145. The 2014D mentions the potential for using the PSM where one party holds the legal ownership of intangibles while another performs important functions relating to the development, enhancement, maintenance, protection and exploitation of those intangibles, and another party provides funding, cf. 2014D, Para. 6.57-6.58 and Examples 17 and 18.

20 The following questions are posed in the draft: 1) Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how? 2) Can transactional profit split methods be used to provide reliable arm’s length transfer pricing solutions for fragmented functions? If so how? Can other methods address the issue of fragmentation, and, if so, how? 3) What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?
First, it should be clear that the draft’s proposal goes far beyond the current provisions of the TPG with respect to the aggregation of different types of controlled transactions for the same taxpayer. The proposal pertains to the aggregation of different types of controlled transactions from different controlled taxpayers, in order to form a “constructed” controlled taxpayer that is more easily comparable to unrelated enterprises than the individual controlled taxpayers that are included in the aggregation would be on a stand-alone basis. The heart of the matter seems to be whether the PSM can be applied to compensate for the lack of comparables.

The draft is not entirely clear on whether the issue is to allocate income among group entities that only perform routine functions, or to allocate income where one, several, or all of the involved entities also contribute unique inputs to the value chain. This question is relevant because if there are unique contributions, there will likely be residual profits. These should only be allocated to entities that contribute unique inputs. Otherwise, intangible income will not be allocated according to intangible value creation. However, I interpret the example to pertain only to routine entities that typically are remunerated under a one-sided method.

Because it in practice will be difficult to find similarly specialised comparable unrelated enterprises, the issue is whether the PSM can be applied instead. The example mentions that the operating profits of a sales subsidiary may be combined with the profits of a distribution subsidiary and that the combined profits are allocated among the two companies pursuant to a contribution analysis.21

The basic idea of the draft seems to be to test that the combined profits of the “aggregated” routine entities are arm’s length using a one-sided method, typically the TNMM. This arm’s length normal market return will then be allocated among the “aggregated” entities, using a contribution analysis. The split should in principle reflect the relative values of the controlled parties contributions to the combined operating profit, but will in practice be carried out based on some of the formulaic allocation keys set out in the TPG (asset value, costs, number of employees etc.).22

The approach of the draft seems motivated by the typical comparability problem that the tested party performs specialised functions and carries out perhaps only one particular form of transaction, while third party enterprises that are candidates for being used as comparables under the TNMM will typically carry out a range of other activities and transactions in addition to those comparable to the functions and transactions of the tested party.

I must say that I find the basic idea to be innovative, but I think it is questionable to what degree the suggested “aggregation” approach will effectively compensate for this problem. Even if controlled entities are aggregated to an extent where it is possible to identify some functionally comparable third party enterprises, there is a high likelihood that the unrelated entities will also carry out transactions other than those comparable to the controlled transaction. In other words, that the

21 Cf. TPG, Para. 2.119.
22 TPG, Para. 2.132-2.145.
functionally comparable entities do not reflect profit data that are *transactionally comparable* to the tested party. Thus, the “aggregation” approach is only helpful to a certain extent. It does not eliminate the “classic” comparability issues connected to transactional comparability.

With that being said however, I do not see any clear negative effects of using the suggested “aggregation approach”, given that the controlled entities perform only *routine* functions, and the total controlled operating profits are benchmarked using a one-sided method. If this “aggregation” approach is introduced into the TPG, it should be made clear that the methodology is inapplicable to entities that contribute non-routine inputs. Otherwise, one risks that residual profits are allocated to routine group entities that have not contributed to the intangible value creation.

### 3.4.3 Profit split: legal ownership, R&D and funding

This brings me to my next point. The draft asks whether the PSM could be used to allocate operating profits from an intangible value chain between:

- an entity that holds *legal ownership* to an intangible, and
- an entity that performs the *important R&D functions*, and
- an entity that *funds the R&D*.

In my view, the PSM should be clearly inapplicable. The reason being that an entity that merely holds legal title to an intangible should not be entitled to any residual profits, but be remunerated on a *separate* basis for the functions performed. If the entity is a pure holding company, it should be remunerated under a one-sided method, such as the cost plus method, for the functions performed, which typically will be administrative and legal services.\(^{23}\) The funding entity should receive a *separate* arm’s length return on its investment, through the allocation of income equal to a risk adjusted rate of return.\(^{24}\) The entity that performs the important functions should be entitled to the residual profits, because this entity creates the intangible value.\(^{25}\)

In my view, there is a pronounced risk that an application of the PSM in such a scenario could end up in a non-arm’s length result. The only way of reliably allocating income to the legal ownership and funding entities is to test them on a separate basis. An arm’s length remuneration of a funding entity must be based on a concrete facts-and-circumstances based assessment, where the key parameter is the amount of risk incurred. Even though a separate allocation of income to a funding entity will rest on a discretionary assessment, it will in my view nevertheless be more precise, and reliable, than to just apply an overall profit split.

Also, the PSM should generally not be deemed as an appropriate method to allocate income to controlled entities that do not contribute unique and valuable inputs to the value chain. Legal

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\(^{23}\) 2014D, Para. 6.47 and 6.57.
\(^{24}\) 2014D, Para. 6.61.
\(^{25}\) 2014D, Para. 6.56.
ownership and funding contributions are, although certainly valuable, not unique.

The situation discussed above is significantly different from the issue in Paragraph 6.57-6.58 of the interim guidance, which suggests that the PSM may be useful in outsourcing situations. The issue there is to allocate residual profits among group entities that carry out important functions.

3.4.4 Lack of comparables

The draft further asserts that the PSM may be useful where there are no reliable comparables available on which to base an application of the one-sided methods.26

The draft refers to a scenario where a MNE operates as a supplier of office stationery in a region, with subsidiaries in several countries.27 Some of the group’s larger customers coordinate their procurement regionally. Each group company sells both to unrelated local customers and to other group companies, with the mix of transactions varying from year to year.

The example does not clarify whether unique intangibles are involved in the value chain, or what entities own them. I assume that office stationary products are often generic and subject to significant competition. To the extent that unique intangibles are involved in such value chains, they will presumably be marketing intangibles. The example seems to suggest that all transactions pertain to sales of the same products. If this is the case, the CUP-method may be applied, using the sales to unrelated customers to benchmark the profits made in the controlled transactions. If there are no unique contributions involved in the value chain, each group company may alternatively be remunerated through a one-sided method.

The draft further asserts that where comparables under a one-sided method do not reliably reflect the level of functions or risk in the tested party, the PSM may sometimes offer the means to “vary or flex the results under a one-sided method”. The question is whether profit margins extracted from comparables that are not fully reliable are best used under the one-sided methods, or whether they could be incorporated into an application of the PSM. Specifically, it is suggested that the baseline could be the median of 7 %, with the allocation varying between 4-10 % depending on the levels of total operating profit or sales.

I am not convinced that the proposal is an appropriate way to address non-ideal comparables. First, the use of statistical techniques, such as the interquartile range, will normally be a better way of compensating for potential lack of comparability. This will reject profit observations in both extremes.

26 The following questions are posed in the draft: 1) How can comparables be found and applied in scenario 5? What method is likely to be appropriate for determining an arm’s length remuneration for the activities of the group companies? 2) How can comparables be found and applied in scenario 3 (or to any other relevant scenario in this discussion draft)? 3) What aspects of scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?

27 2014D, Para. 31. (Scenario 5)
of the arm’s length range. Second, what is the point of “flexing” the result in the manner suggested by the example, if the underlying problem is indeed that the profit data may have been extracted from not entirely comparable third party transactions? The flexing mechanism described uses the entire range of profit data, thus including the observations most likely to be flawed. Would it not be better to compensate for potential comparability issues by just using the median observation in the data set? Third, as long as the tested party is not in possession of any unique contributions, a one-sided method should be used to benchmark the profits directly, not the PSM.

4 ISSUE THREE: ALIGNING TAXATION WITH VALUE CREATION

The draft poses the question of whether the allocation keys used to split profits under the PSM may be improved in order to enhance the alignment between the allocation of profits and value creation.28 I will tie some comments to this.

The TPG state that there should be a “strong correlation” between the allocation key and the creation of value.29 The draft finds that a common criticism of the PSM is its perceived subjectivity, supposedly caused by allocation keys that can be difficult to verify from objective evidence. From this, it goes on to discuss how to develop objectivity in profit split factors, so that pricing outcomes are firmly aligned with value creation.

I find it important to bear in mind that the PSM does not, and cannot, allocate income with objective precision. Historically, the method was developed through case law to allocate income from unique intangibles for which third party benchmarks were unavailable. In my view, the most reliable allocation of residual profits under the PSM will be based on a concrete facts-and-circumstances assessment of causality, not formulaic allocation keys.

In practice, residual profits are normally the result of two or more unique intangibles that are necessary components in a value chain, for instance, the patent and trademark connected to a blockbuster drug. Case law has a tendency towards an equal split of the residual profits between necessary intangibles. It is my view that where unique intangibles are necessary value chain components, but where the precise influence (causality) of each intangible on the residual profits is impossible to ascertain objectively, an equal profit split may realistically be the most sensible

28 The following questions are posed in the draft: 1) In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector? 2) What guidance is needed on weighting of factors? 3) How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for example approaches based on concepts of bargaining power, options realistically available, or a RACI-type analysis of responsibilities and decision making)? 4) Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an MNE operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate?
29 TPG, Para. 2.135.
solution.

I am sceptical of “objective” allocation keys. Even if the keys themselves are objective, in the sense that the number of employees, cost etc. are easily verifiable, the relationship between the keys and the residual profits are not. Quite the contrary, “objective” allocation keys will normally be poor indicators of the relative value of unique intangibles employed in a value chain. If “objective” allocation keys, for instance the number of employees, asset or capital value or costs, are used to distribute residual profits, this will in effect be formulary apportionment.

However, it cannot be ruled out that the PSM could be useful to allocate operating profits from value chains that rely solely on routine contributions, such as the sale of generic products or services, as an alternative to the one-sided methods in cases where there are reliability concerns surrounding the available comparables. The use of “objective” allocation keys to split the combined operating profits may be more reliable in these cases, as it may be reasonable to assume that the relationship between such keys and routine market returns is more predictable than for residual profits.

The draft goes on to describe an example where group company A in country A, purchases technological goods from group company B in country B for resale. Company A is responsible for the strategy of the group. It decides which markets to operate in, the product range and pricing within each market. It licenses relevant IP from group company C, which owns self-developed intangibles. Company B is responsible for the global manufacturing strategy, including procurement and the structure of the supply chain. It develops and owns IP related to the manufacturing processes. The actual manufacturing is carried out on a contract basis by another group entity, Company D, also located in country B.

A profit split is applied between Company A and B. Both companies allocate a portion of their profit shares as compensation to the other group companies using one-sided methods. The split of the combined operating profits between Company A and B is based on their annual contributions to each of the group’s key value drivers.

My interpretation of the example is that the following entities perform routine functions that should be remunerated with a normal market return under a one-sided method, likely the TNMM:

- Company A: re-sale
- Company B: procurement
- Company C: not specified whether this entity carries out routine functions
- Company D: contract manufacturing

30 2014D, Para. 39-43 (Scenario 6).
31 The example presupposes that the licence fee was subject to a separate transfer pricing analysis and is arm’s length.
Further, the following entities contribute unique and valuable intangibles to the value chain, which should be allocated a portion of the residual profits:

- Company B: owns manufacturing intangibles
- Company C: in possession of unique intangibles, separately CUT-priced

The distribution of residual profits should be unproblematic, as a CUT exists for the controlled licensing transaction between company A and C. The arm’s length royalty should be deducted from the residual profits, with the remaining residual profits being allocated to company B.

The example contains ambiguous statements pertaining to value drivers and the importance of a RACI-analysis. In the context of value chains driven by unique and valuable intangibles, it must be determined which group entities are entitled to the residual profits. For self-developed intangibles, this will be the entities that perform the important functions.³² It is therefore unclear to me what role the draft envisions a RACI-analysis to have in this context.

It should be recognised that the PSM-guidance in the current TPG is already broad, allowing a wide range of alternative allocation keys. Comparatively, the specified PSM of the US regulations allow only two allocation keys.³³ Any additional guidance, on top of what already is in place, will in my view likely add more ambiguity and be counterproductive.

5 ISSUE FOUR: HARD-TO-VALUE INTANGIBLES

The development of effective pricing rules for hard-to-value intangibles is part of Action 8 of the BEPS Action Plan. The issue is among the last to be addressed in the OECD intangibles project. The 2014 interim guidance still contains the 1995 consensus text on this matter, but proposes that the PSM may be applied to value partially developed intangibles.³⁴

The draft poses the following question: “What specific aspects of transactional profit split approaches may be particularly relevant in determining arm’s length outcomes for transactions involving hard-to-value intangibles?” I will tie some comments to this.

The value of a partially developed unique intangible comes from its potential of reaching fruition. In other words, reaching completion and being applied in a value chain to earn profits. A valuation must therefore rest on two main estimates.

First, the future profits allocable to the completed intangible must be determined, likely using a DCF-valuation. This is the “normal” assessment under the PSM, albeit in a valuation context. The assessment will refer to the value chain for a particular future product. The valuation must be based

³² 2014, Para. 6.56.
³⁴ 2014D, Para. 6.147- 6.148.
on the best estimates of revenue, costs and growth in future periods, discounted using a risk adjusted rate. The NPV of the operating profits from the sales of the product must, as always under the PSM, be allocated between the routine and non-routine contributions to the value chain, with normal market returns and residual profits respectively. If the non-routine contributions include also other intangibles than the completed intangible, the valuation must include a split of the NPV of the residual profits between these intangibles, based on the normal assessment of the relative values of the non-routine contributions.

Second, it must be determined how much of the value allocable to the completed intangible is due to the partially developed intangible. The question here will in practice be to determine whether the transferor, subsequent to the transfer of the partially developed intangible, will continue to perform the important development functions. If he does, the entire value allocated to the completed intangible should be used as the price for the partially developed intangible.

For instance, it may be that the transferor has carried out the important functions pertaining to R&D up until transfer, and will continue to do so subsequent to the transfer, while the transferee funds the remaining development. In this case, the transferor should be entitled to the entire residual profits, after a risk adjusted return has been allocated to the intangible development funding. It will normally be contrary to the alternatives realistically available to the transferor entity not to allocate all residual profits to it. In reality, this is akin to applying the TNMM in the context of a valuation.

However, if the transferee does contribute important development functions that contribute to the completion of the partially developed intangible, the transferee should be allocated a portion of the NPV of the completed intangible that corresponds to the relative value of his development contributions. This will reduce the value allocable to the transferor, and thereby the arm’s length transfer price for the partially developed intangible. This solution would be akin to applying the PSM in the context of a valuation.

The recent US cost sharing regulations include provisions on the valuation of pre-existing intangibles that are contributed to a CSA. These rules assume that the entire value of the pre-existing intangibles should be allocated to the transferor, based on the view that the first-generation intangible is the platform and the key value driver for subsequent versions of the intangible. The regulations allow a profit split only if the transferee contributes other unique inputs to the cost sharing activity. Outside of CSAs, it cannot in my view always be presumed that the transferee should not be entitled to any residual profits from a partially developed intangible. This issue must be assessed concretely, and the question will be whether the transferee contributes any important R&D functions to the remaining development process.

36 Treas. Reg. § 1.482-7(g)(7).
6 ISSUE FIVE: EX ANTE / EX POST RESULTS

One of the most problematic and ambiguous parts of the TPG pertains to the distinction between ex ante and ex post profits. The current PSM-guidance limits the application of the method to ex ante profits. This limitation is in my view ill-suited and should be removed. I will not elaborate on this here, but rather tie some comments to the draft’s proposal that the PSM may be used to address significant differences between ex ante and ex post results, as well as unanticipated events where strategic risks are effectively shared between associated enterprises.

The draft provides an example which pertains to two associated enterprises that agree to jointly develop a new product. Each enterprise is responsible for developing and manufacturing one of the two key components. Estimated development costs are 100, with 30 to be incurred by one of the parties and 70 by the other. There is a risk that the project will not generate the expected returns, and significant risk of cost overruns. It is agreed that expected operating profits will first be allocated to provide each party with a routine return on its manufacturing functions. The residual profit, or loss, is split 30/70, regardless of whether the actual development costs vary from what was projected. The draft poses the following question: “How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?”

The split must be reflective of the relative value of the unique contributions from each controlled party to the value chain. In this case, the split is determined on the basis of costs. Formulaic allocation factors based on costs are normally poor indicators of the relative value of unique contributions. The example states that the split is locked to 30/70 based on estimated costs. In my view, there is good reason to question whether such a locked split is arm’s length. One would think that unrelated enterprises would not agree to such a split for several reasons.

First, only actual costs may be indicative of the relative values of the parties contributions to the combined operating profits. Second, the development of the new product must necessarily be finished before the product can be sold and generate profits. In other words, the development costs will be final before profit generation starts. It seems unrealistic to assume that third parties with genuine conflicting interests would lock a split before this time. Third, the use of locked splits based on estimated costs represent a significant opening for tax planning and BEPS.

If, on top of the fact that costs are poor indicators of the relative value of non-routine contributions, and that the allocation of such costs among group entities in the first place may rest on subjective accounting assessments, the use of locked splits based on projected costs were to be deemed as arm’s length, it could be asked whether there is a reason to pose any restrictions on the allocation of residual profits under the PSM at all.

37 TPG, Para. 2.128 and 2.130.
38 TPG, Para. 2.108.
39 TPG, Para. 2.139.
In my view, an arm’s length profit split should not be locked at the outset. The reason is simply that a profit split normally refers to the *annual* combined operating profits. It will often be that the relative value of the controlled parties non-routine contributions to the intangible value chain will change over the years. For instance, a patent being the most valuable contribution initially, then the marketing intangible becomes more valuable in later phases. If the split is fixed at the outset and does not take into account such changes, the split should in my view not be regarded as set pursuant to the relative values of the parties contributions, as causality will be lacking in subsequent periods.

Further, the draft contains an example which supposedly illustrates that the PSM “*do not always result in outcomes which report a split of actual profits*”. The draft states that the PSM may be used to determine a *fixed* price, such as a royalty. It is asserted that a conversion of the profit split outcome to a royalty has the practical advantage that a royalty may be simpler to implement and will avoid end of year calculations to true-up the profits to equate to the profit split ratio.

I find it doubtful whether this is an accurate assertion. Royalties are normally a percentage of actual sales revenue. Thus, it will not be possible until the end of an income year to determine what the annual royalty payment will be. True-ups are normally only applied to a tested party under a one-sided method in order to align the actual profits of the tested party to the benchmark profit it is supposed to earn pursuant to a one-sided method. For instance, if the TNMM indicates that a contract manufacturing entity should earn a 5% operating margin, but the actual margin proves to be 10%, there must be a 5% reduction. Conversely, true-ups are not commonly applied in cases where both parties to a controlled agreement contribute unique inputs to the value chain and therefore are entitled to residual profits. In these latter cases, there is nothing to “true-up”, as residual profits cannot be benchmarked.

I do however agree that the conversion of a profit split to a *fixed* royalty may reduce the potential of the PSM to respond to unanticipated events. The royalty will be locked based on the *estimated* value of the non-routine contributions of the controlled parties to the value chain, which may later change. The locking of profit splits to fixed pricing should be avoided. Such splits will normally not be good indicators of the relative value of the non-routine contributions of the parties over time. Thus, there is no reason to simply assume that third parties would agree to such arrangements. Not all third parties like to gamble.

Further, the draft presents an example that pertains to parent P, which licenses patent rights relating to a potential pharmaceutical product to company S. P performs all basic research and most of the

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40 PSMDD, Para. 48.
41 This will also be the case should the royalty alternatively be a percentage calculated on the basis of, for instance, gross or net profits.
42 True-ups may be carried out in a range of ways, such as increasing royalty payments, through allocating more costs to the tested party or by adjusting other prices charged to the tested party.
development functions, with S contributing to late stage development and marketing. Both companies contribute to the intangible development. It is possible to risk-weight the expenditure based on reported industry data on success rates at each development stage for products in the same therapeutic category. The risk-weighted costs are contributed by P and S in the ratio 80:20. At the time of the licence, operating profit projections are prepared on a NPV-basis. The respective contributions to product development are then used to split the anticipated profits in the ratio 80:20. The 80:20 split is locked at the outset to a specific royalty rate.43

The draft poses the following question: “Is the application of a transactional profit split method to calculate the royalty in Scenario 8, or in other circumstances to set a price, helpful? What are the advantages and disadvantages?”

I see two problematic aspects of the locked 80/20 split. First, the general point that intangible development costs may not be indicative of the relative value of the non-routine contributions. Second, the actual development costs may differ from the estimated costs, but the 80/20 split is nevertheless locked at the outset based on the estimated costs. In these cases, the split will not be aligned with the actual relative value of the parties contribution to the residual profits. That is a problem. For instance, if the actual development costs incurred are 60/40 instead of 80/20, the locked royalty will overcompensate company P and undercompensate company S based on the actual relative values.

This result should not be accepted. The allocation of intangible income will not be aligned with value creation. Profit splits that are locked at the outset in the form of a specific royalty represent risks of BEPS.

7 ISSUE SIX: LOSSES

The last part of the draft touches upon some issues pertaining to the PSM and losses.44 While the point of departure under the current TPG is that the PSM applies also to split losses,45 I find the guidance to be unclear. I have not seen any examples in case law, or otherwise, that illustrate allocation of losses through the PSM in the context of value chains that rely on unique intangibles. The typical scenario is that the PSM is used to split residual profits. This observation is logical, as residual profits per definition cannot be negative, only zero. If there are no residual profits, only a

43 The presentation in the example is somewhat peculiar, in that it states that company P licenses an intangible to company S, which then completes the development of the intangible it licenses. I would assume that it would be more appropriate to view company P and company S as co-owners to the patent, as they both perform important development functions. They should be entitled to a portion of the residual profits that correspond to the relative value of their development contributions.

44 The following questions are posed: 1) In what circumstances might it be appropriate under the arm’s length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss? 2) Are there circumstances under the arm’s length principle where parties which would share combined profits, would not be expected to take any share of combined losses?

45 TPG, Para. 2.108.
normal market return will be allocable to the parties, determined under a one-sided method. In these cases, there is no need for the PSM.

However, outside of scenarios pertaining to intangible value chains and residual profits, it may be relevant to use the PSM to allocate losses. In such cases, my view is that losses should be allocated pursuant to the same allocation keys used to split profits. After all, it is the same measure, the net operating result, which is split in both circumstances regardless of whether the result is positive or negative. There does not seem to be any logical reason for using different allocation keys for operating profits and operating losses.

The draft contains an example to illustrate that the PSM may be applied differently when there are losses to be split than when there are profits. The example pertains to three companies in a banking group that carry on trading of financial products. The combined operating profits are allocated between them using a multi-factor profit split that gives different weightings to each factor. The greatest weighting is given to the factor based on remuneration paid to the traders in each location, including bonuses based on performance. The method incorporates principles for adjusting the remuneration where losses are incurred.

In this example, salary cost is the main allocation factor. These costs are larger when the business makes a profit, due to bonuses. The question is whether salary costs including bonuses can be used to allocate profits, and whether the same costs minus bonuses can be used to allocate losses. In my view, the example does not illustrate the use of different allocation keys, as the same allocation factor is used in both the profit- and loss scenarios.

The fact that the size of the factor varies depending on the operating results could simply be viewed as an indication that the relative value of the contributions from the different controlled entities vary from period to period. I therefore do not see that the example departs from the assumption that losses should be allocated in the same manner as profits.

8 CONCLUDING COMMENTS

The final question asked in the draft is as follows: “Paragraph 2.114 of the Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?”

It should be recognised that the text in Paragraph 2.114 essentially is a reiteration of the text contained in the 1995 TPG. In other words, the text was written two decades ago. The introduction of the PSM, along with the TNMM, in the 1995 TPG was motivated by the final 1994 US regulations. The 1995 TPG were sceptical towards the use of the profit based methods and limited their applications in ways that the US regulations do not (e.g. transactional approach, ex ante approach

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46 Confer 1995 TPG, Para. 3.9.
Transfer pricing jurisprudence has moved far since then. The current view of the OECD seems to favour the PSM. I refer in particular to Paragraph 6.142 of the interim guidance, where it is stated that “the transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method”. Since the comparability requirements for applying the CUT-method are strict, the quoted statement in reality points towards the PSM.

The above development should have consequences for Paragraph 2.114 of the current TPG, which in my view does not paint an accurate picture of the weaknesses of the PSM.

First, Paragraph 2.144 states that the PSM cannot be used where one party to the transaction only contributes routine functions, such as contract manufacturing or low risk distribution.47 I do not see this a weakness of the method as such, rather as a limitation of its scope of application. Second, that there may be practical difficulties in applying the PSM,48 such as problems in accessing information from foreign affiliates, difficulties in measuring the combined sales and operating expenses for all participating enterprises and that accounting adjustments may be required. These concerns are in my view clearly not particular to the PSM, but common to all pricing methods. Further, developments such as increased harmonisation of accounting standards (IFRS), more developed rules on exchange of information, CBCR etc., put these concerns in a different light.

My view is that Paragraph 2.144 either should be amended in light of the relevant transfer pricing developments over the two last decades, or taken out of the TPG in its entirety.

Finally, I will tie some comments to, what I see as, the main approach of the draft towards the PSM.

One might get the impression reading the draft that the application of the PSM to allocate combined operating profits from intangible value chains is a new concept. The method was however developed through case law precisely to address such issues. I find the fact that both the interim guidance and the draft embrace the PSM to be a positive development.

I am however somewhat concerned that the PSM may be used in a manner it is neither designed nor suited for. With this I refer to the proposals of the draft to use the method to compensate for the lack of sufficiently reassuring comparables under the one-sided methods, and to possibly distribute operating profits among an aggregate of group entities where some of the involved entities contribute unique inputs to the value chain. Further, some of the language in the draft seems to indicate that the PSM should be used in a manner that will provide weakly founded splits in a manner akin to formulary apportionment.

47 TPG, Para. 2.109.
48 TPG, Para. 2.114.
In particular, the use and further development of so-called “objective” allocation keys to allocate residual profits should be avoided. There is no denying that the PSM was developed as a method where the allocation of residual profits rested on a subjective, facts-and-circumstances, based assessment of the relative value of the involved unique contributions.

This should however be seen as a strength, not a weakness. In my opinion, no formulaic allocation key may replace the effectiveness of a critical functional analysis and thorough assessment of the evidence in each particular case. As an illustration, I refer, for instance, to the assessment carried out by the US Tax Court in the seminal PSM-case *Eli Lilly.*49 Most valuations, and in particular valuations of single value chains based on unique intangibles, are highly subjective. This does not entail qualitative deficiencies in the valuations.

The focus of the TPG should be on ensuring that the assessments of relative value of the unique intangibles involved in a value chain, for the purpose of splitting the residual profits, are sufficiently geared towards finding the real value of the involved intangibles. Further developing the guidance on the “objective” allocation keys seem to be a step in the wrong direction.

An example of the unfortunate consequences it may have to base the split of residual profits under the PSM on “objective” formulaic allocation keys is the experience of the US tax authorities under the previous cost sharing regulations, where taxpayers argued in favour of low buy-in valuations based on rapid depreciation of capitalised intangible development costs, resulting in the migration of valuable US-developed intangibles at low valuations.

In my view, there is a clear risk of BEPS if “objective” allocation keys are further embraced. Instead, the TPG should more clearly emphasise that the split of residual profits, over the entire duration of the controlled agreement, should reflect the relative values of the non-routine contributions of the controlled parties to the intangible value chain. Only then will the allocation of intangible operating profits be aligned with the creation of intangible value.

As a final comment, it is my view that the fundamental principles pertaining to the application of the transfer pricing methods in general, and the PSM in particular, should remain the basis for any new guidance. The rule should still be that the most appropriate pricing method is selected in each case. Further, that the PSM should not be applied to allocate intangible income unless both parties to the controlled agreement contribute unique inputs to the value chain.

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49 84 TC 996 (1985).
Respectfully yours

Oddleif Torvik
February 6, 2015

Dear Mr Hickman,

Comments on the Organization for Economic Cooperation and Development ("OECD") discussion draft on the use of profit splits in the context of global value chains

Thank you for the opportunity to provide comments on the Public Discussion Draft on BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains dated 16 December 2014.

PricewaterhouseCoopers LLP (PwC), on behalf of its international network of Member Firms, welcomes the consideration given by the OECD to provide additional commentary on the use of profit splits in the context of global value chains.

The Discussion Draft uses high-level scenarios to pose questions concerning the potential application of the transactional profit split method and considerations that should be analyzed in more detail before further guidance is provided. These scenarios and accompanying questions cover many of the most controversial areas of transfer pricing and pose many questions with differing, reasonable (and sometimes contradictory) opinions as to how to best approach them. Before answering those questions, however, we believe there must be acknowledgement of fundamental principles as the basis for the OECD’s actions under BEPS. These fundamental concepts form the basis of sound transfer pricing policy and we believe that summarizing these principles within the Discussion Draft may be more useful than, or should be read in conjunction with, the point-by-point analysis of each open-ended question posed in the Discussion Draft.

- The arm’s length standard is meant to provide broad parity of tax treatment for members of MNE groups and independent enterprises. By placing associated and independent enterprises on a more equal footing for tax purposes, the arm’s length standard avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. PwC is concerned that consistency of the arm’s length standard may be compromised if jurisdictions begin to weigh factors differently or lose sight of the overarching rationale for the arm’s length standard - to place associated and independent enterprises on a tax parity. To a certain extent, the Discussion Draft seems to use concepts such as “integration” and “global value chains” to make it easier for tax administrations to apply the profit split method rather than to improve the
guidance on choosing the most reliable transfer pricing method. The profit split method has previously been described as a “method of last resort”; the Discussion Draft contains elements that may in certain situations permit taxing authorities to, in effect, apply it as a default method. Agreement needs to be reached on the objective of this Discussion Draft, and we believe that it should be to improve the guidance on use of profit split methods, not simply to make use of profit splits more widespread. Placing too much emphasis on employing transactional profit split analyses may lead tax authorities to request or prefer profit split analyses in scenarios where such analyses do not assist in the goal of achieving tax parity between associated and independent enterprises.

- Functional analyses and a thorough understanding of the functions undertaken, assets owned and risks borne by all entities involved are critical in appropriately remunerating parties in a related party transaction. A thorough functional analysis resolves many of the issues identified in the Discussion Draft and we believe more emphasis on undertaking a thorough functional analysis may be more useful than emphasizing the use of corroborative profit split analyses as suggested in the Discussion Draft.

We would like to reiterate that the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“Transfer Pricing Guidelines”) already address profit split analyses and the selection of the most appropriate method. Use of the profit split method is only appropriate where it is the most reliable method. That will be the case where there is a lack of reliable comparables to apply a one-sided method or, expressed alternatively, where both parties make “unique and valuable” (i.e., non-benchmarkable) contributions. It is not clear what, if any, further guidance offers in providing a basis for taxing authorities to apply the arm’s length standard. We recommend that sufficient time for deliberation and consideration be utilized to properly consider any change to the guidance on use of profit split methods. Changes to the existing guidance should only be made where they improve the application and reliability of profit split methods and, as noted, in a coordinated and consistent manner with other BEPS Action Items.

- The Discussion Draft recommends the use of transactional profit split methods in a number of scenarios and as a corroborative method. We would like to point out that in many situations, one-sided analyses are appropriate and reliable. In scenarios where one-sided methods are appropriate and reliable based on a thorough functional analysis, we feel corroborative profit split methods may be a precursor to formulary apportionment, as they may improperly suggest higher returns to entities performing routine functions that can be reliably benchmarked. To this end, we would like to emphasize that a value chain analysis and a profit split are not, and should not be considered to be, synonymous.

- PwC recommends the revisions to the Discussion Draft focus on providing objective advice to MNEs. We believe the Discussion Draft includes many subjective terms that may be pejorative and therefore interpreted differently by rational decision makers.

- PwC recommends that the OECD view the revisions to the Discussion Draft in the context of the BEPS action plan as a whole. Other Action items may alleviate some of the concerns surrounding transfer pricing issues. The work to address base erosion and profit shifting should be viewed holistically, and other workstreams may address transfer pricing issues sufficiently enough that the arm’s length principle and the guidance on use of profit split methods does not need to be radically altered.
Overall, PwC recommends that the OECD devote sufficient time for deliberation and consideration in considering any change to the guidance on use of profit split methods. To this end, we emphasize that the Transfer Pricing Guidelines already address profit split analyses and the selection of the most appropriate method. Lastly, any changes in guidance on profit splits should reflect the principle that functional analyses are critical to transfer pricing analysis.

In the Appendix to this letter we have identified a number of items for further consideration by the OECD, mainly in response to the questions posited, in its next version of the document.

On behalf of the global network of PwC Member Firms, with the contribution of our colleagues David Ernick, Patrick Boone, Ian Dykes, Andrew Casley and Jonas Van de Gucht, we respectfully submit our response to the Discussion Draft on BEPS Action 10: Discussion Draft on the use of profit splits in the context of global value chains. For any clarification of this response, please contact the undersigned or any of the contacts below.

Yours faithfully,

Isabel Verlinden
Partner
PricewaterhouseCoopers, Brussels

Adam M. Katz
Partner
PricewaterhouseCoopers LLP, New York

cc Stef van Weeghel, Global Tax Policy Leader

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Appendix - Detailed Comments

1. We commend the Discussion Draft’s reaffirmation of the importance of detailed functional analyses in determining the appropriate transfer pricing method. While the Discussion Draft notes that functional analyses cannot be performed in isolation but must consider the broader context of the MNE business operations, we question how this will be interpreted by tax authorities. We note that functional analyses are meant to identify functions undertaken, risks assumed and assets utilized in an intercompany transaction to better understand how to compare a related party transaction to what would have occurred in an unrelated party context. As such, we recommend the OECD note that profit splits are only useful to the extent that the results match the pricing that would have occurred in unrelated-party transactions based on the knowledge gained in the functional analysis.

2. The Discussion Draft considers a number of scenarios where it may be appropriate to apply a transactional profit split method to align transfer pricing with value creation. Nevertheless, the Discussion Draft notes in paragraph 6 “[i]n many cases, the structure of [an] MNE group’s value chain will allow the identification of relatively discrete, stand-alone elements which can be reliably priced using one-sided methods.” We recommend that the Discussion Draft emphasize the fact that one-sided methods are often appropriate and that many situations do not require a profit split to confirm the results of the one-sided method.

The Discussion Draft acknowledges that in many cases, the structure of an MNE’s value chain permits one-sided methods and transactional profit splits are not appropriate merely because an MNE’s value chain covers multiple jurisdictions. However, the Discussion Draft recommends transactional profit splits may be more reliable than one-sided methods where there is pooling of entrepreneurial functions and risks and the success of the business depends on integration of related parties. It is not clear how it could ever be shown that that type of “pooling” and “integration” do not exist; MNEs exist precisely to take advantage of operating in a coordinated, integrated manner across jurisdictions. The result of the Discussion Draft may be that tax authorities will request taxpayers to prepare a profit split analysis in any scenario where the tax authority does not agree with the result of a one-sided analysis. Thus, we recommend that the OECD make clear that one-sided methods are often appropriate and tax authorities should not always default into requesting profit split methods to corroborate the results of one-sided analyses when such analyses are appropriate.

3. Question 1. Can transactional profit split methods be used to provide a transfer pricing solution to this scenario? If so, how?

Transactional profit split methods only provide a solution to the extent they provide a more reliable arm’s length result than one-sided analyses. Even if the Leadership Board is assumed to consist only of representatives of the three OEMs (a fact not specifically stated, and a necessary prerequisite to considering application of a transactional profit split method to the OEMs in this fact pattern) we still question the ability to apply a transactional profit split method reliably.

As noted in Paragraph 3.132, the criteria or allocation key to divide the combined profits should be supported by data, whether from independent comparables or internal sources.
The likelihood of data being available from either source that could reliably attribute profits to the various activities of the OEM participants on the Leadership Board is exceedingly low. As such, any application of a transactional profit split method is likely to result in an arbitrary division of profits among the OEMs, such that the division of profits has no relation to the division that would result in a true arm’s length scenario.

**4. Question 2. What aspects of Scenario 1 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?**

A more detailed analysis of the comparable companies and the value drivers of the business is necessary to understand whether a transactional profit split would be more reliable than a one-sided method.

**5. Question 3. Is the application of a transactional profit split method more useful than other methods for dealing with particular aspects of value chains, such as highly integrated functions, and the sharing of risks?**

Transactional profit split methods are not inherently any more useful for dealing with particular aspects of value chains. We are concerned that the approach may be used to treat an MNE as a “single firm”, and that too much reliance on transactional profit split methods in complex factual scenarios will lead to an inappropriate “rebuttable presumption” that a transactional profit split is the best method in such circumstances. Such primacy of the transactional profit split method impinges on the most appropriate method analysis and disregards the fact that even in complex factual scenarios, other methods may be more appropriate than a transactional profit split.

We also note that our concern regarding potential for over-reliance on transactional profit split methods is, in many ways, connected to the definition of the controlled transaction at issue and the principles of aggregation in paragraphs 3.9-3.12. We are concerned that tax authorities will, when faced with a complex fact pattern involving several transactions that are tested with one-sided methods, conclude without proper analysis that they are so closely linked that they should be combined for purposes of analysis. Any conclusion that an aggregated approach is appropriate should be based on thorough consideration and analysis of the separate transactions and methods applied thereto.

**6. Question 4 – What guidance should be provided to address application of transactional profit split methods to deal with these aspects of value chains?**

In many cases, a transaction profit split method may be the most reliable method where there is a lack of reliable comparables to apply a one-sided method or, expressed alternatively, where both parties make “unique and valuable” (i.e., non-benchmarkable) contributions. However, the functional analysis and broader comparability process should result in the selection of the most appropriate method. We are also concerned that the “global value chain” concept may be inappropriately used to treat an MNE as really being a single firm and to allocate income to the group members on a formulaic basis. The Discussion Draft notes that transactional profit splits may be preferable where an integrated business model reflecting a global value chain allows various entities to carry out interdependent functions. Such broad, sweeping statements offer little practical advice to taxpayers as there is nothing inherent about a multi-sided business model that results in a profit split being preferable. We worry that this preference for profit splits in the context of multisided business models may provide tax authorities reason to expect or request a profit
split analysis rather than focusing on a most appropriate/best method analysis of why a particular method offers the best approximation at an arm’s length result.

7. Question 5 - Can transactional profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how?
   A profit split may be one of many ways to provide an appropriate transfer pricing solution to the case of Scenario 2, depending on the facts of the transaction and whether similar activities are undertaken by unrelated parties.

8. Question 6 - What aspects of Scenario 2 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?
   The nature and extent of the activities undertaken by the local subsidiaries and whether these services exist in the market place would need to be elaborated. If these activities are undertaken by independent third parties, it may be possible to remunerate them appropriately via comparable returns of unrelated parties.

9. Question 7 – Does the way in which “unique and valuable” is defined for intangibles assist in defining the term “unique and valuable contributions”
   As noted in the Discussion Draft, the phrase “unique and valuable contributions” is utilized in the amendments to Chapter VI contained in the 2014 Report, Guidance on the Transfer Pricing Aspects of Intangibles suggesting “unique and valuable contributions” involve contributions constituting a key source of competitive advantage for the business and create difficulties in finding reliable comparable companies. Identifying competitive advantages in a business involves some subjectivity and there is room for reasonable disagreement as to the weights of competitive advantage. We believe “unique” refers to a situation where good comparables are not available. Use of undefined, subjective terms like “unique” and “competitive advantage” may confuse rather than clarify. It would be much simpler if objective rules were used; we believe it would be sufficient to say that a profit split method will be the most reliable method where there is a lack of reliable comparables to apply a one-sided method. As previously stated, a lack of reliable comparables should be determined based on a thorough functional analysis and broader comparability analysis.

10. Question 8. What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method?
    The nature of the activities undertaken by the competitors of S in Country S need to be elaborated, as does the relative weight customers give to technology and branding vis-à-vis the services and support provided by Company S.

11. Question 9. Based on the abbreviated fact pattern set out in Scenario 3, what method could be used to provide reliable arm’s length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?
    If the nature of the activities undertaken by the competitors of S are similar to those undertaken by S, including the customer relationships, a method such as the TNMM may be the most appropriate method. If the activities undertaken by Company S differ in ways that cannot be reliably adjusted, a transactional profit split method may be the most appropriate method. Rather than specifying how a transactional profit split method would best be applied in a circumstance without full facts, we note that the transactional profit
split would be appropriate so long as it provides for arm’s length remuneration to both entities for their respective functions undertaken, assets owned and risks borne.

12. Question 10. What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3?
   See response to Question 9.

13. Question 11. In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks?
   The Discussion Draft notes that transactional profit splits may be appropriate where an MNE’s business is highly integrated and strategic risks may be jointly managed and controlled by more than one entity. Such an analysis therefore requires an appropriate consideration of strategic risk, further confirming the OECD’s continued reliance on detailed functional analyses. We recommend that the OECD reaffirm that not all risks are the same and different risks may have significantly different risk-reward trade-offs. We also recommend the OECD reaffirm that contractual allocations of risk will be respected. Identifying the risks borne by the tested party is a key aspect of a functional analysis and identifying comparable companies with a similar risk profile is a key task of an economic analysis.

14. Question 12. Would a one-sided method produce more reliable results?
   If reliable comparables to a particular party to the transaction, or for a particular element to the transaction’s pricing, can be identified a one-sided method would produce more reliable results.

15. Question 13. What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?
   Information to be further analysed includes: the nature of the development and production process to better understand the value of the activities undertaken by Companies B and C, the knowledge or know-how developed by Company A that may have been provided to Companies B and C in developing the new generation of equipment, and whether reliable comparables exist for the activities undertaken by Companies B and C.

16. Question 14. Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how?
   No. The paragraphs in the intangibles report that are referenced here (6.57-6.58) are grayed out in that report, meaning there is internal disagreement within the working party. It would not be appropriate to revise the guidance on the scope of transactional profit split methods before that disagreement is worked out, otherwise there is nothing upon which to base any changes with respect to profit split methods. Additionally, those paragraphs seem to be based on the assumption that there are some functions that are so important that they can never appropriately be priced based on comparables and that some functions would never be outsourced by enterprises behaving in a commercially rational manner and therefore can never be priced at all, even under a profit split method. It is likely that some members of the working party believe those paragraphs are flawed in a fundamental (not minor) manner and inconsistent with the arm’s length principle. That is another reason
why it would be inappropriate at this time to revise the guidance on profit splits based on those paragraphs.

17. **Question 15.** Can transactional profit split methods be used to provide reliable arm’s length transfer pricing solutions for fragmented functions? If so how? Can other methods address the issue of fragmentation, and, if so, how?

Many MNEs split functions within a value chain whereby certain entities undertake only limited, specific functions (e.g., logistics, marketing etc.). Due to fragmentation, the Discussion Draft argues that finding comparable companies that are similarly limited to comparable specific and discrete functions may be difficult. As such, the Discussion Draft notes that it may be preferable to undertake a transactional profit split approach as a corroborative method, identifying comparable companies that combine multiple functions and utilizing the principles of a contribution analysis to divide the benchmarked profit. We are uncertain as to the need for such a statement and believe that such an analysis is undertaken in determining the reliability of the comparable set in relation to the functions undertaken, risks assumed and assets owned of the comparable companies in a one-sided analysis. Thus, such analysis should be performed in the process of determining the best comparable companies in the marketplace to be used as benchmarks and need not imply a profit split be used as a corroborative method. While we are not opposed to the profit split method being used as a corroborative method when appropriate, we believe that mere fragmentation is not reason enough to warrant the suggestion of a corroborative profit split when a reliable method has been utilized. We believe that the draft places unwarranted emphasis on the new concept of “fragmentation”, and we are concerned that it may be used inappropriately to disregard separate legal entities. It should not be used to treat all MNEs as a “single firm” and to enable arbitrary application of a profit split method. We note that corroborative profit split analyses are costly and time consuming to taxpayers.

18. **Question 16.** What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?

A proper functional analysis which takes account of the availability and quality of information is the only way to determine the appropriate method. When reliable comparables are not available, a profit split method may be the most reliable method (or an income method or an unspecified method). The Discussion Draft does not present any persuasive arguments as to how “fragmentation” will help in determining the most appropriate method.

19. **Question 17.** How can comparables be found and applied in scenario 5? What method is likely to be appropriate for determining an arm’s length remuneration for the activities of the group companies?

Comparables can be found and applied in Scenario 5 by performing a functional and comparability analysis. We do not see any facts discussed in this scenario that would necessitate any sort of prescriptive guidance being given regarding use of profit split methods under these facts. As such, we reiterate the fundamental concepts related to functional analyses and selection of the most appropriate method discussed in the beginning of this document.

20. **Question 18.** How can comparables be found and applied in scenario 3 (or to any other relevant scenario in this discussion draft)?
We believe this question is best answered by reaffirming the fundamental concepts discussed in the beginning of this document.

21. **Question 19.** What aspects of scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?
   Scenario 5 does not outline the key value drivers of the group’s business and the members of the MNE group which perform those functions, bear those risks, or employ those assets. Without that contextual background, it is not possible to evaluate what method might be most appropriate.

22. **Question 20.** In what circumstances, if any, might an approach described in the last sentence of paragraph 32 be appropriate?
   We note that by definition any point within the range is arm’s length, and we believe that the result in the last sentence of paragraph 32 could more appropriately be achieved by making a comparability adjustment to reflect the level of functions or risk in the tested party, instead of trying to combine two different transfer pricing methods.

23. **Question 21.** More generally, in what circumstances would a transactional profit split approach be useful in supporting the application of other transfer pricing methods, and what guidance would be useful to develop for supporting use of such approaches?
   We continue to emphasize the importance of relying on a proper functional analysis to make a determination as to what method is most appropriate. The concept in the Transfer Pricing Guidelines of having a “best” or “most appropriate” method necessarily implies that one transfer pricing method is better than all others and should be used to their exclusion. Paragraph 2.11 of the existing Transfer Pricing Guidelines is sufficient as to the use of more than one method. Again, we caution against using this Discussion Draft simply to make it easier to apply profit split methods; that should not be the objective of this paper.

24. **Question 22.** In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?
   Value creation factors should be identified in any functional analysis and it is therefore not clear why such suggested factors or weights may be useful on an ex ante basis. In fact, we believe that suggested factors or weights may lead to the unintended results of forcing taxpayers and tax authorities to expend greater effort questioning why the presumed items may not be appropriate in certain scenarios when such analysis would otherwise be clear from the functional analysis. It is also noted that under Action Item 13, the Masterfile already requires the MNE to list the important drivers of business profit.

25. **Question 23.** What guidance is needed on weighting of factors?
   See response to Question 22.

26. **Question 24.** How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for example approaches based on concepts of bargaining power, options realistically available, or a RACI-type analysis of responsibilities and decision making)?
   We believe that a proper functional analysis which analyses the functions, assets, and risks of each party is the appropriate approach to determining the most appropriate transfer
pricing method. There is no shortcut for doing this type of detailed analysis and we do not feel that the concepts mentioned in question 24 add anything that is not already accounted for in a proper functional analysis.

27. Question 25. Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an MNE operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate? We believe this question is best answered by reaffirming the fundamental concepts discussed in the beginning of this document.

28. Question 26. What specific aspects of transactional profit split approaches may be particularly relevant in determining arm’s length outcomes for transactions involving hard-to-value intangibles? With hard-to-value intangibles, key among the considerations in the application of a transactional profit split method would be the relationship between the value contribution associated with a given measure and the overall value created. The ability to perform such an analysis within the context of a transactional profit split method also requires that the contribution to value of a given factor, such as assets or the bearing of risks, be fully understood as compared to the contribution to value of other factors.

29. Question 27. How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable? No special guidance with respect to the most appropriate transfer pricing method is necessary or appropriate to deal with unanticipated results. At arm’s length, unrelated parties often strike a deal based solely upon information known ex ante, and then live with the results of that deal, whether anticipated or unanticipated. The Transfer Pricing Guidelines already include guidance on commensurate with income type rules; consequently, no specific guidance regarding transactional profit split methods is appropriate.

30. Question 28. Is the application of a transactional profit split method to calculate the royalty in Scenario 8, or in other circumstances to set a price, helpful? What are the advantages and disadvantages? We believe this question is best answered by reaffirming the fundamental concepts discussed in the beginning of this document.

31. Question 29. In what circumstances might it be appropriate under the arm’s length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss? We believe this question is best answered by reaffirming the fundamental concepts discussed in the beginning of this document.

32. Question 30. Are there circumstances under the arm’s length principle where parties which would share combined profits would not be expected to take any share of combined losses? The arm’s length principle would generally require a participant in a profit split method to also share losses. One can recognize certain situations in which a start-up enterprise or other unique set of facts may initially place greater risk of losses to the parent or home-
country entity. In such cases however the transfer pricing model should include risk-adjusted factors such as a profit limit or “clawback” to ensure the parties are compensated in a manner consistent with the arm’s length principle.

33. Question 31. Paragraph 2.114 of the [Transfer Pricing] Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?
   We believe this question is best answered by reaffirming the fundamental concepts discussed in the beginning of this document.

34. Question 32. Finally, what further points would respondents wish to make about the application of transactional profit split methods not covered by previous questions?
   We believe this question is best answered by reaffirming the fundamental concepts discussed in the beginning of this document.
(A) Applicability of profit split method

1. Generally, profit split method (PSM) is adopted *interalia* if the parties to the transaction contribute or possess unique or non-routine intangibles, which are not available in the comparables chosen for “one sided” testing under resale price method (RPM) or cost plus method (CPM) or transactional net margin method (TNMM).

2. What constitutes unique or non-routine intangibles, is an extremely difficult question to answer, particularly where the tested party deals in products or services, which are slightly unique from those dealt with by comparable companies.

3. Taking the example of a distributor, dealing in services, say of distributing subscription rights in television channels and also time slots for advertisement in television channels. From a practical standpoint, it is almost impossible to identify independent comparable companies involved in distribution of similar services or intangible products, if one may say so, since most of the global television companies would be distributing subscription rights in channels and advertisement time slots through their subsidiary companies across the world, which get conflicted as comparables on the ground of having significant related party transactions.

4. Now, would difficulty to identify comparables for the tested party distributor, merely on the ground of the tested party dealing in unique products and services as compared to comparable companies, disentitle the application of “one sided” testing of the tested party distributor under RPM or TNMM; and the Revenue would resort to PSM, though the tested party distributor may not actually contribute or possess any unique intangibles?

5. Both RPM and TNMM do not require similarity in products or services from comparability standpoint. The application of the said methods depends upon functional similarity between the tested party and comparable companies. While it is simple to ascertain the functional profile of the taxpayer, it is difficult to ascertain the functional profile of comparable companies, at least from a qualitative standpoint, particularly when comparable comparables deal in altogether different products or services.

6. In such case, what would be the yardstick of functional similarity? It is submitted that an attempt should be made to ascertain functional similarity from a quantitative standpoint, namely by comparing the intensity of functions, being a measure in the form of percentage of selling and general administrative (SG&A) expenses or value added expenses (VAE) against turnover [SG&A or VAE/ Turnover x 100], of the tested party distributor and comparable distributors, selected either with reference to a relatively close genre, say distributors dealing in intangible products, e.g. software, or from the wider horizon of all distributor companies.

7. It is empirically proven that there is a direct correlation between gross margins and intensity of functions [SG&A or VAE/ Turnover] of distributors. Thus, comparable distributors having more or less similar intensity of functions as that of the taxpayer or tested party, may be chosen as comparables in a “one sided” testing under RPM or TNMM; and that the Revenue should not resort to PSM on the pretext or ground that the tested party distributor possesses unique or non-routine intangibles merely because the products or services dealt with by it are unique and vastly different as compared to comparable distributors.

8. This brings us to the next important issue that can financial parameters, e.g. intensity of functions, as above, be a proper guide for ascertaining whether a taxpayer possesses unique or non-routine intangibles as compared to comparables? It is submitted that such financial parameters or quantitative filters provide useful guidance in ascertaining the functional profile of a tested party, vis-à-vis comparable companies; and should be used as tools to determine whether a taxpayer otherwise falls within the realms of comparability under a “one sided” testing by applying RMP, CPM or TNMM, instead of jumping on to PSM in trying to ascertain unique or non-routine intangibles through qualitative measures, which becomes extremely subjective, as it is extremely difficult to understand and ascertain the exact nature and quality of functions performed by comparable companies from brief descriptions provided in websites and public databases.

9. Thus, if the average intensity of functions [SG&A or VAE/ Turnover] of a taxpayer distributor, say over a period of five years, is more or less similar to the same of comparable distributor companies, then a plausible conclusion should be drawn that the taxpayer distributor does not possess unique or non-routine intangibles; and it may be subjected to “one sided” testing under RPM or TNMM, irrespective of whether or not the comparable distributors operate in the same or similar space of products or services; and the Revenue need not try and unnecessarily ascertain whether the taxpayer distributor possesses unique or non-routine intangibles for applying PSM, by carrying out qualitative analysis of functions, being an extremely subjective exercise. It is recommended that the OECD may consider the above suggestions while analysing the applicability of PSM.
(B) Splitting of profits under contribution or residual PSM

1. It would be an ideal outcome if post application of PSM, the profit/ loss gets divided between concerned related parties in a manner as is expected in a joint venture relationship between third parties. PSM seeks to eliminate the effect on profits, of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate), by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions.

2. PSM starts with identifying the profits to be divided between the associated enterprises from the controlled transactions. Subsequently, these profits are divided between the associated enterprises based on the relative value of each enterprise’s contribution, which should reflect the functions performed, risks incurred and assets used by each enterprise in the controlled transactions. In a contribution profit split scenario, the entire profit identified is split between concerned related parties. Whereas in a residual profit split context, the residual profit remaining post allocation of routine returns has to be distributed between concerned parties.

3. The more the transactions are interrelated and the values created are significant, the more in-depth understanding of the qualitative contribution of the parties and corresponding quantification are needed. The ultimate goal is to assess quantitatively the contribution of group entities, to identify an arm’s length allocation of profit and ultimately by applying the appropriate pricing method, derive a transfer price.

4. It is commonly seen that the profits to be split are distributed among concerned related parties based on certain financial parameters, e.g. expenditure on R&D, Advertisement & Marketing etc. However, there are situations when reliable data is not available to capture the relative contribution of concerned entities to each of the key value drivers for premium or non-routine profits. In such cases, there are certain quantitative techniques with the help of which ordinal factors can be converted into cardinal factors i.e. qualitative factors are measured quantitatively. The application of such techniques is widely acceptable.

5. These quantitative techniques can be used to split the profits between associated enterprises involved in the transfer of property or service. The suitable examples for such techniques are analytical hierarchy process (AHP) and preference theory. These quantitative techniques have been successfully used to solve many real life problems. For instance, the application of AHP to complex situations have numbered in the thousands; and have produced extensive results in problems involving planning, resource allocation, priority setting, and selection among alternatives. Other areas have included forecasting, total quality management, business process re-engineering, quality function deployment, and the ‘Balanced Scorecard’.

6. We recommend that the OECD may evaluate the suitability of such quantitative techniques for splitting profits in order to find better transfer pricing solutions to complex scenarios.

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5 February 2015

Dear Sir/Madam

BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

We are writing in response to the OECD’s request for comments in relation to the Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains released on 16 December 2014.

Reed Elsevier is a world leading provider of professional information solutions. We operate across several professional market segments through five business divisions comprising of Elsevier, LexisNexis Legal and Professional, LexisNexis Risk Solutions, Reed Exhibitions and Reed Business Information. Reed Elsevier operates in more than 30 countries and employs approximately 28,500 people worldwide.

We set out below our representations on the discussion draft. Our representations are focussed on the key issues for our business in relation to the discussion draft as follows:

1. It would be helpful to have more clarification on certain areas contained in the discussion draft, particularly in relation to the following:

   a. Paragraph 3 refers to practical difficulties experienced in finding comparables. It would be helpful if the practical difficulties that MNEs experience could be clarified to clearly establish the issues the draft is aiming to address.

   b. Paragraph 7 states “there seems to be some experience of using transactional profit splits to address challenges posed by specific features of global value chains, in a way that one-sided transfer pricing methods may be less well equipped to do”. Again it would be helpful to provide some examples of the experiences referred to in this paragraph, which may help to clarify situations when profit splits may be beneficial to MNEs.

   c. Paragraph 26 refers to problems in finding comparables where there is interdependence between the functions performed by associated enterprises. We do not necessarily agree that this is a problem and it is our view that in the majority of cases it is possible to find suitable comparables for most transactions between associated enterprises.

2. Paragraph 6 of the guidance states that “The fact that a MNE group disseminates its value chain amongst a number of enterprises in different jurisdictions does not imply that transactional profit split methods will be necessary or appropriate to benchmark arm’s lengths returns for those enterprises. In many cases, the structure of the MNEs group’s value chain will allow the identification of relatively discreet, stand-alone
elements which can be reliably priced using one-sided methods”. Despite this comment the guidance then goes on to request views on the applicability of profit splits to a wide variety of scenarios. We are therefore concerned that this discussion document could potentially be viewed as a move towards profit splits as a preferred method for transfer pricing analysis. This concern is enhanced following the recent updates to Chapter 6 of the OECD guidelines on intangibles, where the widely expressed view is that this will result in an increase in profit splits for transactions involving intangibles. It is our view that any work undertaken in this area should not result in an actual or perceived preference for profit splits over the other approved OECD transfer pricing methods and that the taxpayer should be able to select the most appropriate transfer pricing method based on consideration of the facts and the circumstances of the particular transaction.

3. We are concerned that an increased focus on profit splits could be viewed as a fundamental shift in transfer pricing away from the arm’s length principle, towards a global formulary approach. This concern is enhanced further when this discussion draft is considered alongside the recent updates to chapter 6 on intangibles and the discussion draft on low value services. A conclusion from the combination of these documents could result in the suggestion that the preferred approach for a MNE would be to allow all its associated enterprises a routine return for their low value services and then allocate the residual profit of the MNE to each of its associated enterprise based on a profit split methodology. This would be more consistent with the global formulary approach. The arm’s length principle is the globally recognised approach for transfer pricing and MNEs spend a substantial amount of time and incur significant expense to ensure that any arrangements between associated enterprises are consistent with the arm’s length principle. We therefore consider that, while profit splits remain useful as one of the available transfer pricing methods, they should not be viewed as the standard method for transfer pricing analysis.

4. From a practical perspective profit splits can often be more difficult and time consuming to carry out than other one-sided transfer pricing methods. From our experience profit splits are therefore typically used for more complex transactions where each party to the transaction makes a unique and valuable contribution to the transaction. To try and implement profit splits for a greater number of transactions would require significant additional time and therefore the use of one-sided methods may be preferable for most transactions where both parties are not making unique and valuable contributions. Paragraph 18 of the discussion document states that the term “unique and valuable” is not defined and perhaps a clear definition of this in the guidance would assist MNEs in determining in what circumstances profit splits could be considered the most appropriate transfer pricing method. Additionally the term “unique and valuable” is quite subjective and a clear definition may help MNEs determine whether specific contributions are considered to be unique and valuable.

5. Paragraph 35 states that “a common criticism of transactional profit split methods is their perceived subjectivity: allocation keys can be difficult to verify from objective evidence”. We agree with the basis of this statement as the use of the profit split methodology almost always relies on a subjective view of management to determine some part of the allocation key or weighting used to calculate the profit split. The subjectivity of profit splits may therefore result in a greater level of challenge from tax administrations. Additionally, it is more likely tax administrations will disagree with each other on the judgements used in the allocation of the profits. This could in turn increase the burden on tax authorities by increasing the number of cases submitted to competent authorities under MAP procedures.
6. The discussion asks for comments on a number of specific scenarios, particularly in relation to the applicability of profit splits to the scenario. Whilst not all of the scenarios are relevant to our particular business we have provided comments below on some of the scenarios:

a. **Scenario 3** - Based on the facts presented we do not necessarily consider that a transactional profit split would be the most appropriate method for this transaction. In this scenario Company S provides sales and marketing services in relation to products manufactured and developed by company P. Although Company S provides a high level of service, which provides a competitive advantage in country S, we do not necessarily consider that providing a high standard of a service that could otherwise be considered routine, is sufficient to conclude that a profit split methodology should be applied.

b. **Scenario 5** – The facts presented in this scenario are not sufficiently detailed to arrive at a definitive conclusion as to the most appropriate transfer pricing method to be applied, however based on the limited facts available one—sided TP methods may be more suitable than a profit split methodology. In this example the activities of the operating companies could be split into two main components, local business and regional business. Assuming there are no transfer pricing implications for the local business, the activities of agreeing terms and taking orders for other operating companies as part of the regional business could be viewed as a straightforward sales and marketing activity. This could be benchmarked against third parties who provide similar sales and marketing activities and we would expect sufficient comparable data to be available to support this transaction.

c. **Scenario 7** – Again, based on the facts presented, we consider that other TP methodologies should also be considered for this type of scenario in addition to a transactional profit split. For example a cost contribution arrangement could be considered whereby the associated enterprise would share the costs of developing the new product in accordance with their reasonably anticipated benefits from the development activities.

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

Yours faithfully

Paul Morton  
Catherine Harlow  
Paul Hewitt
February 6, 2015

By E-Mail: TransferPricing@oecd.org

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Re: Public Comments on the Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

Dear Mr. Hickman,

Thank you for the opportunity to provide comments on the Discussion Draft on the use of profit splits in the context of global value chains (the “Draft”), related to possible revisions to the guidance on the use of the transactional profit split method in Chapter II of the Organization for Economic Co-operation and Development (“OECD”) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (the “Guidelines”). Please find below our comments and suggestions of issues to address.

Comments on the Draft

General

1. We appreciate the OECD’s efforts in making revisions to the existing Guidelines, in particular the initiative to amend the existing guidance on the application of the transactional profit split methodology (the “Profit Split”).

2. As a general note, we believe that the guidance on the use of the Profit Split should be conceptual by providing the key parameters and considerations for the application of this methodology. We believe that the current Guidelines achieve this objective by discussing the strengths and weaknesses of the Profit Split and providing overall guidance on its applicability. Having said that, we do believe that the Guidelines could be improved by elaborating on the practical application of the Profit Split, which is discussed in further detail below.

3. The Draft presents several scenarios and poses questions concerning the applicability of the Profit Split in order to understand better the circumstances in which this methodology is the most appropriate. However, the scenarios provide limited facts and the OECD asks for comments on additional aspects that require elaboration in order to determine whether the Profit Split or another method would be appropriate.

4. It is our understanding that the OECD’s intention is to rely on these scenarios in revising the existing guidance on the use of the Profit Split. In that regard, caution should be taken in adopting this approach, since the choice of a transfer pricing methodology is highly dependent on the particular facts and circumstances of each case. Only a thorough functional analysis and examination of particular facts of each case will lead to the determination of the appropriateness of the Profit Split. Therefore, we question the effectiveness of the
scenarios in the context of revising the guidance on the Profit Split as any additional facts may affect the method selection process. Furthermore, in practice, the difficulties are most often encountered in the actual implementation of the Profit Split, and not the method selection process.

Practical Aspects

5. We kindly ask the OECD to provide further guidance on the practical application of the Profit Split. The current Guidelines specify in para. 2.108, “the transactional profit split method first identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged”. The Profit Split is typically used when there is a high degree of integration between associated enterprises, which makes it challenging to delineate individual intercompany transactions and determine which portion of the combined profits is attributable to each transaction.

6. In practice, we generally find that the residual analysis described in paragraph 2.121 of the Guidelines is more commonly applicable whereby the combined profits of an MNE are split in two stages. First, the associated enterprises are allocated returns for routine contributions and second, the residual profit (or loss) is allocated based on an economically valid basis that approximates the allocation of profits between arm’s-length parties.

7. One of the key practical challenges in implementing the residual analysis is to apportion the residual profit amongst the controlled transactions. In our opinion, the Profit Split should first attempt to split the combined profits on a company-wide basis and only then adjust the pricing of the controlled transactions such that the allocation of profits between associated enterprises approximates the arm’s-length allocation of profits. In that regard, we propose the following framework for the application of the residual Profit Split:

Stage 1: Determination of routine returns

a. Determination of the pool of the combined profits of an MNE;
b. Allocation of returns for the routine contributions of each of the associated enterprises; and

c. Determination of the combined residual profit (or loss) of an MNE.

Stage 2: Allocation of residual profit

a. Determination of allocation key(s) based on the value-creating activities of an MNE;
b. Allocation of the combined residual profit to each associated enterprise based on the allocation keys;
c. Determination of an adjustment to the profit of each associated enterprise (“profit split adjustment”) in order to arrive at the targeted allocation of the combined residual profit; and

d. Allocation of a profit split adjustment to controlled transaction(s).

8. The last step of the second stage is particularly difficult to apply in practice given the complex web of transactions (e.g. various services and tangible goods transactions) that typically exist when the Profit Split is applicable. This step, however, is very important given its implications not only on the pricing of a particular controlled transaction, but on other non-transfer pricing aspects, such as tax, customs and VAT:

a. From a tax perspective, issues may arise when an expense, resulting from a profit split adjustment, is not deductible in a jurisdiction of an associated enterprise. As an example, if a profit split adjustment is recorded as a “management fee”, the deductibility of such adjustment may be challenged by tax authorities. Another important consideration is a potential withholding tax, which may be applicable if a
profit split adjustment is made with respect to a controlled transaction that has withholding tax implications (e.g. a royalty).

b. Customs considerations should be taken into account when a profit split adjustment is made with respect to a sale or purchase of tangible goods.

c. VAT implications should also be considered when a profit split adjustment is made to either a services or a tangible goods transaction.

9. To summarize, we strongly believe that the focus of the revisions of the Guidelines with respect to the use of the Profit Split should be on the practical aspects of the implementation of the Profit Split and not on developing further guidance on the appropriateness of this methodology.

**Other Comments**

Below we present our comments on some of the scenarios presented by the OECD in the Draft.

**Value Chains**

10. The first part of the Draft addresses how the high level of integration of functions and risks inherent to global value chains can create difficulties in the application of a one-sided transfer pricing method; it asks whether the transactional profit split method may be applied in these circumstances.

11. In general, the facts provided in Scenario 1 are insufficient to determine whether the Profit Split is the most appropriate method. In order to make such determination, the following additional information is required:

   a. The role of the non-European IP owner and the OEMs with respect to IP development and ownership. In particular, it is understood that the IP is owned by the non-European parent, while the decisions with respect to development of new products are made by the Leadership Board, represented by all three OEMs;

   b. A better understanding of the intercompany sales and purchases between OEMs. Specifically, it would be important to know whether these transactions represent occasional sales and purchases or form part of the mainstream business of an OEM; and

   c. Understanding of the intercompany services that arise from the high level of co-operation and interdependence between the OEMs.

12. Having said the above, and assuming that the Profit Split method is the most appropriate to apply in Scenario 1, we would appreciate further clarification from the OECD on the allocation of profit split adjustments to controlled transactions. Based on the facts of Scenario 1, it seems that there are both services transactions as well as transactions involving sales and purchases of tangible goods between the OEMs. The current wording of the Guidelines requires splitting the combined profits resulting from the controlled transactions. However, as discussed above, it is difficult to determine which portion of a profit split adjustment should be attributed to an individual controlled transaction given the inherent subjectivity of this methodology. The profit split adjustment may also have significant implications on various aspects such as the deductibility of an expense for tax purposes, customs and VAT.
Unique and valuable contributions

13. Paragraphs 18 to 21 of the Draft address the potential appropriateness of the Profit Split in cases where both parties make "unique and valuable contributions" to a transaction. Scenario 3 is intended to illustrate this.

14. This scenario falls short in illustrating a situation in which both parties contribute unique and valuable intangibles, as it is not clear what the unique intangibles Company S contributes. As per Paragraph 20, Company S “develops very close relationships with customers…providing a significant competitive advantage”. We do not find this to be a unique contribution, since developing client relationships is the basic premise of being a sales and distribution company. Presumably, a company operating in a similar capacity to Company S would also develop customer relationships in order to simply remain competitive in the marketplace.

15. Furthermore, question 7 asks whether the way in which "unique and valuable" is defined for the purposes of Chapter VI of the Guidelines assist in defining the term "unique and valuable contributions" in relation to the transactional profit split method. The way in which “unique and valuable” is defined for intangibles is tautological and does not assist in defining the term nor provide any additional clarity for taxpayers.

Dealing with ex-ante / ex-post results

16. Scenario 7 is meant to illustrate that “a transactional profit split method can determine from the outset how parties will determine the share of uncertain outcomes”. First, based on the information provided, we question the appropriateness of the Profit Split as this appears to be a cost contribution arrangement, which is dealt with in Chapter VIII of the Guidelines. Second, assuming the Profit Split is the most appropriate method, an ex-ante approach should be the dominant approach in the determining the residual profit or loss split, as it is based on the information available to the parties at the time the parties entered into agreement. Using an ex-post approach creates an undue burden on taxpayers and further increase uncertainty as to the application of the Profit Split.

Conclusion

Thank you again for the opportunity to share our comments with the OECD on transfer pricing matters. As always, we welcome guidance from the OECD to facilitate the application of transfer pricing principles for both tax administrations and taxpayers.

Yours very truly,

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BEPS Action 10 Public Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

Dear Mr. Hickman,

Please find below the comments of RBS RoeverBroennerSusat GmbH & Co. KG Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft ("RBS RoeverBroennerSusat") on the public discussion draft regarding "BEPS Action 10: Public Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains" issued on 16 December 2014 ("OECD Discussion Draft"). RBS RoeverBroennerSusat acts as tax advisor and auditor of the small and medium size entities ("SME") as part of the German mid cap market (Mittelstand). Thus, the focus of our comments is set on the impact of the OECD Discussion Draft on SMEs.
A. Introduction

The OECD Discussion Draft uses various scenarios to contextualize specific questions concerning the application of the transactional profit split methods. RBS RoeverBroennerSusat welcomes this approach, as it directly relates to the actual application of transactional profit splits and thus provides clarification to transfer pricing practitioners. We further welcome that the OECD Discussion Draft emphasizes that the scenarios should in no way be taken to imply that transactional profit split methods will be the most appropriate method in the circumstances outlined in those scenarios. In this context, we find it worthwhile to point out that efforts to facilitate applying profit split methods should not, as a(n) (unintended) consequence, curtail the application of one-sided methods. Respective concerns also relate to the proposed revisions to Section D of Chapter I of the OECD Transfer Pricing Guidelines. The increasing emphasis on the need to take into account how functions, apparently including those qualifying as routine functions, relate to the wider value generation of value by the MNE group as a whole (D.1.10 or D.1.1.16) potentially translates to stricter comparability requirements. In turn the number of comparable transactions will be reduced, rendering the application of one-sided methods will become more difficult. As a result taxpayers would face increased costs relating to conducting and documenting comparability analysis as well as additional uncertainty during tax audits.

In Germany (pursuant to Section 4 No. 3 (b) GAufzV) taxpayers are required to describe the entire value chain including the taxpayer’s contribution thereto. As clarified by the Administrative Principles - Procedure (Verwaltungsgrundsätze-Verfahren), however, the taxpayers contribution to the value chain can regularly be deduced from the functional- and risk analysis and the corresponding economic analysis. Hence, particularly when analyzing routine functions, it is generally not required to conduct a separate value chain analysis and prepare respective documentation.

While RBS RoeverBroennerSusat broadly supports the aim of the OECD, we consider it of the essence to minimize the corresponding administrative burden, particularly for SMEs.

B. Scenario 1: Global Value Chains

1. Applying a profit split to determine an arm’s length allocation of the (residual) profit resulting from the effective pooling of entrepreneurial functions and risks appears sensible. In a first step, as outlined in the scenario, one-sided methods should be used to determine arm’s length pricing for the royalty as well as for the contract manufacturing and distribution activities. In a second step, it should be analyzed whether transactions among the OEMs can be identified for which an arm’s length remuneration can be determined by applying one-sided methods (e.g. the resale price method for buying and selling components as well as finished goods). A trade-off between the identification of relatively discrete elements, which can be reliably priced using one-sided methods on the one hand and synergies and benefits created by integration on the other hand, appears inevitable. Synergies and benefits created by integration tend to be difficult to identify, let alone to quantify and allocate appropriately. Provided that sufficiently comparable data is available, one-sided methods can thus be assumed to reflect an arm’s length allocation of profits more reliable than a profit split. Hence, the focus of the second step should be to minimize the residual profit to be allocated by applying a profit split.
2. All aspects contributing to an evaluation of the aforementioned tradeoff would have to be elaborated to outline an adequate utilization of the profit split, including the functions of the non-EU parent. In particular, the nature of the cooperation should be specified in respect to the individual functions (e.g. local marketing functions performed by OEMs or financing of plant investment). Further, it should be elaborated whether the economic circumstances prevailing on the local markets of the OEMs are comparable.

3. Yes, the application of a transactional profit split method is more useful than other methods - depending on the tradeoff outlined above.

4. Guidance should be provided e.g. on how to apply a profit split when the associated enterprises operate in fundamentally different markets or on the pooling of entrepreneurial functions in respect to investment projects (specifically in case production capacity or value of production are subsequently applied as an allocation key – see para. 37 of OECD Discussion Draft).

C. Scenario 2: Multisided Business Models

5. Given the facts and circumstances of the scenarios, it appears unlikely that the transactional profit split methods constitute the most appropriate method. It appears likely that relatively discrete elements which can reliably be priced using one-sided methods as well as comparable data could be identified, e.g.: a) license agreements for comparable technology to that of Company R. b) companies performing functions (distribution and technical support) comparable to those provided by the subsidiaries of RCo.

6. A detailed functional and risk analysis would be essential. In respect to the subsidiaries the unique and valuable contributions, if any, would have to be substantiated.

D. Scenario 3: Unique and valuable contributions

7. The reference to unique and valuable contributions constituting a key source of competitive advantage generally appears sensible. To avoid an excessive scope of application, further refinement of the definition would, however, be welcome. A wide range of services similar to those performed by Company S can be identified in public databases or reports issued by statistical offices. In scenario 3, the functions performed by the competitors of Group X or other independent distributors either in country S or in similar markets can be assumed to be, at least to a certain extent, comparable to Company S. Considering that the decisive question will be whether Company S contributes to the competitive advantage to Group X in a way the potential comparables do not, further guidance on identifying and quantifying such contributions would be welcome. In particular, it should be clarified that not all sales activities or other services involving immediate interactions with customers are automatically regarded as unique and valuable contributions.

8. A detailed functional and risk analysis, e.g. differentiating between sales of equipment and marketing activities, would be essential. A detailed analysis of the competitors as well as independent distributors should be conducted in order to clarify whether the utilization of one-sided methods could be feasible.

9. See answers to question 1.
10. In case of highly integrated operations in which it is not feasible to differentiate between individual activities (i.e. isolating routine functions) and where both parties make unique and valuable contributions applying a transactional profit split method can generally considered to be advantageous. The main drawback is to be seen in the subjective nature of identifying and quantifying an arm’s length allocation key. Again, more detailed guidance on identifying and quantifying unique and valuable contributions could greatly reduce respective uncertainty during tax audits.

E. Scenario 4: Integration and sharing of risks

11. Applying a transactional profit split method would be appropriate when the related parties effectively pool the entrepreneurial functions and risks – similar to scenario 1.

12. Depending on the conditions agreed between the parties (see answer to 13), it could be possible that the risk-return trade-off would be more accurately reflected by applying a one-sided method (allocating the residual profit to Company A) – for details on accounting for risk-return trade-offs, please refer to our respective comments to “BEPS Actions 8, 9 and 10: Discussion Draft on revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Re-characterization and Special Matters)”.

13. Aspects to be elaborated include the other functions and risks performed by Companies B and C (i.e. blue sky research, research strategy and funding), which would determine whether they could be classified as contract research services providers. It should further be clarified which entity has the legal ownership of the respective intangibles, technology and trademarks.

F. Fragmentation

14. – 16. Whether the application of a transactional profit split method is appropriate in the context of fragmentation of functions depends on the specific circumstances of a transaction. In example 18, the prevalent transfer pricing issue appears to be that Company S is essentially described as a minimal functional entity rather than the fragmentation of functions. In similar cases, it should generally be feasible to determine arm’s length transfer prices by considering issues such as the performance of important functions or ensuring an appropriate risk-return trade-off. In general, applying a transactional profit split method would appear to be beneficial when the high level of integration obscures a unique and valuable contribution of individual entities. In cases such as example 18 (value-chain encompassing merely two related parties) it is rather unlikely that such contributions will be obscured.

G. Scenario 5: Lack of comparables

17. It would generally appear sensible to conduct a functional and risk analysis that adequately differentiates between the activities of the operating companies. Compared to fulfilling orders placed with other group companies, selling products to local customers is likely to involve more complex functions (acquisition and marketing) as well as higher risks. The activities related to agreeing terms and taking orders from local customers would presumably fall somewhere in between. Respective functional differences would have to be reflected in the search for com-
parables. In case the activities constitute routine functions, it should be feasible to identify comparables in commercial databases. In this case, applying the resale price method or the cost plus method could be appropriate.

18. In the case that specific activities of the operating companies would involve unique and valuable contributions, the residual profit to be allocated by applying a profit split should be minimized as much as possible – e.g. by applying one-sided methods to determining an arm’s length remuneration for those activities constituting routine functions.

19. Functions and risks of the specific activities of scenario 5 need to be further elaborated.

20. The suggested approach could be appropriate to identify an arm’s lengths remuneration in cases involving either unique and valuable contributions or the effective pooling of entrepreneurial functions.

21. Applying a transactional profit split approach can be useful for supporting the application of other transfer pricing methods in a variety of cases (particularly those addressed in question 20). Guidance should be provided with respect to the implication on the (narrowing) of arm’s length ranges of operating margins; e.g. could the application of a transactional profit split substitute the application of an interquartile range?

H. Scenario 6: Aligning taxation with value creation

22. Factors reflecting value creation will strongly depend on the idiosyncrasies of a given business model (heterogeneous nature of global value chains). To integrate sector-specific factors into the Guidelines, which are considered likely to reflect value creation, would be reminiscent of formulary apportionment and appears ill-suited for ensuring that the taxation of a specific MNE is aligned with value creation. In this context, it should be noted that the factors proposed for application in scenario 1 (para 37 of OECD Discussion Draft) are unlikely to affect an arm’s length allocation of the residual profit. Considering that the production is (largely) outsourced to subsidiaries providing contract manufacturing services, which in turn suggests that factors related to production and/or headcount will be a poor proxy for value creation.

23. None.

24./25. Methods such as conducting a RACI analysis are sensible supplements to a functional analysis and could enhance the reliability of applying a profit split method. The analysis could be further refined by combining multiple methods (e.g. determining the BATNAs of the involved parties and applying game theory). Ultimately, the adopted approach must reflect the given business model of a specific MNE.

I. Hard-to-value intangibles

26. See answers to question 22 and 24./25.

J. Scenario 7/8: dealing with ex ante/ex post results

27. See answers to question 24./25. Yes, profit splits are generally suitable to deal with unanticipated results. Application should be based on a respective arm’s length analysis, focused on decision-making by third in situations that involve risk (e.g. prospect theory).
28. The application of a transactional profit split method to calculate the royalty appears feasible; it should, however, not readily be applied on a stand-alone basis. The obtained results should be supported by complementary analysis (e.g. value added of marketing function).

K. Scenario 9: Dealing with losses

29./30. Under the circumstances outlined in the scenario, varying the application of splitting factors may ostensibly be regarded as arm’s length. At the same time it appears generally questionable whether the respective factor accurately reflects value creation in the first place (see answer to question 22, above).

L. Sundry

31. Paragraph 2.114 remains relevant.

32. Where both parties make unique and valuable contributions applying a transactional profit split method can generally considered advantageous compared to other transfer pricing methods. The selection of an appropriate transfer pricing should, however, remain at the discretion of the taxpayer. In case tax administrations challenge a selection made by a taxpayer, it should bear the burden of proof regarding the transactional profit split being appropriate instead. This proof would have to include a detailed specification of the unique and valuable contributions of the related parties. When analyzing routine functions, conducting a separate value chain analysis and preparing respective documentation should generally not be required.

Going forward, we consider it of the essence to be mindful of avoiding additional administrative burden, particularly for SMEs. In this context, it could be evaluated whether stipulating a threshold (e.g. based on transaction volume) for the application of transactional profit split methods constitutes a feasible option. The respective working assumption would be that applying transactional profit split methods to transactions below this threshold (e.g. € 5,000,000) would have no material effect on overall BEPS risks (see our respective comments to Action 11 as well as to Actions 8, 9 and 10 regarding the need to facilitate quantitative research BEPS risks and evaluating the trade-offs of applying special measures).
We remain at your disposal for any further discussion of these issues.

Yours sincerely,

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February 6, 2015

VIA E-MAIL

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Re: Comments on BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

Dear Mr. Hickman,

These comments are submitted by the undersigned independent trade associations, described in the attached statements, which together include almost 150 companies as members, in response to the invitation to submit comments on the BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains.

We appreciate the opportunity to comment on the BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains, released on December 16,
2015 (the “Discussion Draft”). These issues are important to our member companies.

I. Summary

We are concerned that this Discussion Draft, together with the other Discussion Drafts on Actions 8-10, signals a general move away from both the arm’s length principle and the separate entity accounting principle. The Discussion Draft appears to bless a general rejection of comparables and one-sided methods, and a broad endorsement of profit split methods, solely on the basis that MNE groups are “integrated” or even merely “coordinated” through their global value chains. These would not be mere clarifications but instead significant changes to fundamental aspects of the arm’s length principle.

We submit that MNE groups have long been integrated. The arm’s length principle has always acknowledged this fact and provided that controlled transactions are to be priced by reference to what comparable unrelated parties would have done in comparable circumstances. We further submit that the arm’s length principle and the proper application of a comparability analysis are essential to ensuring that related-party transactions are taxed consistently with, and not less favorably than, comparable third-party transactions.
It appears that the Discussion Draft may be motivated in part by a desire to achieve a sharing of the perceived synergies and other benefits of operating as an MNE group, which the Guidelines have never provided for. If that decision is to be revisited, special care should be taken not to undermine the arm’s length principle itself and thereby call into question the basis for tax return and financial statement positions and create a large increase in irresolvable disputes that tax administrations cannot handle and unrelieved double taxation that businesses cannot bear. The operation of the arm’s length principle should be changed only on the basis of a proven need, an adequate policy foundation, and a true international consensus, and only if the provisions of Article 9 have been amended in the applicable treaty (and, where necessary, domestic law) to provide this result. It is critical that any guidance adopting such changes be made explicitly applicable on a prospective basis only.¹

We are seriously concerned that the approaches suggested by the Discussion Draft would significantly increase

¹ In this connection, we note that the Discussion Draft unfortunately sets a poor example by referring throughout to the most recent draft of the Guidance on Transfer Pricing Aspects of Intangibles as “interim guidance,” although it was explicitly presented upon its release as not yet applicable, pending completion of related BEPS Actions and further consideration of its Section B in particular. This point should also be clarified.
the economic double (or multiple) taxation of income. While this presumably is not a goal of the Discussion Draft, we believe that the profit split methods that it suggests would have an inherent bias towards that result. This is due not only to the general difficulty of avoiding double taxation when a profit split is applied, but also to the significant subjectivity and imprecision of important aspects of the Discussion Draft itself.

We are also particularly concerned that this Discussion Draft would encourage a move towards global formulary apportionment. The Transfer Pricing Guidelines contain an extensive discussion of the concerns raised by global formulary apportionment and confirm that it “cannot reliably approximate arm’s length conditions.”\(^2\) The BEPS Action Plan explicitly rejects formulary apportionment and reaffirms support for the arm’s length principle.

It is thus surprising to see what appears to be a tacit endorsement of formulary apportionment reflected in this Discussion Draft. Important portions of the Discussion Draft reduce the transfer pricing analysis to an ill-defined formulary apportionment approach based on desired outcomes rather than on an application of the arm’s length principle to the particular

circumstances of the case. Indeed, the factors suggested by paragraph 37 of the Discussion Draft for application in Scenario I appear to correspond closely to the three-factor apportionment system used in various conflicting permutations by many of the U.S. states, which is based on property, payroll, and sales. The shortcomings of that system are well-acknowledged; in addition to systematic double taxation (or double non-taxation), they include the need to reach agreement on the group whose income is to be apportioned, the formidable administrative and compliance challenges posed by a system which depends upon each jurisdiction having detailed information about the business operations, income, and expenses of group members that have no business operations in or contacts with that jurisdiction (or alternatively, if the system is applied only to the subgroup of group members with business operations or a presence in that jurisdiction, the need to resort to arm’s length transfer pricing principles to address transactions occurring between that subgroup and the rest of the group), the potential need to consider different allocation formulas for different types of business operations (including where those different business operations co-exist within a single group), the critical need for participating jurisdictions to agree upon common and consistent tax or accounting rules relevant to the determination of the group’s tax base, the need to reach and maintain agreement on
the apportionment factors and their weighting (particularly in light of the pressures some jurisdictions to feel to change the factors, either to attract investment or to raise more revenue), and the difficulty of reaching agreement on the principles for measuring the various factors (e.g., where do “sales” occur? how are assets valued? how should intangibles be treated?, etc.).³

It is for good reason that the OECD, the G20, and the UN have all consistently rejected global formulary apportionment and reiterated their support for the arm’s length principle and separate entity accounting.⁴ If this Discussion Draft is not intended to achieve a different result, then we respectfully submit that that point needs to be explicitly confirmed and its discussion of profit split methods fully reconciled with that position.

⁴ OECD Guidelines, Chapter I.C.3; UN Commentary on Article 9, para. 3; United Nations Practical Manual on Transfer Pricing for Developing Countries, Chapter 1.4; Action Plan on Base Erosion and Profit Shifting, pages 14, 19-20.
II. Comments on Global Value Chains

The Discussion Draft, like BEPS Action 10 itself and the report of the BEPS Task Force on the Digital Economy, focuses its discussion of profit split methods on global value chains. The Discussion Draft defines “global value chain” as “the full range of firms’ activities, from the conception of a product to its end use and beyond … It includes activities such as design, production, marketing, distribution and support to the final consumer.” This means that all MNE groups have global value chains. Thus, although the Discussion Draft may appear to focus on selected business models, it is in fact addressing the manner in which MNE groups do business throughout the world today.

There is no standard value chain structure, even among our member companies. The way in which a company’s value chain is organized varies depending on factors such as the nature of the company’s goods and services, the location of its markets and inputs, and its relative maturity, and is regularly adjusted to reflect any changes in such factors. Some functions, such as headquarters functions and procurement, tend to be

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centralized either regionally or globally. Other functions, such as customer support and delivery logistics, are more likely to be performed locally, at least in major market jurisdictions. Still others, such as manufacturing and R&D, may be based in a limited number of jurisdictions selected for proximity to inputs, employees, and markets, infrastructure, and cost considerations.

A common feature of global value chains is that they are used for business reasons, such as cost and other efficiencies, proximity to materials and other inputs, and location of major markets. In its brief discussion of global value chains, the Digital Economy Report describes their historical origins as follows:

When the arm’s length principle was initially devised, it was common that each country in which an MNE group did business had its own fully integrated subsidiary to carry on the group’s business in that country. This structure was dictated by a number of factors, including slow communications, currency exchange rules, customs duties, and relatively high transportation costs that made integrated global supply chains difficult to operate. With the advent of the development in information and communication technology (ICT), reductions in many currency and custom barriers, and the move to digital products and a service based economy, these barriers to integration broke down and MNE groups began to operate much more as single
firms. Corporate legal structures and individual legal entities became less important and MNE groups moved closer to the economist’s concept of a single firm operating in a co-ordinated fashion to maximise opportunities in a global economy.7

This account raises other issues, as discussed below, but it does not question the fact that global value chains are used by MNE groups for valid business reasons.

We submit that most businesses operating internationally have long had both global value chains and local operations. The separate country structures that the Digital Economy Report posits as the original business model surely never existed in every market or conducted all of the functions of the MNE group. MNE groups are likely to have operations in additional jurisdictions now, due to the trade liberalization factors cited by the Digital Economy Report, but this is a difference of degree. At the same time, MNE groups still include local subsidiaries in many countries.

III. General Concerns

A. Goals of the Discussion Draft

7 Digital Economy Report, para. 6.2.2.4.v., page 119.
On its face, the new focus on global value chains is puzzling. It is presented as part of the response to the following concerns expressed by the BEPS Action Plan regarding “transfer pricing and the enforcement of the arm’s length principle”:

… multinationals have been able to use and/or misapply those [existing transfer pricing] rules to separate income from the economic activities that produce that income and to shift it into low-tax environments. This most often results from transfers of intangibles and other mobile assets for less than full value, the over-capitalisation of lowly taxed group companies and from contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties.⁸

Action 10 focuses specifically on “other high-risk transactions” and states that it is necessary to ‘[d]evelop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties.”

It is difficult to see how the mere existence of a global value chain would raise any of these particular concerns. The concerns regarding global value chains appear to be different ones, as intimated by the Discussion Draft. After firmly declaring that general arm’s length principles will continue to

govern the application of transactional profit split methods, the Discussion Draft adds:

where there is significant integration involving parties to a specific transaction or transactions within that value chain, for example in the effective sharing of key functions and risks, the reliability of one-sided methods may be reduced. One-sided methods may not be able to account reliably for the interdependence of the key functions and risks, or for the synergies and benefits created by such integration. In such cases transactional profit split methods may be an appropriate means of determining an arm’s length outcome, which takes into account the specific contributions of the parties to value creation.  

This statement signals three positions: (1) a wish to split profits from the synergies and other integration benefits that MNE groups are presumed to realize, (2) a view that one-sided transfer pricing methods do not produce desirable results, and (3) a readiness to lower the existing threshold for application of transactional profit split methods in order to achieve a different outcome. These points also surface clearly in many of the Scenarios that follow the Discussion Draft’s brief introductory remarks.

9 Discussion Draft, para. 7.
As discussed below, we are concerned that these goals go beyond the BEPS mandate and would introduce departures from, rather than clarifications of, the arm’s length principle. The discussion and rationales appear to apply to MNE groups generally, which raises the prospect that profit split methods could become the general rule rather than the exception. Indeed, we believe that the Discussion Draft signals a general move towards profit split methods and away from one-sided methods.

B. Integration Issues

We are particularly concerned that the Discussion Draft’s comments on integration equate many common activities of MNE groups with the “very interrelated transactions” referenced in the current Transfer Pricing Guidelines discussion of profit split methods, such as the 24-hour global trading of investment portfolios.\(^\text{10}\) We believe that this is factually incorrect in most cases. Perhaps recognizing this, the Discussion Draft also signals that a lower degree of integration should suffice for application of a profit split method, such as “significant integration” and “an effective

\(^{10}\) Transfer Pricing Guidelines, para. 3.5.
sharing of key functions and risks.”

The basis for this approach is not clear to us.

The stated rationale is that integration makes it more difficult to find comparables (or comparables for which reasonably reliable adjustments can be made). However, the Discussion Draft simply concludes that the “integrated nature of many MNE groups” makes it difficult to find comparables, without explaining why this is. At the same time, the Discussion Draft argues that finding comparables is also made more difficult by “fragmentation” – the conduct of activities by separate level entities within a global value chain – which seems both counterintuitive and inconsistent with the claim regarding integration.

The Discussion Draft quotes the Digital Economy Report, which similarly asserts that comparables are “unavailable” in some value chain “situations” due to integration, and mentions unique intangibles as well.

These discussions of integration seem to be inspired by the Digital Economy Report’s above-cited reference to the economic “theory of the firm,” which the Report characterizes as a theory that MNE groups operate in a coordinated manner

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11 Discussion Draft, para. 7.
12 Discussion Draft, para. 3.
like a single firm. The theory of the firm dates back to Ronald Coase’s famous work in the 1930s positing that firms arise to avoid the transaction costs of doing business directly with the market. However, even if this theory provides an accurate portrayal of organizational behavior, its implications for transfer pricing between associated enterprises in a particular case are not clear. Is this discussion really meant to imply that MNE groups should also be taxed like single firms? If so, is it meant to suggest that profit split methods are inherently most appropriate for this purpose? Does this open the door to global formulary apportionment? If not, how can principled distinctions be drawn and enforced?

Coase’s work on the theory of the firm and its critiques were known to the drafters of the Transfer Pricing Guidelines interpreting the provisions of Article 9, which have been adopted almost without exception in tax treaties throughout the world. Nonetheless, the Guidelines clearly embrace the arm’s length principle and the separate entity accounting that underlies it and reject a move toward formulary apportionment, as the BEPS Action Plan itself does. We continue to agree with the analysis of the Guidelines and their conclusion that the

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weaknesses of such apportionment approaches significantly outweigh their benefits.\textsuperscript{16}

IV. General Comments on Profit Split Methods

The Transfer Pricing Guidelines recognize that a transactional profit split methodology may be the most appropriate method in certain specified circumstances. We do not disagree. However, the Guidelines appropriately limit the application of transactional profit split methods and acknowledge their weaknesses.

We are particularly concerned that the profit split approach suggested by the Discussion Draft depends on a common determination of profits across jurisdictions and unspecified allocation factors for which virtually no guidance is provided. This would inevitably yield a wide spectrum of possible results for each case. The unpredictability of the result in any particular case is a significant concern for businesses, which need an adequate level of certainty regarding their tax treatment in order to make investment decisions. The range of potential results is a particular concern given the current lack of assurance that disputes will be resolved. As a practical matter, businesses must also know in advance what the rules are and

\textsuperscript{16} Transfer Pricing Guidelines, paras. 1.21-1.32.
how they will be applied in order to file their financial statements, report their income, and pay their taxes.

Profit splits also are highly likely to produce inconsistent results for similarly situated taxpayers, which is a particular concern for businesses trying to compete with each other on a level playing field around the world. This is inconsistent with the principles of good tax administration.

This unpredictability also creates substantial uncertainty and risk for governments, as their revenue collections will hinge in large part upon what their tax administrations are able to negotiate on a case-by-case basis.

Unpredictability will also result in less investment and economic activity. Perhaps more critically, aggressive activity by tax administrations to increase tax revenue using ill-defined profit split methodologies could also reduce investment and employment.

We believe that the current Guidelines strike the right balance by requiring that profit methods be used to “approximate arm’s length conditions” and be applied only “when traditional transaction methods cannot be reliably
applied alone or exceptionally cannot be applied at all.”

The Guidelines appropriately require that profit-based methods be “compatible with Article 9, … especially with regard to comparability” and specify that “[t]he only profit methods that satisfy the arm’s length principle are those that are consistent with the profit split method or the transactional net margin method as described in these Guidelines.”

V. Comments on the Discussion Draft Scenarios

As a general matter, we are concerned that the application of profit split methods as suggested in the Scenarios presented by the Discussion Draft would depart sharply from the arm’s length principle and existing transfer pricing guidance and move towards formulary apportionment. Many of the questions posed by the Discussion Draft regarding the Scenarios do not even acknowledge the arm’s length principle; for example, they ask not whether a profit split method would be the “most appropriate method” but instead whether it would be “useful” or “helpful” or provide “the means to vary or flex the results under a one-sided method.” This focus on

17 Transfer Pricing Guidelines, para. 3.1.
18 Id., para. 3.3.
19 Id., para. 3.1.
20 Discussion Draft, para. 32.
“outcomes” signals a dangerous focus on national revenue collections at the expense of principle.

At the same time, the Scenarios reflect a lack of clear guidance and consensus regarding the concept of “value creation.”

We are especially concerned that many of the Scenarios posit situations that do not exist in the real world to the best of our knowledge. For example, it seems inconceivable that the parent company in Scenario 1 would defer significant decision-making authority to its OEM subsidiaries. This and other such discrepancies between normal business practices and the facts of the various Scenarios suggest that they may represent recharacterized cases in which tax administrations are seeking to achieve transfer pricing outcomes inconsistent with existing transfer pricing guidance.

As discussed below, other Scenarios suggest very broad understandings of integration and risk-sharing, novel concepts of marketing intangibles, and even concerns regarding the “competitive advantage” enjoyed by MNE groups.

We also have specific concerns and questions regarding some of the Scenarios and accompanying questions, which we set forth below.
Scenario 1 suggests that “co-operation and interdependence” among affiliates and the resulting “effective pooling of entrepreneurial functions and risks” can warrant the application of a transactional profit split method. The Scenario helpfully acknowledges that one-sided methods “can reliably be used” to price the royalties due under the technology IP licenses from the foreign parent company to the OEMs and the contract manufacturing and distribution services performed by subsidiaries of the OEMs. However, we believe that it is otherwise off base, for several reasons.

First, the facts posited in this Scenario are unrealistic. MNE group parent companies do not, as a matter of practice, cede authority to a handful of OEM subsidiaries to decide “largely independent of the parent” and “for the business as a whole” issues such as “what new products are developed, where they are developed, where they will be built, what plant investment is to be made, strategic marketing, etc.” While each transfer pricing analysis should turn on the facts and circumstances of the case involved, we are concerned that such an unrealistic scenario could inspire unwarranted efforts to
recharacterize the normal operations of MNE groups in this manner.

Second, Scenario 1 is too quick to reject the application of one-sided methods to transactions among the OEMs. It asserts that “the way in which the three OEMs interact with each other in the European market is highly integrated,” because all of the OEMs are represented on a “Leadership Board” that takes decisions, they buy and sell components and finished goods to each other, and the success of the business depends on having “a wide portfolio of products to sell across the European market.” The Scenario concludes that there is “a high level of co-operation and interdependence between the OEMS and an effective pooling of entrepreneurial functions and risks.” However, the Scenario does not indicate which risks are borne by the OEMs, why their functions are considered “entrepreneurial” or interdependent, or even why there is believed to be an “effective pooling” (although apparently not an actual “pooling”) of such functions and risks. None of these factors would make the application of a one-sided method inappropriate under existing transfer pricing guidance. The transactions conducted by the OEMs are limited to the manufacture of goods and components and the local sale and distribution of those products, which appear to be routine,
non-unique functions for which reliable comparables should be available. It is not clear why any of the OEMs would be due a non-routine return or why any such return would need to be shared among them.

Third, Scenario 1 fails to explain why a transactional profit split method would be the most appropriate method under these facts. There is no indication that unique and valuable contributions are made by all of the OEMs, as existing transfer pricing guidance requires. Surely a profit split method cannot be required simply because there is mere coordination among group companies; if this were the case, most if not all MNE groups would be subject to such treatment. The questions regarding Scenario 1 do not even suggest that transactional profit split methods would be the most appropriate method under these facts; they ask only whether such methods “can … be used to provide a transfer pricing solution,” whether they would be “more useful than other methods for dealing with particular aspects of value chains,” and whether they would be “appropriate in this case.”

• **Scenario 2**

There are, again, no facts in this Scenario indicating that all parties make unique and valuable contributions. There may
be a presumption that a unique and valuable marketing intangible is created by the performance of services by the service provider and thereby owned by it. However, the mere performance of services does not yield this result, and the stated facts do not otherwise establish it. The fact that they “generate demand” for advertising services and relay local market information and even customer feedback on the product does not mean that they create or own a unique and value intangible.

Application of a profit split method is, therefore, inappropriate in Scenario 2 for the same reasons as discussed above for Scenario 1.

- **Scenario 3**

Scenario 3 suggests that “developing very close relationships with customers” and providing certain services to local customers makes a distributor “a key source of competitive advantage” for the MNE group, and not merely a “‘routine’ distributor.” There is no indication that the distributor owns any unique and valuable intangibles or makes any other unique and valuable contributions.

The questions ask whether a transactional profit split method would be the most appropriate method on these facts.
While we agree that this is the right question to ask, we disagree with the implied answer. These functions are common distributor functions. If they create an advantage, it is the same advantage enjoyed by any business that uses local distributors, whether related or unrelated. The existence or absence of a competitive advantage is irrelevant in any event to identification of the most appropriate method.

The application of a transactional profit split method would be inappropriate for the same reasons as noted above.

- **Scenario 4**

The introduction to Scenario 4 suggests that an MNE group with “highly integrated” operations may have its “strategic risks” jointly managed and controlled by more than one group company and that this would make the application of a one-sided method unreliable. Scenario 4 gives as an example a company that manufactures and sells sophisticated medical equipment and outsources the development and production of key components to two associated enterprises, which control and perform their own research, development, and production processes. Proceeds of the sales of the equipment go to the first
company, but it agrees contractually with the two affiliates to share that revenue on an unspecified “profit-sharing basis.”

Although the introduction to Scenario 4 asserts that “the enterprises share in the risk of product development,” the facts do not so indicate. They state that each company controls and performs its own processes but do not indicate that any company other than the one that manufactures and sells the end product to customers ultimately bears any risk of failure. Perhaps the theory of shared risks arises from the fact that the products produced by the affiliates are key components in the finished equipment. However, companies commonly outsource the design and production of components to both related and unrelated parties, and this does not change the incidence of risk.

Therefore, there is no basis in the facts presented for concluding that one-sided methods cannot be used reliably to compensate contract development and manufacturing functions and that a profit split method must be applied instead. We believe that an analysis analogous to the guidance on control at paragraph 9.23 – 9.28 of the Guidelines should apply and that this should be explicitly confirmed to avoid any suggestion that contract development and contract manufacturing functions will normally be subjected to profit split methods.
Scenario 5 addresses a situation in which there is believed to be a lack of reliable comparables. The introductory discussion appropriately acknowledges that an apparent lack of comparables can be addressed under one-sided methods by expanding the search or making reasonably accurate comparability adjustments. However, we submit that the discussion jumps too quickly to suggesting profit split methods when comparable data is not seen as readily available. We believe this is inappropriate where both parties do not make unique, valuable contributions.

The perils of this approach are illustrated by Scenario 5, which considers an MNE group supplying office stationery in a region. Each operating company of the group is assumed to conduct three activities: selling to local customers, agreeing terms and taking orders from local customers buying on behalf of their regional organizations, and fulfilling orders placed with other group companies. The Scenario concludes that each operating company has a purely local business plus a regional business in which each generates business for the other.
There is no indication that any of the operating companies makes unique, valuable contributions, so it is not clear why this Scenario questions the availability of comparables and entertains the possibility of a transactional profit split method. The functions performed are routine functions – sales, distribution, and fulfillment – and should be readily comparable to similar third party transactions. No rationale is provided for application of a profit split method and it is difficult to imagine one.

The approach suggested by paragraph 32 of the Discussion Draft appears to be a hybrid of some sort, combining elements of a one-sided method with a profit split adjustment. It is not clear, however, what the rationale for the profit split adjustment element is, as it would appear to apply even when the result is within the arm’s length range. It appears that the goal may be simply outcomes-focused, as paragraph 32 notes that it “may sometimes offer the means to vary or flex the results under a one-sided method.”

• Scenario 6

Scenario 6 addresses the alignment of taxation “outcomes” with “value creation” and suggests that transactional profit split methods may be a means of achieving
this. The introduction to Scenario 6 suggests that “transactional profit split methods are typically applied using one or more allocation keys or factors to split the profits, based on the outcome of a functional analysis that determines how value is created in the MNE group.”

We submit that the discussion accompanying Scenario 6 presents a novel reading of the transactional profit split method, in that it blesses a focus on “outcomes” and undefined notions of “value creation.” The discussion acknowledges concerns regarding the subjectivity of transactional profit split methods and then suggests, with what appears to be similar subjectivity, that the residual OEM profits in Scenario 1 could be split on the basis of production capacity, headcount, and “value of production” recognizing “contribution to actual output.” There is no explanation for the selection of these factors, which thus appears quite arbitrary. A simple headcount comparison, for example, obviously would not reflect the relative value created by different workforces. It is acknowledged that the factors would need to be given a relative weighting, but none is proposed for Scenario 1.

Scenario 6 even refers with apparent approval to the RACI-type matrix analysis rejected by the United Nations Practical Manual on Transfer Pricing for Developing Countries
as inherently subjective and not suitable for use in splitting profits. 21 Scenario 6 describes the RACI-type analysis as “determined by an analysis of [the parties’] respective contributions … to each of the group’s key value drivers (undertaken as part of a thorough functional analysis). For each process contributing to a particular value driver it was considered which personnel were responsible for, accountable for, consulting in making or merely informed of relevant decisions.” Risks and assets are disregarded for this purpose, on the theory that “they were considered by the MNE group to be embedded in the processes that managed them.” Scenario 6 suggests that Company A, the company deciding the group’s business and development strategy and selling its products to local distributors, could agree with Company B, its affiliate owning the manufacturing IP and determining and controlling the group manufacturing strategy, to split total system profits in accordance with this analysis, with other contributions then compensated by them using one-sided methods. We are troubled by the exclusive focus on functions here and by the

21 UN Practical Manual, section 5.3.2.6. (“This tool, commonly referred to as a “tick chart” is used extensively in this chapter and in Appendix 1. Tick charts, while very useful, are inherently subjective. Accordingly, the same set of facts in the hands of two different analysts may not result in identical tick charts. Caution should be used in giving tick charts quantitative significance. For example, three ticks do not reflect three times more value than a single tick. Moreover, all categories in the chart do not have equivalent weight. Accordingly, tick charts should primarily be used as a tool in evaluating qualitative aspects of the analysis, and should not be used mechanically to split profits according to the relative number of ticks.”).
apparent failure to take into account the actual contributions of each party.

Question 24 suggests that other analyses, such as approaches based on concepts of bargaining power and options realistically available, might be used instead of RACI-type analysis, and question 25 appropriately questions whether a framework can be developed for reliably applying a multifactor profit split, given the heterogeneity of global value chains. There is no discussion of how this decision would be made, by whom, or when, which raises the prospect that taxpayers attempting to comply with applicable rules will not have adequate guidance to report and pay their tax liabilities and will be subject to significant controversy after the fact.

None of these analyses based on concepts of bargaining power, options realistically available or a RACI-type analysis of responsibilities and decision-making seems to us to advance the goal stated by Question 24, which is merely “to supplement or refine the results of a detailed functional analysis…” All would instead introduce significant subjectivity into the functional analysis, which needs to remain objective if it is to provide a reliable foundation for application of the arm’s length principle.”
There is no acknowledgment in the Discussion Draft of the conceptual and practical difficulty of determining the combined profits to be split where the entities involved are based in different countries.

The approach suggested in Scenario 6 and with reference to Scenario 1 comes too close to the formulary apportionment that is a key concern of our member companies for the reasons discussed above.

- **Scenario 7**

Scenario 7 presents an example relating to differences between *ex ante* and *ex post* results. It suggests that the application of a transactional profit split method, with the split agreed in advance by the parties, may provide “an appropriate way” to address situations where “strategic risks are effectively shared” by associated enterprises.

This analysis seems circular. If a profit split is agreed *ex ante*, then the result will be a sharing of the profits on the agreed basis. If no such split is agreed, then the discussion of Scenario 7 does not explain why the strategic risks are considered to be effectively shared, because each party in Scenario 7 otherwise bears its own cost overrun risk. Nor is it
explained why a transactional profit split method would be the most appropriate method in such a situation.

- **Scenario 8**

  We do not believe that the IP at issue in Scenario 8 would ordinarily be licensed to the subsidiary at arm’s length, but we do recognize that a profit split may be used in some circumstances to set a royalty rate or other price. Our primary concern regarding Scenario 8 is that it could be read as permitting the inappropriate imposition of a profit split method in circumstances where a one-sided method is used in comparable uncontrolled transactions, such as in contract R&D transactions.

- **Scenario 9**

  Scenario 9 addresses loss situations. We appreciate the discussion of losses in the Discussion Draft, as the experience of business in most cases is that countries are often extremely reluctant to allow losses even where they have taxed profits from the same transactions in other periods.

  It is essential that profits and losses be treated consistently. As the example given in Scenario 9 demonstrates, this may not necessarily mean that the same allocation keys
should be applied in profitable and loss periods, if the application of those keys would produce a different result in loss periods as would be the case with compensation and bonus factors in Scenario 9. Where a profit split method is applied, the key is to require that profits and losses be shared in the same proportion across jurisdictions regardless of whether there is a profit or a loss to be split, so that the taxpayer’s economic losses are allowed in full and none of the jurisdictions involved is unfairly disadvantaged by inconsistent approaches.

* * *

We appreciate the opportunity to comment on these important issues. We would be pleased to discuss our concerns further as deliberations on this Discussion Draft proceed.

Respectfully submitted,

Silicon Valley Tax Directors Group
http://www.svtdg.org/

TechNet
http://www.technet.org/
SVTDG Member Companies

1. Adobe Systems, Inc
3. Accenture PLC
4. Acxiom Corporation
5. Advanced Micro Devices, Inc.
6. Agilent Technologies, Inc.
7. Altera Corporation
8. Amazon.com
9. Apple Inc.
10. Applied Materials, Inc.
11. Avago Technologies Ltd.
12. Aviat Networks, Inc.
15. Broadcom Corporation
16. Brocade Communications Systems, Inc.
18. Chegg, Inc.
20. Cypress Semiconductor Corporation
21. Dolby Laboratories, Inc.

22. eBay, Inc.

23. Electronic Arts, Inc.

24. Etsy, Inc.

25. Evernote Corporation

26. Expedia, Inc.

27. Facebook, Inc.

28. FireEye, Inc.

29. Flextronics International Ltd.

30. Genentech, Inc.

31. Genesys Telecommunications Laboratories, Inc

32. Genomic Health, Inc.

33. Gilead Sciences, Inc.

34. GLOBALFOUNDRIES, Inc.

35. Google, Inc.

36. Groupon, Inc.

37. Hewlett-Packard Company

38. Ingram Micro, Inc.

39. Intel Corporation

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41. Intuitive Surgical, Inc.
42. KLA-Tencor Corporation
43. Lam Research Corporation
44. Marvell Semiconductor, Inc.
45. Maxim Integrated Products, Inc.
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49. NVIDIA Corporation
50. Oracle Corporation
51. Palo Alto Networks, Inc.
52. Pandora Media, Inc.
53. Pivotal Software, Inc.
54. Plantronics, Inc.
55. Power Integrations, Inc.
56. Qualcomm, Inc.
57. Riverbed Technology, Inc.
58. Rovi Corporation
59. salesforce.com
60. SanDisk Corporation
61. SAP
62. Seagate Technology, PLC
63. ServiceNow, Inc.
64. Silicon Image, Inc.
65. Silver Spring Networks
66. SMART Modular Technologies Corp.
67. SunPower Corporation
68. Symantec Corporation
69. Synopsys, Inc.
70. Tesla Motors, Inc.
71. The Walt Disney Company
72. Trimble Navigation Ltd.
73. Twitter, Inc.
74. Uber, Inc.
75. Visa, Inc.
76. VMware Corporation
77. Xilinx, Inc.
78. Yahoo! Inc.
79. Yelp Inc.
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1. Accel Partners
2. American Standard Development Company
3. Amyris, Inc.
4. Apple, Inc.
5. Arch Venture Partners
6. AT&T, Inc.
7. Blackberry, Ltd.
8. Bloom Energy
9. CA Technologies, Inc.
10. ChargePoint, Inc.
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12. ClearStreet, Inc.
13. Comcast Corporation
14. Covington & Burling LLP
15. Craigslist, Inc.
16. Dewey Square Group
17. Direct Energy PLC
18. Discovery Education, Inc.
19. eBay, Inc.
20. ecoATM, Inc.
21. eHealth, Inc.
22. Elance-oDesk, Inc.
23. EMC Corporation
24. Encryptics, Inc.
25. EnerNOC, Inc.
26. Etagen, Inc.
27. F5 Networks, Inc.
28. Facebook, Inc.
29. Gilead Sciences, Inc.
30. Goodwin Procter LLP
32. Hewlett-Packard Company
33. Intel Corporation
34. Intuit Inc.
35. Kleiner Perkins Caufield & Byers
36. Lee & Hayes, pllc
37. LiveOps, Inc.
38. Lyft, Inc.
39. Madrona Venture Group
40. Marvell Semiconductor, Inc.
41. MHR International, Inc.
42. Microsoft Corporation
43. MIND Research Institute
44. Morgan Stanley
45. Motor Vehicle Software Corporation
46. NASDAQ OMX Group, Inc.
47. OpenDNS, Inc.
48. Oracle Corporation
49. Palantir Technologies, Inc.
50. Perkins Coie LLP
51. Pfizer, Inc.
52. Point Inside, Inc.
53. Qualcomm, Inc.
54. Relevad Corporation
55. Revolution LLC
56. salesforce.com
57. SAP
58. Silicon Valley Bank
59. Silver Spring Networks, Inc.
60. Stanford University
61. SV Angel
62. Symantec Corporation
63. TechNexus
64. Uber, Inc.
65. Visa, Inc.
66. WGBH Boston
67. Wilson Sonsini Goodrich & Rosati
68. Yahoo! Inc.
69. Yelp Inc.
February 6, 2015

The SVTDG is composed of representatives from leading high-technology companies with corporate offices predominantly located in the area between San Francisco and San Jose, California (widely known as the “Silicon Valley”). It was formed in 1981 and now has 81 members (a list is available at http://www.svtdg.org/members.php).

The purpose of the SVTDG is to promote sound, long-term tax policies that support competitiveness. Members of this group believe that tax policies should enhance opportunities for productivity growth by encouraging and rewarding enterprises that develop goods and services that meet international market standards. The companies represented by the group are dependent on research and development in order to remain on the cutting edge of technology innovation and to compete in the international marketplace.

The SVTDG shares the views set out in the attached letter regarding BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains and urges that they be given consideration.

Sincerely,

Jeffrey K. Bergmann
Co-Chair, Silicon Valley Tax Directors Group
February 6, 2015

TechNet is the national, bipartisan network of CEOs and senior executives that promotes the growth of the technology industry by building long-term relationships between technology leaders and policymakers and by advocating a targeted policy agenda at the federal and 50-state level. TechNet’s diverse membership of over 60 companies includes dynamic startups to the most iconic companies on the planet and represents more than two million employees in the fields of information technology, biotechnology, green tech, e-commerce, venture capital and finance. TechNet has offices in Washington, D.C., Silicon Valley, Sacramento, Seattle, Boston and Austin.

TechNet’s membership can be found at: http://www.technet.org/leaders/member-companies/

TechNet shares the views set out in the attached letter concerning the BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains and urges that they be given consideration.

Sincerely,

Michael Ward
Vice President, Federal Policy and Government Relations
mward@technet.org
By email

Mr Andrew Hickman  
Head of Transfer Pricing Unit  
Centre for Tax Policy and Administration  
OECD

Zurich, 6 February 2015

Comments on the Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

Dear Mr Hickman,

SIX welcomes the opportunity to comment on the Discussion Draft on the use of profit splits in the context of global value chains. As a global provider of financial infrastructure services and financial information products, present in 21 countries, SIX has a strong interest in establishing transparent and globally applicable tax rules on profit and loss allocation.

In particular, it is our concern that some countries may refuse the acceptance of loss allocation in case of a consolidated loss. Further, we would find it useful to have a comprehensible description of a valuable, unique contribution. We think that the definition of such a contribution should focus on a considerable and distinctive contribution to the value chain of a MNE.

Please find our comments to the Public Discussion Draft in the attachment.

Yours sincerely,

SIX Group Ltd

Dr Stefan Mäder  
Chief Financial Officer

Patrik Weissgerber  
Group Head of Tax
Comments to the Public Discussion Draft on BEPS Action 10: Discussion Draft on the Use of Profit Split in the Context of Global Value Chains

We would like to present below our remarks and comments to the Public Discussion Draft on BEPS Action 10. Due to the fact that not all questions posed in the Draft address the actual issues related to the application of the profit split method and that some statements and scenarios presented in the Draft raise some new issues, these comments generally address the statements and conclusions of the Draft rather than answer the questions posed therein.

1. General Comments

As a general remark, we would like to remind that the profit split method is complex in its implementation for the MNEs as a whole and for the individual companies affected on the one hand and may pose a challenge to verify for local tax authorities. In fact, only multilateral agreements between an MNE and the tax authorities of the countries in which it operates can ensure the effectiveness of such a method. In particular, it needs to be defined what economic criteria the method bases on, what factors are used for the distribution of profits and losses. Such an agreement should also guarantee that both profits and losses will be shared in accordance with the methodology agreed upon.

2. Integrated Value Chains and Valuable, Unique Contributions

Given the complexity of the profit split method itself, the high costs of its implementation and the manpower required to maintain it, the method should be applied only for highly integrated value chains, where one-sided method would not be suitable, and/or where each of the parties involved in the transactions makes valuable, unique contributions to the controlled transactions, the most prominent example of such a contribution being a valuable unique intangible. Consequently, given the nature of this method, it should only apply to high-integrated MNEs where several group companies make a significant and distinctive contribution to the value chain, where the contribution of each company cannot be analysed on a stand-alone basis for the comparability purposes.

We are of the opinion that, while many MNEs are more or less integrated (as one of the main purposes of operating within a MNE are synergies resulting from an integration), does not mean that finding comparables should give rise to difficulties. This will be only the case if the contribution to the value chain by each entity within the MNE cannot be separated out and thus, there is no basis for a comparable search. Such high degree of integration within an MNE will rather be an exception than a rule. Therefore, there is no need to change or modify the general rules on the selection of the most appropriate method as stipulated in the OECD Guidelines. As regards the application of the profit split method to the unique and valuable contributions, the profit split should be applied when it is likely that third parties in a comparable situation would agree to divide the profits (or losses) resulting from a transaction.

The Public Discussion Draft contains some examples illustrating, in the opinion of the drafting body, the appropriateness and the criteria of the application of the profit split method. We think that these scenarios contain elements that are contrary to the original concept of the profit split method. As indicated in the OECD Guidelines and reinstated by the Public Discussion Draft, the profit split method shall apply when a one-sided method is not appropriate due to the highly integrated operations and/or when unique, valuable contributions are made by both parties to the controlled transaction. The application of the method is the result of the functional analysis of the parties to the transactions, which takes into account the assets and risks of the parties involved.
The profit split method is not appropriate where one party of the transaction performs rather non-complex functions. In the light of these arguments, the application of the profit split method to subsidiaries dealing with local advertising and the adaptation of a product to local market requirements (Scenario 2) is certainly not an appropriate example of when the profit split method should apply. We are of the opinion that the functions performed by local subsidiaries, as described in Scenario 2, are not a good example of a highly integrated value chain nor of a valuable, unique contribution by the local subsidiaries. On the contrary, the activities of local subsidiaries, as described in the scenario, appear to be typical marketing activities of a technology group, without a high level of integration or a unique reps. valuable contribution to the MNE's value chain.

The above mentioned example gives rise to a concern that the purpose of the Public Discussion Draft might be the allocation of profits to large economies solely because of the size of its markets. We are of the opinion that the taxpayers, including MNEs, should have the liberty to choose the appropriate transfer pricing method and apply the arm's length principle on the basis of the well-founded rules included in the OECD Guidelines. The appropriateness of the applied method should, of course, be based on objective and transparent criteria to be examined by the tax authorities. Arbitrary changes to these rules, the erosion or even rejection of the arm's length principle and annulation of the analysis of the contribution to the value chain consisting of the analysis of functions, assets, and risks, will lead to legal uncertainty with regard to the application of the transfer pricing rules and generates a risk of arbitrary decisions by tax authorities.

The paraphrase of the widely accepted concepts of the OECD guidelines, such as “unique and valuable contributions” leads to interpretations that are not convincing. In Scenario 3 (in obvious analogy to Scenario 2), local sales and marketing activities are presented as an example of a unique and valuable contribution due to the pro-active and customer friendly approach of the subsidiary. This scenario leaves aside many instances of third-party distributors who proactively build and maintain close relationships with their customers and offer an excellent service (e.g., car distributors). In our opinion, Scenario 3 is an unjustified attempt to redefine transparent and objective criteria of the OECD Guidelines.

3. Allocation of Profits

As for the allocation of profits, pursuant to the OECD Guidelines, factors should be used in an economically valid way that approximates the division of profits. The Public Discussion Draft postulates to split the post-royalty residual profits on the basis of three factors: production, capacity, headcount, and value of production. In our opinion, these factors are not necessarily suited as economically valid criteria for the division of profits under the profit split method, as they do not accurately reflect the contribution to the value chain, neither the situation in a 3rd party constellation. The production capacity, reflecting the capital investment, does not say anything about the contribution to the MNE's revenue and/or profit. The headcount, reflecting the input of labour, does not say anything about the contribution to the value chain, to the MNE's productivity or innovation. Such approach would lead to overweighing the input of simple, low-paid labour to the value chain. Defining these criteria as relevant for the division of profit does not take into account the diversity of business models, depending on the industry and the particular distribution of tasks and business organization chosen by an MNE. It would be counterproductive to define a set of criteria and their weighting, as they could not adequately reflect the business reality. It should be up to the enterprises to select the relevant criteria for the division of profits. Merely the criterion of the production value appears to be justified in this context, as it in fact recognizes the contribution to the actual economic output.

The application of the RACI method for the distribution of profits leads to numerous differentiation difficulties in the business reality. This method is therefore not suitable for determining the taxable base,
as it will lead to many uncertainties and difficulties in the implementation for the MNEs and in the verification for the tax authorities. The further disadvantage of this method is the exclusion of an explicit analysis of risks and assets, which are material factors for determining the remuneration of a group entity.

4. Split of Losses

The logical consequence of the profit split due to the integrated organization of an MNE and/or the unique and valuable contributions of its members, is the distribution of losses. As a general rule, given that the functions and contribution of group companies does not usually change in a deficit situation, the same method should be applied to the distribution of profits and of the losses. A different method for the distribution of losses has to be defined in advance and the deviation from the profit split method should be justified. There is a general risk, that in a loss situation, tax authorities will attempt to shift losses to other jurisdictions. An open differentiation between profit allocation and loss allocation in the OECD Guidelines may encourage tax authorities to base the rejection of tax loss on the Guidelines. This risk should be addressed in an advanced agreement with the involved tax authorities.

5. Conflict Resolution

An important procedural issue needs to be addressed when discussing profit (loss) split: conflict resolution. As indicated above, only a multilateral advanced pricing agreement can guarantee a smooth functioning of the profit split method, as otherwise there is a high risk of tax authorities allocating taxable profits to their jurisdiction and disregarding the tax assessments in other countries leading potentially to double taxation. Concluding such an agreement is very time-consuming, costly and complex. Any simplifications in this area would be very welcome.

SIX Group AG, Switzerland
Zurich, 6 February 2015/tkm64
February 6, 2015

Sent via email to: TransferPricing@oecd.org

To the attention of Mr. Andrew Hickman – Head of Transfer Pricing Unit, centre for Tax and Policy Administration

Re: Comments on “BEPS ACTION 10: DISCUSSION DRAFT ON THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAIN”

Studio Biscozzi Nobili (SBN) is pleased to provide comments on “BEPS ACTION 10: DISCUSSION DRAFT ON THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAIN”.

SBN commends the work that the OECD has undertaken to date in relation to the BEPS Project, and offers its assistance in support of its further efforts.

SBN appreciates the opportunity to further invest in the process and further assist the WP6 by presenting or clarifying our views and comments, if necessary, on the proposed changes to the Transfer Pricing Guidelines.

Introduction

The ACTION 10 Discussion Draft addresses the issues deriving from the application of the Profit Split Method (PSM) with the aim to assure that transfer pricing outcomes are in line with value creation.

Key criteria for applying the PSM is demonstrating the level of aggregation among the different legal entities involved in the transaction. Therefore, the PSM is generally used when transactions are so interrelated in a way that cannot be evaluated on a separate basis.

Generally, the PSM relies on the characterisation of functions, risks, and assets according to which ‘routine’ functions are distinguished from non-routine
functions. In practice, more often than not, key management with strategic decision power are deemed more relevant than other factors.

The allocation of profit is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled parties, each performing functions similar to those of the various controlled entities engaged in the relevant business activity.

Due to the heterogeneous nature of Multinational Enterprises (MNEs) and the lack of comparability, the problem of allocating profits based on the arm's length principle has become more relevant. As a consequence, the contribution made by each party to the transaction, determined on the basis of a division of functions performed, has become an objective exercise difficult to justify in the absence of external comparable data.

In this context, the objective of the Discussion Draft is to obtain views on how the current guidance may be amended so that transactional profit splits can assure that transfer pricing outcomes are in line with value creation.

The Discussion Draft covers the following main topics in relation to the use of profit splits:

1. Value chain.
2. Scope for the application of the PSM in certain situations, including:
   - Unique and valuable contributions;
   - Integration and sharing of risks;
   - Fragmentation of functions; and
   - Lack of comparables.
3. Aligning taxation with value creation when:
   - Hard-to-value intangibles are involved in the transaction;
   - Dealing with ex-ante/ex-post results; and
   - Dealing with losses.

This document is divided into three parts according to the three main topics mentioned above, addressed in the Discussion Draft.

Comments

Value chain

The Discussion Draft states that in certain situations the use of transactional PSMs may be a better way to address the specific features of global value
chains than one-sided transfer pricing methods. Global value chain is defined as the “full range of firm’s activities, from the conception of a product to its end use and beyond”.

Scenario 1 describes a situation where there is a high level of co-operation and interdependence between the Original Equipment Manufacturers (OEMs) located in several European countries involved the production of durable goods.

The interrelation is mainly engendered by an over-arching Leadership Board consisting of senior managers from each OEM. The Leadership Board is responsible for taking decisions that ultimately drive the business toward the development of new products and components by each OEM.

Given the facts and circumstances of the case, it is thought that transactional profit split methods may provide a useful solution to this scenario. In particular, the application of a residual PSM (that would also take into account the routine functions performed by the OEMs) it is thought to be suitable.

From a procedural point of view, a key initial step when applying the PSM would be to identify the key intangible assets that underlie the generation of the “main profits” of the business. A second step, would be the identification of the management responsible for taking important decisions capable of drive the business forward and especially in which country this contribution takes place.

In this context, the allocation factors would likely include the costs of the Leadership Board (hereinafter referred to as LB) and the personnel involved in the management and planning activities. In particular, the personnel costs to be considered are those of the individuals who take strategic decisions in relation to the technology know-how and product improvement.

The allocation keys mentioned above, however, should not include the costs of the more junior staff receiving directions from the heads of the departments concerned. This is because the know-how is developed through the experience of more senior staff who is able to convert it into strategic decisions.

On the other hand, the role of the LB shall be quantified in a way not to limit its effect on the pure costs of the senior staff: the impact of the skills and capability of the LB on the whole business and more specifically on the success of the local entities of the OEM vary depending on different factors.
In particular, when a local entity is opened and starts up its activity in a new jurisdiction, the LB role is usually emphasized vs. the role of the local management.

At the same time, when a local entity increases significantly its turnover for reasons different from local or external factors, and the increase is not consistent with the turnover average of the other local entities, it might occur that LB has suggested or advised to introduce new factors of success in the value chain.

Other allocation factors that may be considered are the research and development costs incurred to develop new products and components, together with the costs of depreciation and of consumables, or the production capacity which reflects the capital invested by each OEM.

From a comparability perspective, it would be important to further examine the features of the other functions performed by the OEMs so as to understand whether external comparable data, for the routine functions performed, can be found.

In this context, it may be beneficial to receive further guidance on scenarios where differences between the controlled and uncontrolled transactions can still deemed reliable, therefore applying a more flexible approach. For example, considering differences in time/period, geographic location (assuming that accounting practices are similar) and so on, comparability may still be established.

Furthermore, it may be useful to receive further guidance on a possible reasonable allocation formula that may be used in situations where it is not possible to allocate costs, income, and assets directly based on factual relationships and due to lack of comparability.

* 

Scenario 2 involves an internet services provider with subsidiaries located in various countries providing technical know-how to the parent company, which owns the trademark and perform the R&D functions, around product development and customisation to reflect local market features.

Based on the fact-pattern set out in Scenario 2, the technical know-how provided by the subsidiaries, may be deemed routine in nature. Therefore, it may be essential, to further investigate to what extent, the functions performed locally create or add value to the transaction.
Conversely, assuming that the functions performed locally are unique and therefore a PSM may be appropriate, it should be beneficial to receive guidance on how the profit can be split when subsidiaries are deemed “digital” permanent establishments of the parent company. In this context, it may be useful to identify relevant factors needed to establish when a “digital” permanent establishment or presence is found to exist.

In this scenario, it should also be important to understand where the profits are earned. More specifically, whether they are earned in the hands of the parent company (i.e. where the technology is developed); where customers are located; or, where the servers are based.

Again, the main focus should be on headquarter functions that generate additional profits (business clients portfolio via cross selling strategies, key factors of the product, glocal marketing campaigns) rather than on functions that, being centralized in the parent company site, allows cost saving to the Group.

Scope for the application of the PSM

This section focuses on the appropriate scope for the application of transactional PSMs.

Based on the 2014 Report “Guidance on the transfer pricing aspects of intangibles”, contributions that constitute a ‘key source of competitive advantage for the business, and create difficulties in terms of finding reliable comparables’ can be defined as unique and valuable.

One of the situations described in the Discussion Draft (Scenario 3) involves a party (Company S) responsible for selling the equipment produced within the group and carrying out marketing activities. Scenario 3 recognises Company S not merely as a “routine” distributor, but as a source of competitive advantages derived from the customer services and after sales activities which entails developing close relationships with customers.

As high value-added activities/services usually incorporate know-how intangibles, which are reflected in the compensation of the individuals performing those functions, the level of interdependence between group profitability and sales force know-how should be fully examined.

In this context, the analysis should focus on examining to what extent, the significant people functions (the sales force), rather than the risks assumed by the parties, represents a source of competitive advantage therefore giving scope
for the application of a PSM. In particular, it should be further examined how the professional qualifications and technical know-how of the sales force, contribute to generate revenues for the group.

The Discussion Draft describes a situation where an MNE group, operating as a supplier of office stationary to customers with regional activities, has operating companies located in several countries that generate business for each other.

In this case scenario, it is thought that the use of the PSM may not be as appropriate as in other cases. In fact, the interrelation created by the operating companies generating business to each other, may be compensated with a commission based on the profits earned by the related party from the business that has been passed on.

Aligning taxation with value creation

Aligning taxation with value creation is the focus of the BEPS project. The Discussion Draft illustrates considerations for developing profit allocation keys such that transfer pricing outcomes are aligned with value creation.

The problem arises when the allocation factors utilised are not objectively perceived and, therefore, do not reflect what third parties would have agreed upon. In this respect, a possible guidance should identify a (non-exhaustive) list of key factors divided per industry or sector.

The following list identifies examples of allocation keys per industry:

- Luxury: Sales promotion; Marketing and Advertising
- Automotive: Production capacity; Value of production; Headcount
- Pharmaceutical: R&D
- Consumer product: Marketing and Advertising; Digital investment (e-commerce), if any.

The list of allocation factors to be included in the OECD Guidelines, should be non-exhaustive in nature so that the taxpayer should be able to select allocation keys not listed therein, if properly justified, that better fit each particular case.
In addition, developing a framework for conducting profit split analysis to situations where more than one factors is likely to be utilised, it is thought to be too restrictive for taxpayers.

* 

In relation to hard to value intangibles, the Discussion Draft recognises the difficulty in using transactional profit split approaches based on the cost of the contributions made by the parties.

In practice, when intangible property development expenditures have been relatively constant over time and the estimated life of the intangible property is known, the amount of actual costs incurred in the recent years for example, may be used to estimate the relative value of non-routine intangible property contributions.

Conversely, when there is little relationship between costs and value of contribution made by each party deriving from fluctuating expenses incurred, the PSM is not considered to be as reliable as other transfer pricing methods.

* 

The Discussion Draft describes a scenario involving a banking group carry on trading activities. This scenario considers whether profit split methods may be applied in a different way when there are losses to split instead of profits.

In practice, there are circumstances under which it might be appropriate to vary the application of splitting factors depending on whether a profit or loss has incurred. For instance, in the presence of proprietary trading transactions when using the hedge fund model to split profits/losses.

The hedge fund model on proprietary trading transactions is usually implemented using a 75% / 25% split of the total positive return and, 100% / 0% of the total negative return.

The 75% of the total positive return of the managed portfolio is allocated to the risk taker, i.e. the legal entity which is the provider of capital (usually the booking legal entity); and 25% of the total positive return is allocated to the provider of “human capital”, i.e. the group that manages the bank’s own investment exposure, the trader employing legal entity.
In case of losses, 100% / 0% of the total negative return is split as allocating 100% of the total negative return of the managed portfolio to the risk taker, i.e. the provider of capital and, 0% is allocated to the trader. The latter, will not suffer from the loss incurred due to the transaction failure, however, will suffer from not having remunerated the costs incurred for the activity performed.

* *

Finally, it may be beneficial to receive guidance on the possible weight given to the use of internal data for the recognition of contribution made by each party to the transaction, for example, with regard to information taken from the company’s management information systems.

Yours truly,

Franco Pozzi
Marco Abramo Lanza
Roberta D’Angelo
Andrew Hickman  
Head of Transfer Pricing Unit,  
Centre for Tax Policy and Administration  
OECD  
4, Quai du Point du Jour  
92100 Boulogne-Billancourt  
France  

Neuilly-sur-Seine, February 6th, 2015

Sent by email at: TransferPricing@oecd.org

Dear Sir,

Following the publication of the Discussion Draft on the use of profit splits in the context of global value chains, we are pleased to provide you with our comments related to the potential use of profit split in the context of setting-up transfer pricing methodologies.

We remain available for any additional comment on our work.

Sincerely yours,

Julien Pellefigue  
Partner  

Grégoire de Vogüé  
Partner, Attorney at law
INTRODUCTION

We welcome the opportunity to comment on the Discussion Draft on the Use of the Profit Splits in the Context of Global Value Chains. We believe that providing well designed guidelines for the application of profit splits will be instrumental in the success of the overall BEPS project.

In the past few years, it is our experience that Tax Administrations ("TAs") have increased pressure on Multinational Enterprises ("MNEs") and that the number of transfer pricing related litigations has increased. It appears that TAs are growing dissatisfied with the transfer pricing methods that are most generally used by MNEs (like TNMM), considering that they do not take into account properly the value of the contribution of the entity located within their jurisdiction. For that reason, we have also seen a significant rise in the use of profit splits by TAs to establish reassessments.

We believe that one of the consequences of the implementation of BEPS is likely to be an even more frequent use of Profit Splits by TAs. Indeed, the BEPS objective of aligning the allocation of income with the economic activity that generates that income could be understood as a "philosophical" justification for profit splits. In addition, the information that will be made available through the Country by Country report might make it easier for aggressive TAs to claim that the profit located within their jurisdiction does not represent their “fair share” of the MNE profit and make important reassessment.

Considering this probable increase in the use of profit splits by TAs, we believe that the current OECD guidance is not sufficient to protect the taxpayers from arbitrary reassessment, based on weak economic reasoning or even the use of formulary apportionment. Indeed, there is currently a significant element of subjectivity to determine how profit should be split, which would put taxpayers in a difficult position to defend themselves against TAs. Furthermore, the lack of solid principles upon which a profit split can be set can make it harder to avoid multiple taxations, as several Countries might have different ideas about what creates value within a MNE.

The unclear nature of the current profit split guidance also creates a problem for taxpayers that would be willing to implement a profit split because they believe it is the best suited method to represent their operations. At this point, it is our experience that a number of such MNEs refrain from implementing a profit split. Indeed, they tend to consider that this method would create an exposure since it is based on an economic calculation that might not be accepted by at least one of the concerned TAs, or which result might very well become completely different if one the TAs should change certain parameters of the model.

Within that framework, a clarification of the profit split guidelines would provide two types of benefits:

- It would prevent the multiplication of reassessments based on badly designed profit split, therefore reducing the risk of multiple taxations of MNEs.
- On the other hands, provided with clear principles, profit splits could contribute to improve the quality of the dialogue between taxpayers and TAs, reaching BEPS objectives of aligning taxable base with value creation while improving tax security of MNEs.

In this respect, this document presents some economic principles that could be used to set up an analytical framework for the profit splits (I). It then discusses the possibilities of evolution of the international tax governance, in order to secure the application of the profit splits (II). Finally, it provides with some comments on the use of profit splits in the various examples detailed in the OECD Discussion’s draft (III).
I. Profit Splits methods should be grounded in sound economic theory

We believe that a right profit split methodology should be rooted in a more general analytical framework that explains why multinationals exist, how they operate and how they generate profit. Even if, in real business situations, shortcuts and proxies will have to be used, it is obviously much better to understand what would be the “right” theoretical answer to a profit split problem. Indeed, relying on a robust and empirically validated economic framework would be the best way to avoid arbitrary decisions and to facilitate the discussions between taxpayers and Tax Administrations.

The reason for using a profit split instead of one-sided methods is related to the “make or buy” dilemma: when a firm decides to expand its operations in a new Country, it is faced with the choice of either contracting with a local third party firm (buy) or creating a subsidiary (make). In many situations, a firm would be indifferent between the two choices (which explains why the boundaries of the firms are moving so much with M&A operations). However, in certain other situations, one solution is much more efficient than the other, and by choosing it the firm can generate extra profit.

For instance, if a German manufacturer decides to expand in the French market, it is possible that by contracting with third party distributors, the sum of the arm’s length profit of both entities (manufacturer and distributor) would be 100, whereas by setting up a subsidiary, the consolidated profit is 200, therefore generating a surplus of 100.

Explaining the make or buy tradeoff is a key economic question, as underlined by Slade and Lafontaine: “Understanding what determines firm boundaries and the choice between interacting in a firm or a market is not only the fundamental concern of the theory of the firm, but it is also one of the most important issues in economics". There is extensive economic literature dealing with this topic. It is beyond the scope of this note to propose a full bibliography; we can, however, list the main theories explaining where the “integration surplus” comes from:

- **Incentives.** The internalization of a transaction between two subsidiaries can change significantly the incentives of each party, and therefore the assets they will use, the strategies they will follow and the profit they will generate. In certain situations, a more efficient incentive system can be set through the creation of a subsidiary, generating the “integration surplus”. Several different theories address this issue with different perspectives: transaction cost economics, Property Rights and Moral Hazard.

- **Market failures.** Certain goods are very difficult to trade on a market (e.g. know-how embodied in human capital, non-patentable information goods too difficult to protect after they have been transferred or information goods which value is too difficult to assess by a third party on a market). The only way to transfer these goods is therefore to create a subsidiary and internalize the transactions. Goods such as “corporate culture” are often the source of a MNE’s competitive advantage. Therefore creating a subsidiary is sometimes the only way to use a valuable input in a different jurisdiction, allowing to generate profit surplus.

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In the situations where the “make” option is clearly the more efficient, all competing firms will create a subsidiary in the new country and internalize the transaction within the firm (the firms which keep on relying on a “buy” strategy would disappear as they are less efficient).

Using the previous example, the profit generated by the multinational firm composed of the German manufacturer and the French distributor is equal to the sum of the arm’s length profit that both firms would earn if they had decided to contract through the market (such profit can be estimated using a TNMM), plus an “integration” surplus.

If the “integration” surplus is significant, considering it has been created by both entities, it could be argued that it should be split between them, warranting the use of a profit split method. Indeed, by using a one-sided Transfer Pricing method, such as TNMM, one entity would obtain its arm’s length profit, whereas the other one would obtain the whole surplus, which would not be compliant with the BEPS objectives of aligning taxable base with value creation.

According to a “fair” profit split, each party to the transaction should theoretically obtain the arm’s length profit it would earn by transacting over a market, plus a share of the integration surplus that should be proportional to the value of its contribution to the generation of this surplus. Another way of looking at this problem, fully compatible with the arm’s length principle, is to acknowledge that in situations where trading over a market is not the most efficient strategy, firms would either integrate the transaction (by merging together, or creating a subsidiary), or they would engage in some form of alternative institutional arrangement such as entering into a long term contract or creating a joint-venture. Under such arrangements, the parties would agree ex ante on some form of profit sharing, using their relative bargaining power (that depends on how much profit they could make using their second best strategy) to establish their profit shares. The kind of profit sharing that independent party would agree to would hence be a good benchmark for a BEPS-compatible allocation of the taxable base.

Certain game theoretic tools can be used to replicate the outcome of such a bargaining process between independent parties⁶. However, their application is often rather complex in practice, as it relies on counterfactual analysis. To cope with that practical difficulty, many different solutions have been devised to come up with proxies of the contribution of each party. All such methods are a priori acceptable, as long as they are used to approximate the relative contribution of each entity to the creation of the surplus.

As a concluding comment, it is worth mentioning that a large multinational is a very complex entity, and coming up with a method to establish the contribution of one given subsidiary to the profit of the whole group is a very complex task for which there exists no simple and straightforward solution. “Formulary” solutions, based on simple accounting allocation keys are very unlikely to give a good approximation of the value of each entity for the group.

II. Evolutions in the international tax governance should be contemplated to secure profit splits

As good as a profit split method may be, it will still have some subjectivity in it, which, for taxpayers, may create uncertainty. Thus, though profit splits may allow them to better reflect their internal organization and value creation processes, they may renounce to implement such a sophisticated method due to the level of risks and uncertainty attached to profit splits. Reducing the risk by providing more empirical and theoretical proofs is always possible, however it would only come at a cost that would make it an unreasonable option for many taxpayers.

It is unlikely that it will ever be possible to come up with a profit split method that would be both perfectly correct (and therefore acceptable by all Tax Administrations) and easy to implement. Within that framework, an improved governance structure might however help promote an efficient use of profit split, when profit splits are needed.

We see at least three ways to make this new favorable international tax governance emerge:

- **Development of Advance Pricing Agreements.** Tax Administrations should try to promote more effectively APAs, by ensuring a quick and efficient treatment of the cases submitted by taxpayers. This could notably include:
  - Harmonizing the level of requirement to file an APA and the submission process (making it quicker and less burdensome), by developing clear frameworks and patterns.
  - Creating a light approval process to replicate APAs already signed with other TAs, on the same type of transactions (e.g. once an APA is signed between France and Japan, the same APA could be easily validated by Germany, for transactions between Germany and Japan).
  - Making APAs public in order to disclose the type of solutions that are deemed acceptable for a given TA. This would help developing safe harbors for taxpayers, when replicating situations already stamped by TAs.

- **Development of tax unity areas**, where Tax Administrations would agree on a given corpus of rules and principles, applicable to their vicinity (e.g. within the European Union). Countries within that area would share a unique set of rules to determine the taxable bases of the companies, but would potentially keep their freedom regarding the taxation rate. A given regulatory body could be empowered to validate profit split models, on behalf of the contributing states.

- **Define different approaches based on the size / complexity of the groups of companies.** For instance, Tax Administrations could try to reach a global agreement to find specific ad-hoc solutions for the most complex group of companies, having a wide international span and a high level number of hard to value intangibles (e.g. in the digital area). We believe that a limited number of companies (e.g. less than 1000) would trigger most of the complexity currently discussed under BEPS. If the Tax Administrations of the largest economies were able to settle on a list of companies that would be worth dealing with on a global basis, and would sit together with these companies to determine and stamp a proper tax allocation model (e.g. based on profit splits), we would have gotten rid of most of the complex transfer pricing issues currently under discussion. Under this approach, each of the concerned companies could develop a global taxable profit allocation model, mixing together profit splits and more
traditional methods. Such models (potentially complex) would be discussed and stamped by the TAs, or by a given international body (UN, OECD, etc.) that would be empowered on behalf of its stakeholders.

We do recognize that these proposals would create a huge shift in the current international tax system, and would require that Tax Administrations and States clearly change their current way of thinking, which mainly focuses on their internal boundaries. We measure the level of efforts required to come to some consensus on these solutions, but the gain is potentially huge:

- For TAs, it would probably mean a higher level of taxes, with a fairer split of the taxable rights among TAs, and less investment in tax audits and litigation to increase their tax base.
- For companies, it would mean an increased level of security and certainty, and a lower burden of compliance (in essence requiring to cope with very different sets of rules) and less painful tax audits. Thus, they could focus on developing their business, in the organizational framework they want to, without being distracted by tax constraints.
- And, for the average citizen, it would mean a higher prosperity due to a better development of the commercial transactions on a worldwide basis.

Nevertheless, through BEPS, Tax Administrations are very demanding towards multinationals that need to cope with a higher level of transparency and an increased compliance burden. This can only be acceptable to the multinationals, if, in exchange, Tax Administrations bring more certainty and security to them. Thus, in return for the increased transparency requirement, Tax Administrations should increase their level of cooperation.

And in the end, it would also neutralize the race to tax optimization, since it would reduce the strategic advantage created by the search for low effective tax rates. Indeed, in the current environment, tax is one aspect of the economic competition, and some MNEs may develop huge financial advantages from aggressive tax structuring approaches, using the flaws in the current transfer pricing regulations (e.g. treatment of complex intangibles). Having a common approach to deal with large and complex intragroup structures would allow significantly reducing the arbitration possibilities that are available in the current international tax environment. It would help refocus competition between the states more on business, and less on tax.
III. Review of the OECD profit splits cases

In this chapter, we will provide a few economic comments – related to the more general elements described in chapter I - on certain examples described in the OECD discussion document.

III.1 Scenario 1

The economic analysis of this case would focus on the sales side complementarity of the product lines manufactured by the three OEMs. It might be the case that the clients of the OEM value the fact that they can buy a wide range of compatible products from the same OEM. Assuming (i) none of the three firms can produce efficiently the whole range of products on its own (for instance, because of economies of scale in production) and (ii) the OEM clients have a real preference for buying a whole set of products from one single firm rather than from different providers, then having the three firms under a common control is likely to give each of them a competitive edge on its geographical market. Indeed, suppose that one of the three European firms, firm 1, produces product A, and faces a lot of competition from other OEMs on the product A market. If bundling product A with product B (manufactured by a sister company) allows firm 1 to sell more volume or negotiate better prices, then the multinational would generate a surplus compared to the profit the three subsidiaries would generate if they were operating separately.

In this case, the profit split might be an appropriate method for splitting this surplus profit.

III.2 Scenario 2

In order to determine whether profit split could be used in that example, the main point that should be investigated is whether or not a third party company could bring the same value to R as its local subsidiary. Indeed, in certain situations, a third party company would not have the right incentives to provide R with valuable insights regarding the end customers’ requirements, and therefore would provide R with a less valuable service, which would lead to generating less profit for all the firms.

A third party needs to be incentivized properly by R in order to perform efficiently. If this third party is involved in both selling (which are easy to monitor and therefore to incentivize) and information gathering (harder to monitor and harder to incentivize), this might end up in a situation where the third party focuses on the selling and less on the information gathering⁷.

If the profit difference between both scenarios (“make or buy”) is significant, a profit split might be a reasonable method to consider.

III.3 Scenario 3

In this example, we should try and understand if, and why, the activity of Company S is a key source of competitive advantage for the group. Sources of competitive advantage can include:

- Unique features that cannot be replicated by the competitors: specific know-how, human capital, goodwill, etc.
- Alternatively, the competitive advantage might come from the vertical integration of the firm (the fact that the distributor is a subsidiary and not a third party), which might give the distributor incentives to perform activities that an independent distributor would not perform\(^8\).

If the economic analysis of the case shows that for any of these reasons, the activity of Company S contributes to the creation of a significant surplus, a profit split might be envisaged.

**Conclusion**

Developing the appropriate framework to implement and secure profit splits is a long journey, which will need cooperation and goodwill from both Tax Administrations and multinationals. And we are still at the beginning of that journey, since no practical profit split methodology can yet be proposed to the market.

We therefore advocate for the development of academic research on profit splits, in order to bring on the table clear frameworks and approaches. To us, this is one of the ways to avoid an increased tax competition among states, which would result in increased unsolved double-taxation, and, in the end, harm the development of multinationals and impact dramatically international trade and economic growth.

\(^8\) This might for instance come from specific investment that a third party distributor would never make. On this subject, see for instance Williamson, *op cit.*
5 February 2015

Dear Mr. Hickman,

RE: Taxand responds to OECD discussion draft on Action 10: Use of profit splits in the context of global value chains.

Further to the publication of the OECD’s invitation for public comments on the discussion draft on BEPS Action 10: Use of profit splits in the context of global value chains, Taxand is honoured to provide written comments based on the practical experience we have as tax advisors.

Our response provides comments and practical suggestions for improvements to the relevant draft language.

We would like to salute the efforts of the OECD Center for Tax Policy and Administration for its continual and vast work on laying down the cornerstones for the ambitious and comprehensive BEPS Action 10: on the use of profit splits in the context of global value chains.

Taxand can confirm that we have no objections with posting the comments on the OECD website and that comments represent Taxand and are based on our experience working with multinationals worldwide.

We appreciate this opportunity to provide comments to the Center for Tax Policy and Administration and would be pleased to discuss this further and to participate in any further discussion on these matters.

More information about Taxand is provided below. Taxand is wholly committed to supporting the Center for Tax Policy and Administration and we look forward to contributing to further debate.

If you wish to discuss any of the points raised in this letter, please do not hesitate to get in touch with us directly via the contact details below.

Yours faithfully,

Taxand

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ABOUT TAXAND

Taxand provides high quality, integrated tax advice worldwide. Our tax professionals, more than 400 tax partners and over 2,000 tax advisors in nearly 50 countries - grasp both the fine points of tax and the broader strategic implications, helping you mitigate risk, manage your tax burden and drive the performance of your business.

We're passionate about tax. We collaborate and share knowledge, capitalising on our expertise to provide you with high quality, tailored advice that helps relieve the pressures associated with making complex tax decisions.

We're also independent—ensuring that you adhere both to best practice and to tax law and that we remain free from time-consuming audit-based conflict checks. This enables us to deliver practical advice, responsively.

Taxand has achieved worldwide market recognition. Taxand ranked in the top tier in Chambers Global Guide 2014 global network rankings and in the International Tax Review’s (ITR) World Tax 2015, 41 Taxand locations were commended and a further 26 locations listed in ITR’s World Transfer Pricing Guide 2015. 31 countries were voted top in the ITR Transaction Tax Survey 2014 and 29 in ITR Tax Planning Survey 2013. Taxand has received 65 national awards and 14 regional awards in the ITR European, Americas and Asia Tax Awards since 2009. These include Latin America Tax Disputes Firm of the Year, European TP Firm of the Year, European Indirect Tax Firm of the Year, Asia Transfer Pricing Firm of the Year, and Asia Tax Policy Firm of the Year. Full details of awards can be viewed at:

www.taxand.com/about-us

www.taxand.com
Introduction

Taxand would like to thank the OECD for the opportunity to respectfully provide the following comments to “BEPS Action 10: Discussion draft on the use of profit splits in the context of global value chains”. Our comments below intend to be practical and experience-based, as well as constructive, in our responsibility as global tax advisors to contributing to a more comprehensive debate on the important issues raised.

Profit splits, as outlined in the OECD document, will become increasingly important in Transfer Pricing as the global economy continues to transform. Critical to the success of implementing robust profit split methodologies will be the extensive analysis required with respect to both the industry itself and the functions therein. The importance of the functional and industry analysis is indeed greater when considering a profit split approach.

This response will address numerous specific questions as raised by the OECD, while concluding as to general trends or points to address going forward.

Scenario 1: Value Chains
Questions 1 – 4
We agree with the use of a profit split to reward the respective entities in the related scenario. There are several factors compounding transactional complexity, including the significant matrix of intergroup transactions. Given the scenario as described, we believe a contribution based profit split would be the most appropriate method, as calculating a residual profit would essentially require similar workloads to a routine TNMM analysis (considering the complex web of transactions).

To improve this example, we would recommend providing clarity on the location(s) of the over-arching senior board described in Scenario 1. Further, we would recommend the board be split across multiple jurisdictions for reinforcement of the validity of the profit split.

Regarding question 4, we would hope to see guidance supporting that taxpayers may rely on a strong industry analysis to generate weightings for the contribution / allocation key. As will be outlined later, we believe the industry analysis will become the core component of a transfer pricing report detailing complex or unusual allocation keys in a profit split analysis.

Scenario 2: Multisided Business Models
Questions 5 – 6
We agree, in general, with the use of the profit split method in Scenario 2; however there may be an argument that certain functions provided by local subsidiaries are actually “routine” in nature. Should the locally developed functions demonstrably create additional / independent IP exploited across the group, this would reinforce the notion that this group should be rewarded according to a profit split.

Separately, we agree that the inter-relationship of terminology from the OECD’s work on IP directly applies to the work received on profit splits.
Scenario 3: Unique and Valuable Contributions
Questions 7 – 10
We agree that further clarity is needed to define “unique and valuable” in relation to the contributions of entities leading to the use of a profit split. Referencing the definition of “unique and valuable intangibles” in the 2014 report, *Guidance on the Transfer Pricing Aspects of Intangibles*, we understand and agree that “unique” contributions can be defined by a corresponding lack of availability of comparables. However, as regards the “valuable” nature of a contribution, we believe that referencing the “competitive advantage for the business” is rather opaque and requires further development. Scenario 3, to provide an example, states that the extensive advice provided to customers on equipment choice, and modifications for maximizing performance and efficiency as performed by the local distributors constitutes such a “valuable” contribution. Arguably such functions are also generating marketing / technical IP. Hence perhaps the definition of “valuable contributions” should be linked to the establishment of IP.

We suggest that additional language be provided here expanding the definition of “unique and valuable” (particularly “valuable”), perhaps with further examples of competitive advantages, in order to provide more precise guidance for the taxpayer. This is particularly pertinent in cases such as a distributor helping to build a brand locally, whereby there may be subjectivity with regard to whether unique and valuable contributions have been made.

Scenario 4: Integration and Sharing of Risks
Questions 11 – 13
Scenario 4 should be developed to reference which party undertakes the risk of development in the situations outlined. A profit split would arguably only be relevant in this situation if the local entities also bear certain risk of failure of the research undertaken.

Fragmentation
Questions 14 – 16
In our opinion, scenarios involving fragmentation of function are not adequately served by existing TNMM-type analyses, as it is all too rare to find such fragmentation in arms-length situations. Most “distribution” providers will necessarily have some form of sales function attached, as dictated by the requirements of commerce. As such, the OECD’s example of grouping certain functions (e.g., an MNC’s sales and distribution functions) could be helpful in producing an arm’s length result with a combination of profit split with a TNMM analysis.

Scenario 5: Lack of Comparables
Questions 17 – 18
In our view, the situation provided in Scenario 5 would likely be replicable in a third party scenario. Indeed, we understand many sales entities distribute products of their own in addition to fulfilling orders for others (e.g., Amazon.com Inc., Tech Data Corp.) As such, we do not believe that fulfilling orders for third parties would present a significant problem for comparability. The larger issue (and one more pertinent to the solution of a profit split) is the web of transactions, as echoed by Scenario 1.
Questions 20 – 21
The range in the example represents an arms’ length range. Applying an upward or downward change to the baseline return should be applicable if there are specific facts and circumstances during a particular year that results in a party undertaking greater (or less) value creation functions and/or risks.

Questions 22 – 23
Profit splits by their nature are harder to verify objectively, however by this same nature they are more suited to occasions when objective data (e.g. comparable data) is harder to come by. We recommend increasing the reliance and importance of an industry analysis to determine the appropriate allocation keys, and then applying weighting techniques based on that analysis. Using the industry analysis (and data which is objectively found relating to the industry as a whole) can provide an element of stability / comparability to the profit split analysis, even if the allocation key used is uncommon.

We do not recommend providing significant general guidance regarding the weighting of factors, as often this will be unique to a given set of facts / circumstances / industries, and as such, attempting more over-arching guidance would likely muddle the issue.

Scenario 6: RACI
Questions 24 – 25
RACI analyses may be appropriate methods to form the basis of a profit split allocation, however ultimately a company’s functional analysis built from an understanding of the industry will determine the optimal split, whatever form it takes. We believe this concept remains regardless of the level of heterogeneousness indicated in the specific business.

Scenario 9: Dealing with Losses
Question 26
We believe the industry analysis should be the specific aspect of the transactional profit split approach which would be particularly relevant in determining the arms’ length outcome for transactions involving hard-to-value intangibles.

Question 27
Profit splits should be delineated by intra-group agreements originating before the operating profits have been established, at the beginning of any project or venture. In occasions where the precise contribution has yet to be established, but is intended to be the basis of the profit share, the initial agreement should be worded with flexibility. The agreement should outline that the ultimate profit split may be flexed depending upon the ultimate outcome (e.g. that profits will be split based on costs incurred, although the split of costs incurred, and associated actual split of profits, to be determined based on actual annual spend).

Scenario 8: Royalties
Question 28
We find the application of a transactional profit split methodology to calculate the royalty provides a reliable result.
Questions 29 – 32

We consider that if two methods are required, the result is not being split on the correct factors.

We agree with the difficulties as expressed in the current version of the guidelines, and no other comments are to be made regarding the use of profit splits.

Conclusions:
In conclusion, Taxand fully supports the work of the OECD in enhancing the guidance relating to profit splits. In our view, the key to the appropriateness of profit splits will be evidenced in the industry and functional analysis. An overarching formulaic approach to profit splits will clearly not meet the objectives of the BEPS initiative. More so than ever before the specific economics of an industry and the MNC therein will be critical in ensuring that profits follow value creation.

Taxand considers two key issues to have emerged from the discussion draft:

- Digital economy / movement of commerce

The world is moving towards more integrated supply chains, with functions split across the world according to convenience and history, rather than functions split according to geography. As such, we are in agreement with the OECD that the use of profit splits should increase reflecting the greater complexity found within such enterprises. Providing further guidance to taxpayers in this regard can only be helpful, and indeed Taxand looks forward to the greater clarity provided on conclusion of this exercise.

- Harder to find appropriate comparables

In territories with restrictions on the comparables which may be used in TNMM benchmarking, such as the US, it is increasingly difficult to find comparables which truly represent the functions of the tested parties involved. As such, the move towards profit splits (particularly in situations of fragmented services) will likely result in “purer” economics based on theory, (rather than attempting to manipulate comparables to better represent the tested party), and a more coherent outcome for taxpayer and tax authority.

We appreciate this opportunity to provide comments to the OECD Center for Tax Policy and Administration and would be pleased to discuss this further, and to participate in any further discussion on these matters.

More information on how to contact Taxand is provided above. Taxand is wholly committed to supporting the OECD Center for Tax Policy and Administration and we look forward to contributing to further debate.

Yours faithfully,

Taxand
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DEAR Mr. Hickman:

On 19 July 2013, the OECD published an *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Action Plan or the Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries’ tax bases are being eroded or profits shifted improperly. Pursuant to Action 10 of the Plan, on 16 December 2014 the OECD published a document entitled *BEPS Action 10: Discussion Draft on the use of Profit Splits in the Context of Global Value Chains* (hereinafter the Discussion Draft or Draft).

The OECD solicited comments from interested parties no later than 6 February 2015. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD’s request for comments.

**TEI Background**

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws,
at all levels of government. Our nearly 7,000 individual members represent over 3,000 of the largest companies in the world.¹

**TEI Comments**

**Background Comments**

TEI commends the OECD for posing questions about experiences and best practices in applying transactional profit splits to further the overall goal of the BEPS project with respect to the arm’s length principle to ensure transfer pricing outcomes are in line with value creation. TEI agrees that there are situations where the use of profit splits may be appropriate. We recommend, however, that the use of profit split methodologies be limited to scenarios where traditional transfer pricing methodologies do not provide reliable arm’s length pricing. For example, instead of properly analysing or characterising the functions and risks, treaty partners and taxpayers may resort to the use of profit splits as an easy way out, which may lead to a profit allocation based more on convenience instead of arm’s length principles.

Regrettably, the Discussion Draft provides very brief examples, describes the application of the profit split, and then asks whether and under what circumstances a profit split would be appropriate. This is a somewhat awkward approach, as the simple examples do not lend themselves to comprehensive replies from stakeholders that take into account the complexity inherent in business today. A more detailed approach, with real life examples at its base, would provide a better process for public input. Moreover, the examples in the Discussion Draft refer primarily to functions performed (although still very briefly) and rarely to risks assumed and assets used. This approach creates the risk that certain tax authorities will use the highly simplified examples in asserting transfer pricing adjustments against taxpayers without consideration of the taxpayers’ specific circumstances and local market conditions.

**Comments on Specific Portions of the Discussion Draft and Answers to Certain Questions Asked about Various Scenarios**

The Discussion Draft states that: “there seems to be very little experience of using a transactional profit split method in a way that could appropriately and comprehensively reflect the range of contributions to value in a diverse value chain.”² TEI concurs with this statement, and asks why this is the case? TEI submits that this may be because (i) the profit split method is extraordinarily complex to implement, and (ii) tax authorities would in many cases be unhappy with its outcome, particularly if it results in a lower profit allocation to their jurisdiction. In

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¹ TEI is a corporation organised in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

² Discussion Draft, p.4.
addition, the profit split method is arguably less consistent with the arm’s length standard than other transfer pricing methods.

**Scenario 1.** Applying a profit split to this scenario would be a complex endeavor and would have the same negative effects for tax administration as formulary apportionment, i.e., applying a profit split will likely cause multi-national enterprises (MNEs) to move more functions into countries with a lower corporate tax rate.

**Scenario 2.** Question 5: *Can transaction profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how?* TEI suggests that, in the absence of a functional analysis that defines what kind of activities the local subsidiaries perform to “generate demand” and who bears the contractual risks of the transactions, it is not possible to adequately answer this question. Based on the brief factual description, however, a profit split is not likely to be the applicable method since the activities of the local subsidiaries are probably routine, especially in comparison with the functions and intangibles of Company R. Thus, a profit split would not be the right solution since one of the parties performs simpler functions than the other. On the other hand, it could be the case that subsidiaries generating demand are uniquely valuable to the organisation, because of the type of product produced or the industry in which the group operates necessitates targeted selling that can only be done locally. This shows that careful attention must be paid to the underlying characteristics of the particular industry being analysed.

Question 6: *What aspects of Scenario 2 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?* A functional analysis would need to be performed focusing on the functions of the local subsidiaries, how they generate demand, and the risks of all parties involved.

**Scenario 3.** Question 8: *What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method?* Who bears the contractual risks of the transactions should be described. In addition, a functional and risk analyses of Company S may be required to enable the application of traditional transfer pricing methodology without resorting to a profit split. A better understanding of how Company S contributes value to the group is needed. For example, is Company S providing market intelligence and contributing to the development of the global marketing strategy regarding global competitors located in Country S, or is it merely required to incur additional local marketing expenses to make sales in Country S due to higher competition in Country S?

Question 9: *Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm’s length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?* Based on the current description, it is very likely that comparables can be found for Company S, either under a resale method or
the transactional net margin method (TNMM). A profit split, which due to its complexity is often a method of last resort, therefore does not need to be analysed; should it nevertheless be applied, its application would need to be fixed through a functional analysis.

Question 10: What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3? A profit split method is usually to be avoided due to its complexity and its relative departure from the arm’s length principle when compared to more commonly used methods. It is thus a method of last resort when the arm’s length remuneration of the parties cannot be determined through other methods or it best fits the contractual risk allocation between the parties.

Moreover, the facts described are so brief, that the scenario can easily apply (or argued to be applicable) to many “common” distributors. All the marketing and research and development are performed centrally by the Parent. However, a profit split is applied with the distributor, as the scenario states that the distributor’s “activities provide for a significant advantage as customers place high value on the reliability and performance of the equipment.”³ That opens discussions in many situations as distributors are always close (or at least closer) to the clients and have some role in after sales services, etc. This type of example just starts a sliding scale and opens room for many (subjective) discussions, resulting in double taxation. TEI recommends that the example be redrafted so that the description of Company S (the distributor) shows in greater detail the functions it performs and how they go beyond merely “routine” distributor activities to further distinguish the company from ordinary distributors.

Scenario 4. Question 11: In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks? This scenario represents an appropriate circumstance for applying a profit split method because this is the way that the parties have agreed to interact by contract (“The rewards to companies A, B, and C are contractually determined by the MNE group on a profit-sharing basis.”⁴)

Question 12: Would a one-sided method produce more reliable results? No, a profit split would be the best method under this scenario because tax authorities should follow the contractual arrangements of the parties.

Question 13: What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method? As above, a functional analysis still needs to be performed; yet there should be a strong presumption that a profit split is the best method because it would follow the parties’ contractual arrangement.

³ Id. at p.7.
⁴ Id.
Fragmentation. The Discussion Draft states that “[i]n some cases, it may prove difficult to find comparable uncontrolled enterprises that are similarly specialised in their activities and carry out just the narrow activity conducted by the controlled enterprise” and that “[b]ecause of fragmentation, available data on similar independent transactions may generally not have a comparable mix of functions, assets and risks to the tested party or parties.” These statements are surprising. TEI submits that fragmentation makes transfer pricing documentation easier to perform and less controversial, not the opposite, and is one of the benefits of an MNE structuring its operations in this manner. TEI urges the OECD to use more neutral language or at least remind tax authorities of the benefits of fragmentation.

Question 14: Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how? TEI recommends that any guidance on profit split methods limit their scope to methods of last resort, otherwise taxpayers will shift functions to low tax jurisdictions, as noted above. When the arm’s length remuneration of the parties cannot be determined through other methods or it best fits the contractual risk allocation between the parties, then a profit split method may be applied.

Scenario 5. Question 17: How can comparables be found and applied in scenario 5? What method is likely to be appropriate for determining an arm’s length remuneration for the activities of the group companies? TEI submits that there is currently sufficient direction in the OECD transfer pricing guidelines on the search of both internal and external comparables as applied to Scenario 5 and therefore additional guidance is not needed.

Question 18: How can comparables be found and applied in scenario 3 (or to any other relevant scenario in this discussion draft)? The main difference between Scenario 3 and Scenario 5 is that a comparable uncontrolled price is more likely to be found in Scenario 5 than in Scenario 3; this should lead to the application of a resale method or the TNMM to Scenario 3.

Question 19: What aspects of scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate? Additional functional and risks analyses are needed with respect to the regional activities that each company is performing for the other to determine what method is most appropriate.

Paragraph 32. The Draft asks two questions about this paragraph, which reads in full:

In cases where available comparables for the application of a one-sided method may not reliably reflect the level of functions or risk in the tested party, concepts of a transactional profit split approach may sometimes offer the means to vary or flex the results under a one-sided method. For example, application of a one-sided method may result in establishing a range of operating margins of 4-10%

5 Id. at paragraphs 26-27, p.8.
for one of the parties to the transaction: a baseline return of 7% is adopted which would vary in accordance with a pre-determined computation upwards to 10% and downwards to 4% depending on the levels of consolidated profits or sales achieved by the parties to the transaction.

Question 20: In what circumstances, if any, might an approach described in the last sentence of paragraph 32 be appropriate? While TEI does not disagree with the statement made by the OECD in principle, it has been of little relevance in practice to date. In fact, having already obliged the taxpayer to perform a one sided transfer pricing analysis, it would seem unreasonable in most cases to ask an MNE to also perform a profit split analysis. Most tax authorities have solved this issue by implementing concepts such as interquartile ranges.

Question 21: More generally, in what circumstances would a transactional profit split approach be useful in supporting the application of other transfer pricing methods, and what guidance would be useful to develop for the supporting use of such approaches? As noted, requesting a profit split in addition to a one-sided or comparable uncontrolled price analyses seems unreasonable in nearly all cases. In theory there may be cases when such additional analysis might be required, in particular when there is great uncertainty over the result of the more traditional methods and the materiality of the transactions warrant a further in-depth review.

Aligning taxation with value creation. This section of the Discussion Draft focuses on how to develop objectivity in profit split factors so that transfer pricing outcomes are aligned with value creation. The section refers back to Scenario 1 and adds the additional facts that the associated enterprises (three manufacturing OEMs) split post-royalty residual profits or losses on the basis of three factors: production capacity, headcount, and value of production. These factors are then given a weighting. Question 22: In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector? Scenario 1 does not have any reference to risk allocation or the contractual arrangements between the parties. TEI submits that these are essential tenets of the arm’s length principle, and indeed in the OECD’s own words these are the starting points of any functional analysis. Their absence in this scenario is troubling.

Scenario 6. Question 24: How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for example approaches based on concepts of bargaining power, options realistically available, or a RACI-type analysis of responsibilities and decision making)? The scenario states that “[r]isks and assets were not considered separately as they were considered by the MNE group to be embedded in the processes that managed them.” This appears to ask tax authorities to disregard risks and assets. It thus seems to suggest that the OECD is moving away from the arm’s length principle based

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6 Id. at paragraphs 33-37, p.10.
on assets and risks and that functions should be paramount. Is this intended by the Discussion Draft?

Question 25: Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an MNE operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate? From the facts provided, it seems that reliable comparable uncontrolled prices were available to determine the remuneration of Company C. Why would a profit split analysis then be substituted? As to Company D, it is a contract manufacturer located in the same country as its principal, Company B. If a one-sided method was chosen by the taxpayer that is willing to bear the risk of eventually running one company at a loss while the contract manufacturer is always running at a profit for the unique benefit of reducing its compliance costs, it would generally be expected that the tax authorities of Country B would readily accept that arrangement. Why would it then be necessary to impose an additional compliance burden of a profit split analysis? Extending the use of the profit split is inappropriate here.

The use of profit split in the circumstances presented by scenarios 3, 5 and 6 suggests a potential proliferation or application of profit splits to many MNEs since many MNEs have similar scenarios. Application of profit split methodologies should only be utilised where traditional transfer pricing methodologies do not arrive at reliable arm’s length pricing (e.g., where highly integrated, hard-to-value, unique and valuable intangibles exist).

Scenario 7. Question 27: How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable? A transactional profit split can certainly be used to deal with unanticipated risk. In the case at hand, however, the parties have agreed to bear the risk of their own cost overruns. Such contractual arrangements are often used by management of certain MNEs to keep each side responsible for its own costs, and should be respected by tax authorities.

Scenario 7. Question 29: In what circumstances might it be appropriate under the arm’s length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss? The only reason for splitting losses differently than profits is when this is decided beforehand in a contractual agreement between the parties. An MNE may, for example, create a limited risk distributor (LRD) whereby relatively high routine profits are allocated to the LRD as long as the principal has a positive earnings before taxes, in return for a zero profit for the LRD when the principal incurs loss; in such a case, the LRD bears more risks than a conventional LRD, yet also earns a higher return.

Question 30: Are there circumstances under the arm’s length principle where parties which would share combined profits, would not be expected to take any share of combined losses? The OECD should maintain the existing guidance as referred to in paragraph 50 of the Discussion Draft,
i.e., that any reference to “ profits” should be taken as equally applying to losses, and that profit splits should be applied consistently. Opening up the possibility that losses may be subject to different treatment would create significant uncertainty, may be abused by tax authorities, and leave MNEs facing the prospect of going through the MAP process to ameliorate double taxation. Experience shows that some tax authorities ignore relevant market factors, e.g., a sales drop of 40% due to a local market collapse one year. Instead, the authorities maintain the position that a local entity of an MNE group should have the same level of positive operating profit no matter the circumstances based solely on comparables with prior year data, which does not reflect recent market changes. To avoid this approach by tax authorities, many MNEs adopted a principal structure, which leaves tax authorities worldwide with a steady, albeit smaller, profit allocation.

The official and unofficial process and environment surrounding most of the BEPS project has created the impression that many countries believe that MNEs have hidden abundant profits “somewhere,” which will be reallocated to the “right” country as a result of the BEPS project. This may be true in a limited number of situations, but not as a general rule for MNEs. Based on the above assumption, and the fact that tax auditors often have key performance indicators tied to the amounts reassessed, it is likely that any exception for loss sharing proposed by the OECD may be subject to abuse by tax authorities taking a profit split approach in the case of overall profits, and then claiming that local entity should not bear any of the losses.

Such guidance would create non-arm’s length results, as no independent third party is protected from various market factors and from incurring losses, unless it is has an extremely limited function and risk profile, in which case it would incur neither losses nor exceptional profits (in line with functions performed and risks assumed). It is important to keep at the forefront of this discussion that a loss is a negative profit. By applying a profit split method, the general approach is to determine the appropriate routine remuneration for routine functions and then share the residual profit based on certain criteria/contributions, etc. Thus, treating negative profit differently cannot be justified if functions performed and risks assumed by the parties remain the same. If one party should bear more or all of the losses given its functions and risks, then, all else being equal, it should also receive most or all of the positive profits. Otherwise, one of the two situations will not be in line with the functional and risk profile of the entity, and therefore not be arm’s length.

Examples 17 and 18. TEI agrees with some of the country delegates that profit split methodologies should not be used in places where further functional and risk analyses may be needed to determine appropriate traditional transfer pricing methodologies or where re-characterisation or disregard of transactions may be more appropriate (the latter approach only being appropriate in exceptional circumstances).
Other Issues

Retroactive or hindsight application of all transfer pricing methodologies, including profit split methodologies, should only take place in exceptional circumstances. Profit split methodologies are often applied to situations where activities are highly integrated. Therefore, it is likely that unanticipated results or events may arise. Treaty partners need to recognise that the allocation keys or methodologies may need to change to arrive at more appropriate transfer pricing results over time (i.e., it may be more of journey to arrive at a reasonable result rather than a direct path; therefore, taxpayers should not be subject to uncertainty if it took reasonable efforts to determine an appropriate transfer pricing methodology and allocation keys). To mitigate this issue, safe harbour rules should be introduced, and agreements between related parties under the safe harbour should be limited to no more than three years. This will allow treaty partners to agree on more reasonable profit split methodologies in subsequent years without the need to make adjustments by applying hindsight (i.e., the use of hindsight would not be necessary because the contract expires in three years or less).

We also note that it will be difficult for countries to agree on an exact profit split for many reasons. Thus, it is critical that advance agreements (such as advanced pricing agreements) be in place between the tax authorities and the taxpayer. Agreements on profit splits between multiple tax jurisdictions may be extremely difficult due to a number of factors. Different approaches to financial accounting and the tax base will complicate matters between jurisdictions unless the same requirement is adopted by all countries. Thus, taxpayers may be required to calculate a profit split in numerous ways, which would likely result in double taxation in addition to increased complexity. If a general rule is to be implemented, we recommend that consolidated financial statements be used because such information will be more readily available, auditable, supportable, and simpler. If tax adjustments are required, the rules among the countries should be consistent or the MNE should be allowed to use the tax rules applicable in the parent company.

Summary of Prior TEI Comments on Profit Splits

In addition to the comments specific to the Discussion Draft set forth above, we reiterate the following general comments on the profit split method from our earlier letter⁷ to the OECD regarding its 2013 discussion draft on intangibles:

1. The profit split method requires a great deal of international cohesion, expertise, and dialogue among different tax authorities. We are

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skeptical of the ability of certain authorities to apply the profit split method fairly and efficiently.

2. Regular use of the profit split (and similar) methods also raises the specter of increased transfer pricing documentation and compliance costs.

3. The profit split method presents complex and difficult administrative issues for tax authorities and similar compliance problems for taxpayers.

4. As a practical matter, the use of two sided methods by tax authorities, through a wider use of the profit split method, will likely result in increased controversy and the risk of double taxation.

Conclusion

TEI appreciates the opportunity to comment on the OECD Discussion Draft regarding the use of profit splits under BEPS Action 10. These comments were prepared under the aegis of TEI’s European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +41 786 88 3772, nickhasen@sbcglobal.net, or Benjamin R. Shreck of TEI’s legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,

TAX EXECUTIVES INSTITUTE, INC.

Mark C. Silbiger
International President
Subject: Comments on the Public Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains (BEPS Action 10)

Dear Mr. Hickman,

TPA is pleased to contribute through this representation to the valuable work performed by the OECD on the “discussion draft on the Use of Profit Splits in the Context of Global Value Chains”, published on 16 December, 2014.

TPA and its Global Alliances would like to congratulate the OECD with the progress being made on study of the use of a profit split method as well as Chapter II of the OECD Guidelines.

TPA sees some areas of concern as well: especially, when OECD would allow a wide application of profit splits in case of global value chains, this could be perceived as a trend to replace the arm’s length principle by a more formula-based approach. The main challenge will be to find “economically relevant” allocation factors.

TPA has structured its comments as follows:

- What defines an “integrated supply chain” (see Section I);
- What aspects of value chain justify using a profit split method (see Section II);
- How are “unique and valuable contributions” defined (see Section III);
- What aspects need to be considered when applying transfer pricing methods to risk being shared among group entities (see Section IV);
- How and when can functions be compensated on a fragmented basis (see Section V);
- Does the lack of comparables justify using a profit split method (see Section VI);
- What approaches may enable alignment of taxation with value creation (see Section VII);
- How can a transactional profit split method address differences between ex ante and ex post result (see Section VIII); and
- Can different set of factors than the ones used to allocate profits be used to allocate losses (see Section IX).

Yours Sincerely,
Steef Huibregtse
On behalf of TPA Global and its Alliance Partners
I. What defines an “integrated supply chain” (Paragraphs 5-12)

1. Non-Integrated Supply Chain vs. Integrated Supply Chain

Following diagrams illustrate how a non-integrated supply chain and an integrated supply chain operate, respectively:

A. Non-Integrated Supply Chain (Picture 1)

In a non-integrated supply chain, separate management boards control its own business unit.

[Diagram of Non-Integrated Supply Chain]

Focus: I/C compensation per entity / geography

B. Integrated Supply Chain (Picture 2)

In an integrated supply chain, one management board performs “wall-to-wall” management for all business units throughout the process.

[Diagram of Integrated Supply Chain]
II. What aspects of a value chain justify using profit split method (Paragraphs 5-16)

2. Picture 2 in Section I above is different from Picture 1 only in that one management board performs “wall-to-wall” management throughout the process.

TPA is of opinion that only if /insofar one (1) managerial board centrally “drives” the “wall-to-wall” management of the activities from (a) through (e) below on a transactional basis, a profit split method might be justified as the prevailing methodology.

a. Supply chain & logistics
b. Financial
c. Ownership and management of IP
d. Managerial
e. IT / Dashboard to manage business and functional risks

Otherwise, profit split can only be used as a corroborative, if at all.

3. “Drives” in point 2 above would be equivalent to the concept of “control over risk” which is already defined in Chapter IX. If it is already covered by Chapter IX, TPA can hardly see why we need a separate paper on the application of the profit split method.

4. Multisided business models (Paragraphs 13-16)

If / Insofar a local subsidiary provides services as follows:
- To promote the use of online services provided free of charge to users;
- To translate them into the local language;
- To tailor them to the local market and culture;
- To ensure that the services provided respect local regulatory requirements;
- To provide technical consulting to users; and
- To generate demand for and adapt advertising services,
in majority of business configurations, such an activity would classify either as a “cost center” or a “revenue center.” This means a profit split cannot be applied.

If / insofar OECD would allocate intangibles to the local subsidiary activities such as the above, a profit split approach could be defendable.

III. How are “unique and valuable contributions” defined (Paragraphs 17-21)

5. The fact that a business is capital-intensive, service-intensive and/or technology-intensive does not automatically imply that the roles performed by its local subsidiaries would constitute “unique and valuable” contributions, for which a profit split approach would be appropriate to compensate them. Merely because the functions or role performed by local subsidiaries are “valuable” it should not be concluded that they are “unique”.

<table>
<thead>
<tr>
<th>Routine functions performed by local entities</th>
<th>Routine return</th>
</tr>
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<tbody>
<tr>
<td>Merely because the functions are in relation to a “unique and valuable intangible” should not impact the inference. Does not entail functions involving decisions which significantly impact the organisational performance.</td>
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<table>
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<tr>
<th>Complex functions performed by local entities</th>
<th>Premium return</th>
</tr>
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<tbody>
<tr>
<td>Entails decision making functions which significantly impact organisational performance.</td>
<td></td>
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</table>

<table>
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<tr>
<th>Unique functions performed by local entities</th>
<th>Share of Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local entity is likely to be the owner of the marketing, human capital or other intangibles created.</td>
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</tbody>
</table>

IV. What aspects need to be considered when applying transfer pricing methods to risk being shared among group entities (Paragraphs 22-25)

6. In case risk is being shared by multiple group entities, such a risk factor could be taken into account by application of the so-called comparability standards, for example:
   If a manufacturer carries high product liability risks and/or creates huge synergies, OECD seems to suggest that a “shared risk / shared reward” standard could be applicable.
   However, OECD should recommend an industry relevant standard for taking bargaining power into account, before automatically applying such “shared risk / shared reward” standard.

V. How and when can functions be compensated on a fragmented basis (Paragraphs 26-28)

7. If / insofar activities of an integrated supply chain can be run with the same degree of autonomy, such functions can be compensated on a fragmented base. Even, in case of a fully integrated management of a supply chain, OECD requires taxpayers to assume such degree of autonomy of each function / fragment as a working hypothesis.

VI. Does the lack of comparables justify using a profit split method (Paragraphs 29-32)
8. Comparables are independent third parties which suffer agency cost on their interaction with other third parties in the market place. The fact that MNEs have eliminated (most of their) agency cost cannot be used as a leading argument to disqualify the often one-sided approach in benchmarking and comparables. It would be proper to reflect the quantifiable differences on the one-sided methods, rather than assume profit split is the most appropriate road to solutions.

VII. What approaches may enable alignment of taxation with value creation (Paragraphs 33-43)

9. A potential approach for addressing transfer pricing issues could be depicting the roles of all entities in a value chain matrix i.e., by determining whether the services provided by the local entities vis-à-vis the MNE group’s supply chain involves (a) non-core support functions; (b) core support functions; (c) customer facing functions; and (d) core business functions. Economically, the non-core support functions entail low value routine services and the service provider typically bears minimum risks. The nature of functions and the degree of risk borne by the service provider increases higher up the supply chain, such as when the service provider provides core support services, customer facing services and core business services (such as product / offerings development). The same is depicted below.

<table>
<thead>
<tr>
<th>TERTIARY FUNCTIONS</th>
<th>Non-core support</th>
<th>Core support</th>
<th>Customer facing</th>
<th>Core business</th>
<th>PRIMAR</th>
</tr>
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<tbody>
<tr>
<td>Judgmental</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>Highest value Profit Centre; High risks, Location Savings and Intangibles; Use of Profit Split Method</td>
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<td>Y</td>
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The value chain context can enable the determination of: (a) whether the local subsidiary is making a valuable contribution; and (b) assess the risk of a one-sided method in the context of the specific transaction.

10. Particular factors which are likely to reflect value creation in the context of a particular industry or sector can hardly be defined in a uniform manner.

A contribution profit split analysis is a proper mechanism as a corroborative method, since it is close to impossible to use a simple and/or complete set of allocation keys to allocate the total profits in an MNE’s value chain.
Strong correlations like that do not occur in a more complex economy. Temptations to move to formulae apportionment will by definition simplify how real businesses work. Appendix A, which is attached hereinto, lists the relevant criteria for such a contribution analysis.

11. **What approaches can be used to supplement the results of a functional analysis to improve the reliability of profit splitting factors**

The organizational “best practices” of transfer pricing refer to concepts like RACI. The “star diagram” resulting from such an RACI approach (workflows / activities / risk / assets vis-à-vis who is “responsible / accountable / consulted / informed) could be indicative on a profit on revenue allocation. However, the weighting of each workflow / activity / risk / asset might become highly subjective.

VIII. **How can a transactional profit split method address differences between ex ante and ex post result (Paragraphs 45-49)**

12. In case two or more group entities act as “investment center” and/or “profit center”, in a third party situation, the conditions would be fixed when closing the deal. Therefore, only in few exceptional conditions, e.g. a change in strategy, some “ex post” contingences will be allowed to apply between third parties, which “de facto” leads to an “ex post” profit and/or price adjustment. In most cases, an “investment center” or “profit center” will absorb its own financial success or failure without any restatement of profit allocation.

13. **Considerations in royalty situation (Paragraphs 48-49)**

When an intercompany royalty fee is fixed for a certain period, typically the underlying facts will have to account for the risk run by either of the parties. After a reasonable period of fixed royalty sales, these “underlying facts” need to be compared with today’s facts being relevant for the pricing of the royalty. Only if a significant deviation is recognized, a re-pricing of the royalty fee seems appropriate.

IX. **Can different set of factors than the ones used to allocate profits be used to allocate losses (Paragraphs 50-53)**

14. In case of an integrated supply chain, the factors allocating profits are the same when allocating losses. The dynamics of less integrated supply chains, which covers the majority of all industries, might lead to a different set of allocation factors for profits versus losses.
OECD on a practical approach to the application of a contribution margin profit split method

Following is an extract of the relevant paragraphs under Chapter II of the OECD Transfer Pricing Guidelines for Multinational Enterprises ("OECD report") and Tax Administrations, 2010.

In cases where the application of a one sided method is not supported, given that both parties are performing certain valuable contributions, the application of a profit-split may be supported. As also indicated in Para. 2.111 of the OECD, “in those cases where there is no more direct evidence of how independent parties in comparable circumstances would have split the profit in comparable transactions, the allocation of profits may be based on the division of functions (taking account of the assets used and risks assumed) between the associated enterprises themselves.”

Additional support for this method is provided under Para 2.113, where it is mentioned that “A further strength of the transactional profit split method is that it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result, since both parties to the transaction are evaluated. This aspect can be particularly important when analyzing the contributions by the parties in respect of the intangible property employed in the controlled transactions. This two-sided approach may also be used to achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administrations.”

When applying this method, a contribution analysis should be carried on the combined profits, so as to divide the total profitability amongst the associated enterprises. Para 2.119 of the OECD report mentions that such “division can be supported by comparables data where available. In the absence thereof, it is often based on the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions, taking account of their assets used and risks assumed. In cases where the relative value of the contributions can be measured directly, it may not be necessary to estimate the actual market value of each participant's contributions.” Where the relative value contribution of each participant becomes difficult to assess, the split of the combined profits may be facilitated through the use of allocation keys. More guidance on the application of allocation keys is provided in para. 2.135. “In practice, allocation keys based on assets/capital (operating assets, fixed assets, intangible assets, capital employed) or costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) are often used. Other allocation keys based for instance on incremental sales, headcounts (number of individuals involved in the key functions that generate value to the transaction), time spent by a certain group of employees if there is a strong correlation between the time spent and the creation of the combined profits, number of servers, data storage, floor area of retail points, etc. may be appropriate depending on the facts and circumstances of the transactions.”

When calculating such allocation keys, taxpayers may typically rely on the use of internal data, in the absence of third-party market data. The relevant guidance included in the OECD report can be found under para. 2.141 “Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the combined profits, consideration should be given to internal data, which may provide a reliable means of establishing or testing the arm’s length nature of the division of profits. The types of such internal data that are relevant will depend on the facts and circumstances of the case and should satisfy the conditions outlined in this Section and in particular at paragraphs 2.116-2.117 and 2.132. They will frequently be extracted from the taxpayers’ cost accounting or financial accounting.”
The OECD report, further discussed the use of a capital based allocation key to split the total profits. The relevant paragraph is presented below.

2.145 One possible approach not discussed above is to split the combined profits so that each of the associated enterprises participating in the controlled transactions earns the same rate of return on the capital it employs in that transaction. This method assumes that each participant's capital investment in the transaction is subject to a similar level of risk, so that one might expect the participants to earn similar rates of return if they were operating in the open market. However, this assumption may not be realistic. For example, it would not account for conditions in capital markets and could ignore other relevant aspects that would be revealed by a functional analysis and that should be taken into account in a transactional profit split.
February 6, 2015

VIA E-MAIL – TransferPricing@oecd.org

Mr. Andrew Hickman
Head of Transfer Pricing Unit
Organisation for Economic Co-operation and Development
Centre for Tax Policy and Administration
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Dear Mr. Hickman,

We are writing to share the comments of the Treaty Policy Working Group on BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains, released on 16 December 2014.

The Treaty Policy Working Group (TPWG) is an informal association of large global companies based throughout the world that represent a broad spectrum of industry sectors. The TPWG has been working since 2005 with the OECD, and more recently with the UN, to analyze and provide constructive comments on tax policy and administration concerns regarding transfer pricing, permanent establishment (PE), profit attribution, and related issues that are critical to our ability to avoid double taxation and conduct international trade and investment. The TPWG has provided comments on, and participated in consultations regarding, most if not all OECD discussion drafts on transfer pricing issues over the past decade, and also provides input on UN transfer pricing work.

The TPWG is pleased to comment on the Discussion Draft, which raises a number of issues of importance to our member companies.

1 The membership of the Treaty Policy Working Group is currently comprised of the following companies: Amazon.com, Inc.; BP plc; Cisco Systems, Inc.; Procter & Gamble Co.; Salesforce.com Inc.; TD Bank Group; Thomson Reuters Corporation; Tupperware Brands Corporation; and Vodafone Group plc.
As the Discussion Draft suggests, most, if not all, MNE groups have extensive value chains, with research, design, production, manufacturing, assembly, marketing, sales, inventory management, distribution, logistics, customer support, and other functions performed in a variety of jurisdictions, usually by a mix of related and unrelated entities. For coordination and cost reasons, overall management of the group’s operations is typically centralized on a regional or global basis. Each group’s value chain structure is tailored to its particular operations and is subject to ongoing change as circumstances warrant. The recent OECD report referenced by the Discussion Draft, *Interconnected Economies: Benefiting from Global Value Chains*, confirms that global value chains “are very heterogeneous across industries, companies, products and services.”\(^2\)

Like other businesses, most TPWG member companies have extensive “global value chains” of the sort described by the Discussion Draft and are concerned about some aspects of the approaches currently under consideration. Even TPWG members with more centralized operations share these concerns, however, because of the broader implications that the Discussion Draft approaches could have, if adopted in their current form.

### I. Executive Summary

TPWG members are concerned that the Discussion Draft signals a general move away from one-sided methods towards profit split methods that would create great uncertainty and controversy for most MNE groups and tax administrations.

The view of global value chains reflected in the Discussion Draft is far more negative than the positive view taken in other recent OECD, UN, WTO, and World Bank Group analyses and reports to the G20. This view appears to be premised on a paradigm of fully integrated, separate-country operations that does not correspond either to general historical reality or current practice and fails to adequately recognize the fact that such value chains typically involve not only intra-group transaction but also transactions with unrelated suppliers at many levels that provide reliable comparables.

Although the Discussion Draft begins with assurances that general arm’s length principles and guidance on the selection of the “most appropriate method” will continue to apply, it quickly moves to statements that effectively call these principles into question. The discussion does not make clear why the mere centralization of functions or conduct of functions in additional jurisdictions within a global value chain or the presence of “unique intangibles” cannot be satisfactorily addressed by existing transfer pricing guidance. Its discussion of global value chains and comparables is puzzling because it suggests that both the increased integration within global value chains and the increased “fragmentation” of global value chains make it impossible to identify comparables. The performance of separate functions by separate entities should, if

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anything, make it easier to find comparables, especially as those functions are often routine in nature.

Many of the Scenarios presented by the Discussion Draft suggest results that seem inconsistent not only with the general principles of the existing Transfer Pricing Guidelines but also with their discussion of transaction profit split methods. This appears to disregard the explicit assurance at the start of the Discussion Draft that the provisions of Chapters I-III of the Guidelines will continue to govern the application of transactional profit split methods even in the context of global value chains.

Much of the discussion in the Discussion Draft and its BEPS Action Plan and Digital Economy Report precedents appears to be inspired by a desire to change the results of applying the arm’s length principle and current transfer pricing guidance, without any discussion of these goals. It is important that the policy considerations underlying any proposed change to transfer pricing principles be explicitly articulated and agreed. Otherwise, the current lack of consensus on what constitutes “value” or “value creation” and whether and how to share “synergies” and other “benefits” could easily leave taxpayers without adequate guidance for the preparation of their tax returns, lead to unprincipled, case-by-case positions and results focused exclusively on revenue maximization, and spawn countless disputes that tax administrations would lack the resources to handle. Companies are already starting to experience these effects in audits and MAP proceedings.

There is a legitimate concern that, once country-by-country reporting data become available, transfer pricing administration could further degenerate into the unilateral application of inconsistent formulary apportionment methods. If the participating countries continue to oppose the use of global formulary apportionment and favor the application of the arm’s length principle, as has been repeatedly confirmed both by current OECD and UN guidance and in connection with the BEPS project, we respectfully submit that they need to revisit the approaches presented in the Discussion Draft and take the necessary steps now to avoid this result.

Our comments below first offer some perspectives on global value chains, as they are the stated impetus for and the context in which the profit split approaches under consideration would be applied. We then set forth our key concerns regarding the approaches proposed in the Discussion Draft.

II. General Comments Regarding “Global Value Chains”

A. Economic Development Perspectives on Global Value Chains

Although the Discussion Draft does not discuss them, the OECD has coauthored other recent reports, in 2013 with the WTO and UNCTAD and in 2014 with the WTO and the World Bank Group, that emphasize the significant macroeconomic opportunities created by global value
chains. This work was done in response to a call from G20 leaders, who acknowledged at their 2012 Los Cabos summit “... the relevance of regional and global value chains to world trade, recognising their role in fostering economic growth, employment and development and emphasizing the need to enhance the participation of developing countries in such value chains.”

The 2013 Report highlighted the fact that “[t]he income from trade flows within GVCs has doubled between 1995 and 2009: for China it has increased 6-fold, India 5-fold and Brazil 3-fold,” as well as the fact that this income growth “means more job growth: in Germany jobs associated with GVCs have doubled to about 10 million jobs between 1995 and 2008.” It also noted that “[t]he emergence of global value chains has benefited all G20 economies.” The 2013 Report concluded that “in today’s more interconnected world both the costs of trade and investment protectionism and the benefits of multilateral opening are much higher than previously thought.... Importantly, appropriately-tailored complementary policies that accompany increased trade and investment openness help ensure that this growth potential is realized and is widely inclusive.” Taxation is one of the other policies identified as important for this purpose.

The 2014 Report noted that:

“The message that the 2013 OECD-WTO-UNCTAD report to G20 Leaders, Implications of Global Value Chains for Trade, Investment, Development and Jobs had for the G20 Leaders was clear: Global value chains reflect 21st century production and provide potential mechanisms for countries – large and small, developed and developing – to improve income, employment, and productivity.”

One of the 2014 Report’s key conclusions was that:

“GVCs are especially important for developing countries, for which the best metaphor would not be a chain but a ladder. The disaggregation of production into


4 G20 Leaders Declaration, Los Cabos, Mexico, June 19, 2012, para. 29.


6 Id., page 14.

7 Id., Foreword, page 3.

8 Id., pages 20, 28.

separate stages allows their firms not only to find their place on the ladder, but to move up the rungs as their capabilities improve.”

Accordingly, both the 2013 and 2014 Reports strongly support the growth of global value chains, recognize their key role in both international trade and local economic growth, employment, and development, and provide advice to governments on how to foster their further development. The global value chains described throughout these reports, as well as in the report cited by the Discussion Draft, include economic activity conducted both by affiliated entities which are part of MNE groups, and third parties that contract with others to be part of the global value chain of their contracting counterparties. Indeed, the 2013 Report emphasizes that participation in “MNE-coordinated GVCs” has a much lower barrier to entry and may be the only current option for small and medium-sized enterprises in developing countries.

B. BEPS Perspectives on Global Value Chains

In contrast to these other recent reports to the G20, the BEPS work – including the BEPS Action Plan, the September 2014 report of the Task Force on the Digital Economy (the “Digital Economy Report”), and the scenarios presented by the Discussion Draft – reflects a negative view of global value chains.

BEPS Action 10 itself called for the development of “rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to … clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains…” The Digital Economy Report similarly expresses concern regarding global value chains, although the only rationale cited in its one paragraph of analysis is that advances in information communications and technology were one of several factors that accelerated “the spread” of global value chains and facilitated their ability to “take advantage of the features of the local market.” The Digital Economy Report’s discussion of global value chains appears to provide, or perhaps share, the inspiration for many of the scenarios considered in the Discussion Draft.

It is striking that the Digital Economy Report proceeds from the paradigm of a separate, full-fledged, vertically integrated operation in each country, maintaining that “[w]hen the arm’s

10 Id., page 18.
11 Interconnected Economies: Benefiting from Global Value Chains, Executive Summary, page 10.
length principle was initially devised, it was common that each country in which an MNE group did business had its own fully integrated subsidiary to carry on the group’s business in that country. \textsuperscript{16} It is certainly true that there has been a general increase in recent decades in the degree of global or regional centralization of some functions and a general extension of value chains to include functions performed in additional jurisdictions. However, we question whether the single-country paradigm cited by the Digital Economy Report ever in fact existed. Functions such as local marketing, sales, inventory management, distribution, and customer support may have been localized, especially in larger markets. On the other hand, remote sales models were also commonly used and other functions such as research, design, production, manufacturing, and assembly were centralized. The outsourced functions which have been the largest reason for the global reach of global value chains typically involve manufacturing, assembly, development, and similar functions which even in prior decades normally would not have been performed by multiple separate-country entities, as the Digital Economy Report seems to envisage. While many MNE groups continue to have subsidiaries at least in their larger markets, those subsidiaries are still likely to perform only selected functions – not every function or even most of the functions of the group as a whole.

Even if some single-country operations historically were, or presently are, conducted by local subsidiaries, it is not clear why such structures should be embraced as a general paradigm for tax policy decisions to be made in 2015 for coming decades. The international network of treaties and the principles on which they are based have been developed over many decades to foster cross-border trade and investment, and current trends towards greater international integration and geographical reach have evolved for business reasons such as cost savings and other efficiencies, not for tax reasons. It would make no sense to abandon these principles and provisions in favor of a purely domestic, single-country paradigm.

### III. Concerns Regarding the Digital Economy Report

After invoking the single-country paradigm, the Digital Economy Report asserts that the increased integration of MNE groups and the geographical reach of their global value chains raise new transfer pricing concerns:

“[W]ork in this area should devote attention to the implications of the increased integration of MNEs and the spread of global value chains, in which various stages of production are spread across multiple countries. In this context, the work should evaluate the need for greater reliance on functional analyses (assets used, functions performed, and risks assumed) and on value chain analyses and should also address situations where comparables are not available because of the structures designed by taxpayers and the unique intangibles involved.”\textsuperscript{17}

\textsuperscript{16} \textit{Id.}, para. 6.2.2.4.v, page 119.

\textsuperscript{17} Discussion Draft, para. 5, citing Digital Economy Report, page 16.
Of course, existing transfer pricing provisions require that each subsidiary in an MNE group (along with the parent company and any permanent establishments) be compensated at arm’s length. Functional analyses of assets used, functions performed, and risks assumed are already required and performed by MNE groups. So it is not clear why there is a new call for “greater reliance” on functional analyses in the context of global value chains.

It also is not clear what is intended by the “value chain analyses” that are called for in addition to such functional analyses, or how the two would differ from each other. The term is used in both the Discussion Draft and the Digital Economy Report, but not defined or explained in either. The fact that both types of analyses are referred to together several times indicates that they are intended to have different meanings. If so, we are concerned that the value chain analysis may be intended to modify the results of the functional analysis required by the arm’s length principle. For example, if the reference to value chain analyses is meant to suggest that every transaction must be evaluated and priced with reference to the MNE group’s entire global value chain, we worry that this could promote results inconsistent with the arm’s length principle and encourage increased revenue demands from many jurisdictions, each seeking a larger share of the total system profit without regard to whether their positions together create double or multiple taxation.

Finally, the Digital Economy Report expresses concern regarding “the structures designed by taxpayers and the unique intangibles involved.” However, it does not make clear why the mere centralization of functions or conduct of functions in additional jurisdictions within a global value chain or the presence of “unique intangibles” would create new transfer pricing concerns that cannot be satisfactorily addressed by existing transfer pricing guidance. The Discussion Draft contains a similarly puzzling discussion of global value chains and comparables because it suggests that both the increased integration and the increased “fragmentation” of global value chains make it impossible to identify comparables.18 The performance of separate functions by separate entities should, if anything, make it easier to find comparables, especially as those functions are often non-unique in nature.

The Digital Economy Report does not sufficiently reflect the fact that many global value chains involve the participation of unrelated suppliers at many levels. Even very large MNE groups engage unrelated contractors as part of the MNE’s global value chain to perform critical functions. The increase in outsourcing over the last few decades actually makes it easier to identify reliable comparables for those component functions of a global value chain. This has been recognized by courts for many years.19 Every indication is that the use of third party contractors by MNEs will continue to increase, especially as the economic capabilities of developing economies continue to expand to support these businesses.

18 Discussion Draft, paras. 26-27.
19 See, e.g., the U.S. Tax Court opinion in Compaq Computer Corp. and Subsidiaries v. Comm’r., T.C. Memo. 1999-220 (July 9, 1999).
The Digital Economy Report asserts, without discussion or analysis, that “unique intangibles” exist in global value chains. The implication is that such “unique intangibles” should be shared in some way with all participants in the global value chain. Other discussions of this issue refer only to the expected synergies and other unintended benefits of operating within an MNE group, so if the term “unique intangibles” is meant to refer to these, we would note that WP6 confirmed last year in its latest draft Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions that synergy benefits do not constitute “intangibles.” In any event, we submit that, at arm’s length, whatever synergies may arise from the operation of a global value chain are allocated between the parties according to their respective bargaining positions. That market-based allocation is entirely reflected in the financial results of the unrelated party participants to these transactions. Given that the prevalence of third party contracting in global value chains is increasing, the arm’s length results of participating in a global value chain are more and more transparent through a careful and principled identification and analysis of appropriate comparables.

It is clear from unrelated party behavior that in the normal case, an enterprise which wishes to engage an unrelated party to perform a function as part of the enterprise’s global value chain does not share with that party the value created by the intangibles owned or developed by the enterprise. This is true even if the function being acquired by contract is a critical one, such as precision manufacturing of a high-tech consumer electronic product.

Taken as a whole, the Digital Economy Report’s discussion of value chains and profit splits seems unusually results-oriented. Its purpose seems to be to advocate a general shift from one-sided transfer pricing methods based on comparables to transactional profit split methods with “value chain analyses.” The tax policy concerns motivating these proposals are unstated, but need to be clearly articulated so that the proposals can be understood and evaluated in the proper context.

IV. Concerns Regarding the Discussion Draft

The Discussion Draft sends mixed messages. On the one hand, after acknowledging the mandate of BEPS Action 10 regarding profit split methods and the Digital Economy Report’s concern regarding global value chains, its introductory discussion very helpfully puts the question of whether profit splits should be used in the context of global value chains firmly within the framework of general transfer pricing principles. This portion of the Discussion Draft properly emphasizes the importance of a thorough functional analysis of how the associated enterprises operate, and the requirement to select the most appropriate transfer pricing method for each case. Unlike the BEPS Action Plan and the Digital Economy Report, the introductory discussion also reassuringly refers throughout only to transactional profit split methods, presumably in an effort to preclude explicitly more formulary apportionment methods of splitting profits. Finally, the introduction takes care to caution, in bolded text, that:

20 Discussion Draft, Preface, page 2.
“The scenarios included in this discussion draft have been provided to illustrate points for discussion only and should in no way be taken to imply that transactional profit split methods will be the most appropriate method in the circumstances outlined in those scenarios. Similarly, the scenarios are necessarily brief for the purposes of identifying discussion points, and should not be interpreted to imply that the proper process of a thorough transfer pricing analysis can be dispensed with.”\textsuperscript{21}

The introductory section of the Discussion Draft is similarly helpful in confirming that it cannot be assumed that a transactional profit split method will prove to be the most appropriate method of determining arm’s length prices for transaction within a global value chain:

“Since the term global value chain describes all a firm’s activities in relation to a product or service, there can be no assumption that a particular transfer pricing method is more appropriate in determining arm’s length prices for transactions between associated enterprises within that global value chain. Instead Chapters I-III of the Guidelines and in particular the guidance on method selection in paragraph 2.2 apply in analysing global value chains. A global value chain is likely to involve extensive and varied functions involving many enterprises and multiple transactions; there seems to be very little experience of using a transactional profit split method in a way that could appropriately and comprehensively reflect the range of contributions to value in a diverse value chain. The fact that an MNE group disseminates its value chain amongst a number of enterprises in different jurisdictions does not imply that transactional profit split methods will be necessary or appropriate to benchmark arm’s length returns for those enterprises. In many cases, the structure of the MNE group’s value chain will allow the identification of relatively discrete, stand-alone elements which can be reliably priced using one-sided methods.”\textsuperscript{22}

These unusually clear statements seem to offer valuable reassurance that existing transfer pricing principles will be respected under any Action 10 measures relating to profit split methods. It is also an accurate reflection of the business reality in arm’s length transactions of how MNE groups deal with third party contractors which form part of the group’s global value chain.

All of this is potentially called into question, however, by a statement at the very end of the Discussion Draft’s value chain discussion, which seems intended to signal a general lowering of the bar for the application of transactional profit split methods:

“[W]here there is significant integration involving parties to a specific transaction or transactions within that value chain, for example in the effective sharing of key

\textsuperscript{21} \textit{Id.}, para. 4.

\textsuperscript{22} \textit{Id.}, para. 6.
functions and risks, the reliability of one-sided methods may be reduced. One-sided methods may not be able to account reliably for the interdependence of the key functions and risks, or for the synergies and benefits created by such integration. In such cases transactional profit split methods may be an appropriate means of determining an arm’s length outcome, which takes into account the specific contributions of the parties to value creation.”

This statement seems to be based on assumptions about “effective sharing of key functions and risks” which simply do not occur in arm’s length behavior between unrelated parties. This premise as a reason to select an appropriate pricing method thus appears to depart from the Transfer Pricing Guidelines in the following respects:

– It would permit the application of transactional profit split methods where there is “significant integration” such as the “effective sharing of key functions and risks,” and not only where there are “highly integrated operations” such as global trading of financial instruments or other arrangements where both parties make unique and valuable contributions. (Compare TPG paras. 2.4, 2.109.)

– It suggests that a transactional profit split method may be applied because it “may be an appropriate method,” without any indication, or even an assertion, that it would be the “most appropriate method.” (Compare TPG paras. 1.9, 2.2.)

– It describes transactional profit split methods as an appropriate way to account for “the synergies and benefits created by such integration,” whereas the Guidelines currently do not presume this. (Compare TPG Chapter IX.B.2.)

– It describes “an arm’s length outcome” as one that takes into account the parties’ contributions to “value creation,” without regard to whether the result even approximates a result that would have been agreed to by independent parties in similar circumstances. (Compare, e.g., TPG para. 2.115.)

This statement also raises the following interpretive issues:

– The example of “significant integration” given is “the effective sharing of key functions and risks,” which seems to indicate that no legal or other formal sharing of functions and risks is required and that such “sharing” might even be deemed to occur when not contemplated by the taxpayer. This would create an untenable level of uncertainty.

– There is no indication of which functions and risks might be considered “key” or of what constitutes “value creation” or how these determinations would be made, which would create highly subjective standards subject to dispute.

23 Id., para. 7.
It is asserted that one-sided methods would have “reduced reliability” in such a scenario because of the “interdependence” of the functions and risks involved or because of the “synergies and benefits” resulting from the integration, but the basis for this conclusion is not explained by the Discussion Draft or apparent from existing transfer pricing guidance.

This troubling paragraph is then followed by a much longer discussion of nine “Scenarios” in which the applicability of transactional profit split methods is queried in various circumstances. So great is the contrast with the introductory discussion that it appears as if these sections of the Discussion Draft were written separately by different persons.

Many of the Scenarios suggest results that seem inconsistent with the discussion of transaction profit split methods in the Transfer Pricing Guidelines, such as the consideration in Scenario 6 of a so-called RACI analysis and the suggestion of Scenario 9 that losses might be split on a different basis than profits in other years. With limited exceptions, most of the questions regarding the Scenarios ask not whether a transactional profit split method would be the most appropriate method or would provide reliable arm’s length results, but only whether a transactional profit split would be “appropriate,” “an appropriate transfer pricing solution,” “more useful” than other methods, or even simply “useful” or “helpful.” This appears to disregard the explicit assurance at the start of the Discussion Draft that the provisions of Chapters I-III of the Guidelines will continue to govern the application of transactional profit split methods even in the context of global value chains.

Transfer pricing analysis is necessarily an intensely factual exercise. But at bottom the arm’s length principle is a matter of law, and the purpose of interpretative guidance is to provide a reasoned and principled structure to the application of that law. The essential structure is that taxpayers and tax administrations are tasked with determining the “most appropriate method.” That assessment requires a FAR analysis, but also a close review of the available data and the possible comparables. Concepts such as whether a method is “useful” or “helpful” create a significant risk of corroding the steel frame of the “most appropriate method” structure.

V. Key Concerns

A. Rejection of Comparables and One-Sided Methods

We are particularly concerned that most of the Scenarios in the Discussion Draft appear to be designed, like the general statements in the BEPS Action Plan and the Digital Economy Report, to promote the broader application of transactional profit split methods instead of one-sided methods, even when sufficiently reliable comparables are available to make a one-sided method the “most appropriate” method. For example, Scenarios 3 and 5 suggest the application of profit split methods to marketing and distribution functions that are clearly routine in nature and widely

24 See TPG, Chapter II.C., including paras. 2.115, 2.117.
respected as such in practice. As noted above, we submit that the discussion is internally inconsistent and generally unpersuasive.

We do not believe that the existence of a value chain that extends across borders makes comparables unavailable. To the contrary, the usual segmentation of functions and the common outsourcing of selected functions in value chains should make comparables more readily identifiable in most cases. Nor do we believe that the presence of a “unique intangible” in the value chain always requires the application of a transactional profit split method. At arm’s length, an MNE enterprise which seeks to engage an unrelated party to participate in the enterprise’s global value chain will not share the benefits of the enterprise’s “unique intangible” with the third party. We agree with the existing Guidelines that a transactional profit split method may be appropriate where both parties to a controlled transaction contribute unique and valuable intangibles, but where only one party does so, the other party should be treated as the tested party and receive a non-unique return. In the case of comparables which themselves are highly sophisticated enterprises, the results of the comparable already incorporates a return to the unique intangibles that are associated with the functions of the comparable. The Guidelines already provide adequate guidance on this analysis.

B. Difficulties in Applying Transactional Profit Split Method

The TPWG is not opposed in principle to the proper use of the transactional profit split method where it is the most appropriate method. We appreciate that it has been used successfully in a few multilateral APAs to split the residual profits from highly integrated global trading operations in the financial sector and even to achieve pragmatic compromises in some MAP cases. However, these applications have been tailored to the facts of each particular case and agreed by all parties.

The general application of a transactional profit split method would be a very different proposition. The concerns expressed in the Guidelines regarding the difficulties of applying the transactional profit split method are present in the context of global value chains as well. These include the difficulties in accessing the detailed information needed from foreign affiliates, in determining combined revenue and costs for all the relevant enterprises on a common basis, in identifying relevant operating expenses, and in isolating costs allocable to the transactions at issue.25

In addition, we note that the Discussion Draft Scenarios appear to contemplate the use of multiple allocation factors, which would add substantial complexity, subjectivity, and risk of disputes to the analysis. The inability to identify a single set of allocation factors that could be applied to all cases, given the variations in their value chains and functions, assets, and risks, would make the application of transactional profit split methods to particular cases uncertain as well. This would create a level of uncertainty and risk of inconsistent treatment from case to case.

25 TPG, para. 2.114.
case that would be unacceptable to businesses and should concern tax administrations and tax policymakers as well.

If profit split methods were applied as suggested in the Scenarios, the treatment of every case would have to be negotiated separately by the tax administrations and taxpayers concerned. While this is theoretically possible under APA and MAP programs where available, the volume of cases would make it impossible to achieve in practice if profit splits become the default method for MNE groups generally. Unless mandatory, binding arbitration were available, there would be no effective mechanism to avoid double or multiple taxation or resolve other disputes. The Discussion Draft thus comes uncomfortably close to creating conditions that could force a wholesale move towards global formulary apportionment – albeit without providing an agreed formula or guidance on how to apply it. If this is not the intent, then the goals and approaches of the Discussion Draft should be reconsidered.

C. Lack of Policy Basis and Consensus

Much of the discussion in the Discussion Draft and its BEPS Action Plan and Digital Economy Report precedents appears to be inspired by a desire to change the results of applying the arm’s length principle and current transfer pricing guidance. All three documents refer to achieving “outcomes” consistent with “value creation.” Portions of the Discussion Draft also refer to “synergies” and “benefits” of “integration” and suggest a desire to share them. In light of this, it is curious that the Discussion Draft does not contain any discussion of these goals.

It is important that the policy considerations underlying any proposed change to transfer pricing principles be explicitly articulated and agreed. Otherwise, the current lack of consensus on what constitutes “value” or “value creation” and whether and how to share “synergies” and other “benefits” could easily leave taxpayers without adequate guidance for the preparation of their tax returns, lead to unprincipled, case-by-case positions and results focused exclusively on revenue maximization, and spawn countless disputes that tax administrations would lack the resources to handle. Companies are already starting to experience these effects in audits and MAP proceedings.

There is a legitimate concern that, once country-by-country reporting data become available, transfer pricing administration could further degenerate into the unilateral application of inconsistent formulary apportionment methods. This would create massive uncertainty for both businesses and treaty and other trading partners. It would also spawn countless disputes that may prove impossible to resolve. If the participating countries continue to oppose the use of global formulary apportionment and favor the application of the arm’s length principle, as has been repeatedly confirmed both by current OECD and UN guidance and in connection with the BEPS project, we respectfully submit that they need to take the necessary steps now to avoid this result.
* * *

The Treaty Policy Working Group hopes that these comments will be helpful as deliberations continue on these important issues. We would welcome the opportunity to participate in the consultation on these and other transfer pricing issues on March 19-20.

Sincerely yours,

For the Treaty Policy Working Group

Carol A. Dunahoo

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Gary D. Sprague
February 5, 2015

VIA EMAIL
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Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 10: Discussion Draft on the use of Profit Splits in the Context of Global Value Chains

Dear Mr. Hickman,

USCIB appreciates the opportunity to comment on the discussion draft on the use of profit splits in the context of global value chains (the “discussion draft”).

General Comments

Arm’s length principle and separate entity accounting

USCIB believes that both the arm’s length principle and the separate entity legal principle are fundamental to Article 9 of the OECD Model Income Tax Treaty and the current transfer pricing guidelines interpreting those provisions. We believe that the OECD should reaffirm its continuing support for these fundamental principles. We are making this request in light of BEPS discussion drafts that, taken together, seem to indicate a movement away from these standards to a formulary apportionment/systems profit allocation approach. This discussion draft as well as those addressing country-by-country reporting, the digital economy, intangibles, and risk and recharacterization raise these concerns.

Dispute resolution

Clarity on the transfer pricing standard is especially important given the lack of binding arbitration in the dispute resolution draft. As USCIB points out in our comment letter on dispute resolution, we expect disputes to proliferate as the BEPS outcomes are implemented. Disputes will be reduced if the Transfer Pricing Guidelines (“TPGs” or “guidelines”) narrow the possible options rather than expanding them infinitely. Trying to value the “global value chain”, measure the impact of “integration”, or “fragmentation”, will lead to various inconsistent results that the guidelines anticipate resolving by reference to profit splits. A vague standard that seems to promote profit splits in virtually any case will, however, only increase disputes. There should also be a recognition that not all businesses are
profitable, particularly those in a startup phase. As such, if profits are to be split then losses should be split as well. Without agreed upon methods for determining profits and the allocation keys, there will be no substantive basis for resolving those disputes. This combined with a lack of binding dispute resolution will lead to more double taxation.

Even if disputes can be resolved, the time and expense to both taxpayers and tax administrations expended in reaching resolution is significant. Therefore, an important part of dispute resolution is dispute avoidance. To achieve that goal rules must be clear and certain of application. USCIB believes that the discussion draft is neither clear nor certain of application.

Best methods and comparability

USCIB believes that profit splits have a place in the overall transfer pricing framework. The standard for determining the applicable transfer pricing method should always be the best method and in some cases a profit split may be the best method but should never be the default option. USCIB believes that the current TPG provide workable rules and guidelines that guide both taxpayers and tax administrators to the best method for assessing intercompany transactions. This is illustrated by our responses to scenarios/questions attached as an appendix to this letter.

The current TPGs acknowledge that “methods based on profits can only be accepted insofar as they are compatible with Article 9 of the OECD Model Tax Convention especially with regard to comparability. USCIB is concerned – despite the language in paragraph 3 preserving the wider framework – that the discussion draft may be read as requiring the use of a profit split method if company operations include any degree of integration – which would affect all MNEs. USCIB continues to believe that appropriate comparables for individual entity activities can be found in most cases, that it is appropriate to distinguish between routine functions and those that make unique and valuable contributions, and that one-sided methods continue to be appropriate for compensating routine functions. All companies are unique; they have different structures, people and cultures. That does not mean they are not comparable. To some degree, nearly all MNEs employ an integrated business model, usually in order to provide a better commercial value to their customers. Cross group integration does not mean that routine functions cannot be identified and priced. MNE integration can include unrelated entities (e.g., contract manufacturers and contract development centers) as well as related entities, so third party comparables will exist. If integration, however, becomes the standard for disregarding one-sided methods, then profit splits will become the de facto method for tax administrators.

The current transfer pricing guidelines contain an excellent description of the advantages and disadvantages of the profit split method. A profit split may be found to be the most appropriate method in cases where both parties make unique and valuable contributions. A transactional profits split method would ordinarily not be used in cases where one party to the transaction performs only simple functions. We note that part of the problem with this standard may be the notion of a simple function. For example, in the pharmaceutical industry the sales force usually comprises individuals with degrees in medical fields (e.g., nursing, pharmacology, and life sciences). Therefore, the individuals performing the

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1 For ease of reference, all references to “profit” splits should be read to assume “loss” splits as well.
2 All snowflakes are unique, but they are comparable and not particularly valuable.
3 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, paragraph 2.109, page 93. (Hereinafter OECD TPGs.)
4 OECD TPGs paragraph 2.109, page 94.
sales function are considered to be highly educated compared to other industry sales forces.\(^5\) However, the sales functions are similar across companies, comparables can be found, and in fact a highly educated work force does not mean that the functions are complex or that a profit split is required. At the end of this letter we briefly respond to some of the scenarios/questions based on the guidance provided in the current TPGs. Those responses demonstrate that the current guidance can be applied to achieve reasonable results in the vast majority of cases.

**Current guidelines on formulary apportionment**

We also have serious concerns that the OECD is reversing the guidance that it issued as recently as 2010. In the 2010 update to the Transfer Pricing Guidelines, the OECD noted that advocates of global formulary apportionment argue:

\[\text{[T]hat an MNE group must be considered on a group-wide or consolidated basis to reflect the business realities of the relationships among the associated enterprises in the group. They assert that the separate accounting method is inappropriate for highly integrated groups because it is difficult to determine what contribution each associated enterprise makes to the overall profit of the MNE group.}^6\]

The “global value chain” analysis described in the discussion draft seems entirely consistent with the contention noted in paragraph 1.19 that an MNE group must be examined on a group-wide or consolidated basis. The argument that that MNE groups are now operating on a more “integrated” basis (consistent with the economist’s conception of a single firm operating in a coordinated fashion) seems entirely consistent with the argument, rejected in 2010, that separate accounting is inappropriate, and that a unitary approach which erases the boxes on a legal entity organizational chart is appropriate. It is not at all clear how the arguments found in the discussion draft can be reconciled with the OECD’s 2010 rejection of global formulary apportionment.

Formulary approaches were rejected for the sound reasons set out in the current Guidelines.\(^7\) In particular the Guidelines note:

The most significant concern with global formulary apportionment is the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation. To achieve this would require substantial international coordination and consensus on **predetermined formulae** to be used and on the composition of the group in question. For example, to avoid double taxation there would have to be common agreement to adopt the approach in the first instance, followed by agreement on the measurement of the **global tax base** of an MNE group, on the use of a common accounting system, on the factors that should be used to apportion the tax base among different countries (including among non-member countries) and on how to measure and weigh those factors. Reaching such an agreement would be time consuming and extremely difficult. It is far from clear that countries would be willing to agree to a universal formula.\(^8\)

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\(^5\) The sales function maybe complex, but it earns routine returns. Sales functions are widely available “commodities” for which there are known prices.

\(^6\) OECD TPGs, paragraph 1.19, page 37.

\(^7\) OECD TPGs paragraphs 1.21 -1.32, pages 38 through 41.

\(^8\) OECD TPGs paragraph 1.22, page 38, emphasis added.
The example of the States of the United States is sometimes given as a successful application of formulary apportionment. In our view, the success of this model is over estimated. States have many different apportionment formulae, which can result in both double taxation and so-called “double non-taxation”.

The discussion draft would increase these difficulties as the scenarios seem to be proposing a variety of different formulas with different apportionment factors and different weightings. It is difficult to envision how sovereign taxing jurisdictions could reach an agreement on multiple formulae including the profit to be split and the allocation keys in the BEPS time frames on topics raising the most difficult of pricing issues: multi-sided business models; unique and valuable contributions; and hard to value intangibles.

The current TPGs also note that:

Global formulary apportionment cannot, as a practical matter, recognize important geographical differences, separate company efficiencies, and other factors specific to one company or subgrouping with the MNE group that legitimately play a role in determining the division of profits between enterprises in different tax jurisdictions.  

USCIB agrees with the conclusion of the OECD TPGs that global formulary apportionment should be rejected.

OECD move away from arm’s length principle and separate legal entity

We are particularly troubled that the OECD may propose a significant policy reversal in such a short amount of time, as stability and certainty are two of the traditional hallmarks of sound tax policy.

We also note our disappointment that the discussion draft follows closely the conceptual paradigm set forth in the earlier report on the tax challenges of the digital economy. In our comments on that digital economy discussion draft, we noted several serious flaws including:

- Disregard of the distinction between an origin-based income tax and a destination based VAT,
- Used of inconsistent reasoning regarding the importance of “substance” in supporting income allocations depending on whether the allocation was proposed by the taxpayer or the tax authority,
- Movement away from the OECD’s application of the arm’s length principle substantially in the direction of formulary apportionment, and
- Risk of creating a hybrid transfer pricing system composed of both formulary and arm’s length aspects that threatened the OECD’s traditional role in furthering world trade and economic development by promoting uniform rules for taxing cross border transactions.

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9 OECD TPGs paragraph 1.29, page 40.
10 OECD TPGs paragraph 1.32, page 41.
12 The OECD also assumes that all internet or “cloud” based transactions are always profitable. This analysis ignores the significant costs for data center infrastructure and delivery costs that must be incurred in order to provide “SAAS” or “PAAS” to customers. In the physical delivery world these costs would be borne by the
In our view, this discussion draft exacerbates those flaws, rather than ameliorating them.

The movement towards formulary apportionment and a unitary approach to the taxation of multinational enterprises (MNEs) was perhaps most succinctly encapsulated in this paragraph from the digital economy report:

> When the arm’s length principle was initially devised, it was common that each country in which an MNE group did business had its own fully integrated subsidiary to carry on the group’s business in that country. This structure was dictated by a number of factors, including slow communications, currency exchange rules, customs duties, and relatively high transportation costs that made integrated global supply chains difficult to operate. With the advent of the development in ICT, reductions in many currency and custom barriers, and the move to digital products and a service based economy, these barriers to integration broke down and MNE groups began to operate much more as single global firms. **Corporate legal structures and individual legal entities became less important and MNE groups moved closer to the economist’s conception of a single firm operating in a coordinated fashion to maximise opportunities in a global economy.** Attention should therefore be devoted to the implications of this increased integration in MNEs and evaluate the need for greater reliance on value chain analyses and profit split methods. This work should also address situations where comparables are not available because of the structures designed by taxpayers and could also include simpler and clearer guidance on the use of profit splits along the lines that have been successfully applied in connection with global trading and other integrated financial services businesses.\(^\text{13}\)

That paragraph inappropriately confuses economic concepts with long-established international tax principles. It may be true that an MNE consisting of many legally separate entities is, for some economic purposes, a “single firm.” However, structures have important legal and economic consequences, which companies consider carefully when setting up or changing their legal structures. The corporate form exists to encourage investors to pool their funds in risky ventures. Although the ultimate risk of success or failure of the combined firm rests with the ultimate shareholder,\(^\text{14}\) as between separate legal entities within a firm, limited liability may protect the assets of one company, and therefore the ultimate shareholder, from the mistakes of another related company; legal entities are not merely separate pockets of the same person. The location of assets may also reflect the local legal system’s ability to protect specific assets particularly intellectual property. Valuable intangibles will not be located in jurisdictions that do not offer protection for intellectual property rights.

Consistent with history of limited liability and separate corporate personality, the architecture of the international tax rules has for the last century been built upon the notion that separate legal entities are customer but in the cloud these costs must be borne by the provider. While some companies may in fact earn significant profits, the bulk of cloud service providers are heavily investing in the hope of profit at some point in the future.

\(^\text{13}\) Id. at ¶166, emphasis added.

\(^\text{14}\) The implication of the ultimate individual shareholder being the person ultimately at risk should create a drive towards the integration of corporation and personal income taxes rather than a formulary splitting of the profit of the corporation enterprise.
generally respected for tax purposes. This is both important and necessary. If a creditor of a corporation can only collect from the assets of that corporation\textsuperscript{15}, then it is important that the separate return to that corporation be appropriately determined under arm’s length principles. If the profits of that entity are shifted to another entity then the ability of that creditor to collect against the corporate debtor would be impaired. Thus, the longstanding respect of corporate structure has legal, economic, commercial and tax consequences. If the result of the BEPS project is to overturn that architecture and move towards a more unitary approach (an approach with which we strongly disagree, and that we think would have enormous, negative consequences), then it should be done explicitly, but with considerable forethought into the consequences\textsuperscript{16} and only with an enforceable agreement between governments to adopt a standardized profit allocation methodology. We believe that incremental change is far worse than an explicit and immediate change to a new standard like formulary apportionment. Incremental change creates uncertainty for business and could have broader economic consequences as corporate taxpayers might delay investment or expansion decisions while awaiting additional policy guidelines or would be subject to different treatment in different parts of the world.

MNEs exist precisely because of the benefits that come from operating in an integrated, interdependent, and synergistic manner. A parent company and its related entities share a common goal of maximizing profits, but how the local country business unit accomplishes this can vary from country-to-country given the need to localize and adapt to local country business practices and customs, which is of course done within the accountability and corporate governance principles adopted by the company’s board and shareholders.

The term “fragmentation” is also used throughout the draft to cast doubt on the viability of proposed comparable transactions and one-sided transfer pricing methods. So while “integration” creates problems for use of one-sided transfer pricing methods, apparently the opposite of integration, “fragmentation,” is also occurring and also causing problems with the use of one-side methods. In practice, it is often easier to find comparables when the entity performs fewer functions, thus so-called “fragmentation” should not create an obstacle to finding the right transfer price.

MNEs focus on what they do best and outsource non-core activities. Thus, MNEs routinely “fragment” their businesses in part to unrelated parties. For example, outsourcing of manufacturing is commonplace in the electronics business. Both computer hardware and consumer electronics are routinely manufactured by third parties. These decisions allow companies to free up capital and resources to focus on their strengths. If, on the other hand, an MNE decided to keep this activity within the group, but in a separate legal entity with only that limited function, should they be treated differently than another group that “fragmented” the activity by outsourcing it a third party? We believe that consistent with the arm’s length principle they should not be treated differently. Outsourcing also provides comparables to help determine the appropriate compensation when these functions are performed by affiliates.

Outsourcing functions is common in many other industries, including the pharmaceutical and chemical industries as examples. Pharmaceutical companies can and do outsource different aspects of their business. Some might outsource (or partner with an unrelated party) on research and development.

\textsuperscript{15} Creditors frequently require conditions limiting the ability of corporations to transfer assets out of the corporation. Attributing the profit from a valuable asset out of one corporation to another related corporation may function like a transfer of that asset. The implications of such rules for creditors ought to be considered.

\textsuperscript{16} For example, the UK’s proposed “Diverted Profits Tax” may result in reduced foreign investment in the UK.
Marketing and sales may be outsourced, manufacturing may be outsourced. In the context of the global enterprise, different functions may be performed internally or outsourced, so that it is very likely that internal comparables exist. Putting different activities in different entities makes sense from a business perspective and is not tax avoidance. These activities will be managed separately and a one-sided method will likely be the most appropriate method; however, in limited and complex cases a two-sided method may be appropriate.

The concept of uniqueness is relevant here. Even under the current rules, tax administrations routinely reject internal comparables because of slight differences in the transactions. Tax authorities demand essentially identical transactions (which of course do not exist) and inappropriately reject transactions with unrelated parties that are functionally equivalent to those with related parties. The notions of “integration”, “fragmentation”, and “global value chains” seem designed to give support to these unwarranted rejections of comparable transactions. The OECD seems to be arguing that a price within an integrated company is never comparable to one that is not part of an integrated group; therefore, the prices – even internal comparables with unrelated parties – cannot be comparable because of the fact of integration in the global value chain. Demanding perfect comparables, and rejecting their application with integrated MNEs is tantamount to a rejection of the arm’s length principle. Consistent with the arm’s length standard, this notion must be rejected.

The term “global value chain” is apparently taken from a 2013 report by several OECD committees regarding the international “fragmentation” of production in global value chains and its effects on the global economy. It is defined as the “full range of firms’ activities, from the conception of a product to its end use and beyond . . . . It includes activities such as design, production, marketing, distribution and support to the final consumer.”

It is difficult to see how examining a firm’s “global value chain,” including the full range of firms’ activities, from the conception of a product to its end use and beyond” will be relevant or useful to the transfer pricing of the vast majority of related party transactions. It will certainly not be relevant to transactions involving limited-risk distribution, manufacturing, or R&D. In the absence of the international agreement identified in paragraph 1.22 of the OECD’s TPG, analyzing the “global value chain” is likely to give rise to an infinite number of possible profit allocations. How are taxpayers to settle on a particular outcome? How are they to document their transfer price? How are tax authorities to audit and resolve the inevitable disputes (both with taxpayers and other concerned jurisdictions) concerning these profit allocations?

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17 For example, within the EU MNEs are able to centralize distribution functions as a result of the removal of restrictions on the cross border movement of goods and the existence of explicit VAT rules. MNEs are able to save costs by avoiding duplicate operations and those savings may be passed on to customers in the form of reduced prices, making the MNE more competitive.
19 We note that the discussion draft, in paragraphs 38-43, page 11, has also appropriated the “RACI” (Responsible, Accountable, Consulted, and Informed) matrix from the project management field. We will not comment extensively on this framework, and only note in passing that we are leery of incorporating the latest fads from the fields of management consulting and business administration into the Guidelines; their usefulness to a transfer pricing analysis is not readily apparent.
20 There is no evidence that such an agreement can be reached within the BEPS timeframe. Indeed, there are no proposals on how profit splits should be split in this discussion draft.
It seems that many of the BEPS Action Items are aimed at giving countries both permission to use profits to achieve formulary outcomes and the tools necessary to implement these outcomes. The Actions that raise these concerns include: the digital economy report, the interest deductibility report, virtually all the transfer pricing work including the work on intangibles, risk and recharacterisation, and documentation, especially the country-by-country report.

**Current use of profit splits**

Profit splits have been used successfully in a limited number of bilateral APAs and in exceptional Competent Authority agreements. However, these are case-by-case determinations with a discrete set of participants to the negotiation. These agreements, therefore, do not present the same significant difficulties as a potential global agreement on one or more formulae. In this regard, business was very supportive of the proposal to develop bilateral or multilateral MOUs to reflect transfer pricing methodologies that countries have agreed on in particular cases and extending those agreements more broadly. There has been no evidence of any progress on this front at the OECD. It appears that it would be far easier to reach agreement on these more limited cases before tackling global agreement on formulas for a variety of different and difficult issues. That is, if countries cannot reach agreement to extend previously agreed narrow solutions more broadly, then it will be impossible for them to reach agreement on the broad range of difficult issues raised by the discussion draft.

**Conclusions**

For all of these reasons, we believe that the conceptual framework set forth in the discussion draft should be carefully reconsidered by the OECD and the individuals who prepared this document. We believe it represents an unwarranted and flawed attack on the arm’s length principle and separate entity accounting. Even if that were not the intent, we believe the risk of interpreting the discussion draft in that manner is high and can only lead to confusion and unprincipled approaches to transfer pricing assessments.

We would also point out that the arm’s length principle is based on Article 9 of the OECD Model Tax Convention, which respects separate entity accounting. The Transfer Pricing Guidelines, which are essentially the commentary to Article 9, must be consistent with it. To the extent revisions are made to the Guidelines as part of the BEPS project which are inconsistent with Article 9, as incorporated in thousands of existing bilateral tax treaties, it could create years of needless disputes. Given that the recent discussion draft on dispute resolution mechanisms proposed only modest improvements, this could contribute (along with other BEPS project recommendations) to a substantial expansion of unresolved tax disputes and the “global tax chaos marked by the massive re-emergence of double taxation” of which the BEPS Action Plan warned.

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21 Consider an MNE with operations in 100 countries. It is unrealistic to assume that all countries concerned, or even a minority of the countries, could agree on a common base and allocation keys. The practical consideration of implementing a profit split point overwhelmingly toward maintenance and improvement of the arm’s length standard.

22 Many MNEs are already seeing unprincipled tax assessments on theories that have not been approved by the OECD or enacted into local law.

23 We also note our support for the earlier work on safe harbors and bilateral or multilateral MOUs for the competent authorities to reflect agreement on a transfer pricing method that could be extended beyond the parties involved in that agreement (http://www.oecd.org/tax/transfer-pricing/50514053.pdf). We have seen no evidence of any progress on that front. We respectfully submit that that work could be very useful both in terms
USCIB appreciates the opportunity to comment on the discussion draft and looks forward to working with the OECD to achieve appropriate outcomes.

Sincerely,

[Signature]

William J. Sample  
Chair, Taxation Committee  
United States Council for International Business (USCIB)

of clarifying application of the arm’s length principle, consistent with its historic understanding, and in minimizing tax disputes and conserving precious competent authority resources. We strongly urge that resources be devoted to finalizing that work as soon as possible.
USCIB has some responses to the scenarios/questions posed on the application of the current TPGs, in particular whether profit splits should be appropriately applied. We have preserved the numbering, by including a number without comment in cases in which we have no comments.

Scenario 1.
1. Transactional profit split method could be used to provide a transfer pricing solution. First, the taxpayers could determine total operating profit in the European market as the difference between sales to end customer and the sum of fully-loaded production and selling/distribution costs. Second, the taxpayers could determine the routine return for the fully-loaded selling/distribution function, and subtract that amount from operating profit. The residual profit could be split between the OEMs. The split could depend on a number of factors, as discussed in (2) below.
2. The aspects that need further elaboration include the differences/similarities in OEMs operations, and their risk profiles.
   - If the OEMs are very similar in all respects except for the assortment of manufactured products, residual operating profit can be split in such a way as to equalize the return to OEMs’ operating assets. The OEMs’ royalty for technology IP can be split along the lines of the profit split to ensure that the royalty payment is commensurate with income.
   - The OEMs, however, might be different in respect of the use of specialized inputs and economies of scale. For example, one OEM might be able to use a batch process to manufacture the product with minimal utilization of labor whereas the other OEM may employ a process that is labor-intensive. The split of the residual on the basis of equal return on operating assets may under-allocate the profit to the labor-intensive OEM. In this case, the split can be based on the ratio of returns for unrelated companies that are, correspondingly, capital- or labor-intensive. Similarly, if one OEM employs a process that generates economies of scale, the effect of the economies of scale would need to be incorporated into the split.
   - One might also have to consider whether excess capacity exists at each OEM, and why. If the Leadership Board decided that putting in place the process with excess capacity was the only way to produce the necessary component utilized by all OEMs, then all OEMs should bear the cost; if, however, excess capacity is the result of poor management by the OEM, the cost should be borne by that OEM.
3. Overall, if all OEMs bear risks, play an entrepreneurial role, and have significant cross-selling activity, a transactional profit split method could be preferable to other methods provided that all countries involved have agreed to the appropriate allocation keys.
4. Additional guidance would describe how to approach disparate technologies, uneven risk profiles, and differences in scale among the parties to the transaction.

Scenario 2.
5. The use of transactional profit split method in this case depends on whether the local subsidiaries face material risks. The fact pattern in this scenario might be interpreted that “suggestions” on the algorithms and technologies provided by the subsidiaries to Company R, as well as translation, tailoring, and regulatory compliance functions, do not impose operating risks on the subs, in which case the subsidiaries’ remuneration can be
provided on a cost-plus basis. This scenario ignores the costs associated with providing the service to external customers. For example, RCo Group would likely be required to create multiple data centers around the world to provide the advertising services to individuals. These data centers are very costly (in the hundreds of millions of US dollars to create and initially equip). In addition, the annual expenses of the data center would need to be properly accounted for in determining the profit split. These annual expenses include operating expenses, and update and replacement of the equipment. The OECD should recognize that once all costs are taken into account, there may be a loss that should be split among the relevant jurisdictions.

6. The transactional profit split method should only be considered if the subsidiaries have an entrepreneurial role with regard to their demand generating function, in which case the relative contributions of this function and technology owned by Company R would have to be considered in determining the split. The demand generating function has to be spelled out with regard to the actual risks that it imposes on the subsidiaries’ operations.

Scenario 3.

7. The aspects that require further elaboration are as follows:

- Whether Company S operates at risk.
- Whether the functions performed by Company S could be purchased by Company P from 3rd parties.
- Whether “competitive advantage” provided to the Group by Company S can be quantified.
- The extent of “modifications” and “proactive maintenance” offered by Company S (full-fledged distributors often provide these services to their customers).
- The extent of Company S’s dependence on the marketing strategy developed by Company P.
- The Company S contributions are overstated in importance. There are countless examples of a third party distributor providing these services today which provide comparables to determine appropriate compensation for these activities. The value in the equipment is in the intellectual property that created the technology. There is limited “value” in the functions that Company S performs.

9. Under the fact pattern of scenario 3, transactional profit split method might not be necessary. If Company S operates at risk, a Resale Price Method might be an option if appropriate comparable transactions can be found. If Company S provides significant marketing service, a TNMM with an operating margin, plus an additional marketing return, might be preferred.

10. Transactional profit split method might be appropriate if Company S’s intangible contribution (e.g., the effect of modifications and proactive maintenance) were quantifiable. This would require concrete examples of how the competitive advantage is manifested and such examples would likely to be difficult to find and subjective.

Scenario 4.

11. Transactional profit split method might be an appropriate approach if the contributions of Companies B and C were unique and risky and if similar components could not be obtained from unrelated parties. The profit split method would also be appropriate if the total amount of profit generated from the manufacture and sale of this medical equipment (Companies A, B, and C combined) were smaller than the sum of individual
returns to Companies A, B, and C if such returns could be measured by reference to comparable companies. To elaborate, suppose that one could find suitable comparable companies whose data could be used to calculate the return on operating assets to be used as a benchmark for Companies A, B and C. When this benchmark is applied to the operating assets of Companies A, B and C, the sum of individual companies’ profit components based on the benchmark can be higher than the total amount of profit generated from the manufacture and sale of this medical equipment. Under such circumstances, a split of the available profit could be necessary. It would only be an appropriate method if tax authorities in the relevant countries accept an appropriate allocation of costs associated with the risks to each entity concerned. The discussion draft appears to assume that costs are minimal and profits are both common and significant. Absent specific acceptance by all countries that costs can be allocated and deductions allowed for such allocations across borders, the transactional profit split method is incomplete.

12. A one-sided method might produce more reliable results if Company A can outsource the development and production of key components to unrelated parties. (The fact in this scenario that the components are unlikely to be useful in other types of products does not indicate that Company A is precluded from sourcing these components from unrelated parties.) If the components can be outsourced to 3rd parties, Company A’s bargaining power will be significant over that of Companies B and C. The suitability of a one-sided method also depends on the degree of risk borne by each company with regard to the finished product. If Company A is ultimately responsible for the quality of the sold equipment, Company A might be more likely to compensate Companies B and C on an operating asset or cost-plus basis.

13. The degree of shared risks, options realistically available to the parties, availability of comparable companies.

14. [ ]

15. Whether transactional profit split methods are appropriate for fragmented functions depends on these functions’ uniqueness, complexity, risk, and value contribution to the overall supply chain. When the uniqueness, complexity, risk, and value contribution are limited, the remuneration of the function can be determined using one-sided methods. Even in cases where the tested party’s functional composition is somewhat different from the functions performed by the comparables, the one-sided methods may be acceptable if the functional difference of the tested party is reflected in the cost base (for a cost-plus method).

16. The functions’ uniqueness, complexity, risk, and value contribution to the overall supply chain need to be elaborated.

Scenario 5.

17. The overall profitability of the supplier of office stationery in a region should be in line with comparable distributors that operate in that industry and region.\(^{24}\) Whether transactional profit split methods or one-sided methods are appropriate depends on the similarity of markets in which the companies operate. If the markets are similar – i.e., if the product composition and the associated functions have similar profit potential – then one can remunerate individual operators on the basis of the comparable

\(^{24}\) This scenario outlines precisely why MNE’s have moved to a centralized structure. Customers’ desire for centralized billing and distribution causes MNEs to adopt centralized risks and functions. This structure also makes sense from an economic perspective; MNEs save money by avoiding duplication of functions across legal entities.
companies’ results. However, this could effectively produce the results consistent with a profit split if, for example, the selected one-sided benchmark is an operating margin which, when applied to individual operating countries, would produce the total operating profit in the region. The profit in this case would be split on the basis of sales.

Where certain operating companies perform services for other members that exceed the scope of functions performed by other members, a profit split approach becomes more relevant because the direct application of the comparables’ benchmarks might produce the sum of parts exceeding the total. In this case, such additional services can be compensated separately on the basis of a one-sided method, and the residual profit can then be split using an appropriate basis (e.g., sales, cost, or assets).

Whether the operating companies sell to local customers or fulfill orders placed with other group companies might be of minor importance if there is limited marketing to local customers which can be the case if the overall brand of the MNE group is the main driver of the business. In such a case, operating companies may function like logistics/warehousing service providers, and would be compensated on a cost-plus basis subject to the total profit cap.

If the markets are different – i.e., if the product composition and the associated functions have different profit potential, and require varying degrees of marketing effort – then the applicability of the profit split method might be necessary.

18. Publicly available financial statements are available in most countries and could potentially be used with appropriate adjustments to serve as comparables.

19. The aspects requiring further elaboration are the degree of difference/similarity across the markets, including product composition, functions performed by operating companies, whether unique assets are being employed, and what risks are being borne. It is unclear why an MNE group should be concerned about the buying activities of its unrelated customers. The fact that the customer may be buying on behalf of a regional entity is a transfer pricing issue for the customer, not the MNE group. The regional purchasing activities of the customers do not generate measurable compensable value for the MNE affiliates accepting regional orders. MNE affiliates are taking orders and fulfilling them whether on a regional or single jurisdiction basis. Even if the transaction was transparent such that the MNE was fully aware of its customers purchasing activities, it will be virtually impossible for the MNE group to be able to track and compute a separate transactional profit split for each customer as accounting systems are not capable of tracking and reporting this level of detail. Also, to the extent that the regional capability allows the group to make additional profit, this profit will be earned by all the members of the MNE group participating in these transactions and thus it should not be necessary to aggregate that profit and split it.

20. This approach could be applicable under a very specific set of facts and circumstances. The establishment of the floor and ceiling on the operating margin can suggest several things, including, among others, (i) that the operating performance of the party is linked to the profitability of the group (which does not have to be the case if the party is a routine service provider), or (ii) that the risk of the party varies only within the prescribed range and only when the group’s performance changes. If the party in this example were a distributor, the ceiling on the OM can be interpreted as a performance...
bonus whereas the floor can be viewed as price protection, both of which could be addressed through a one-sided method. Whether a one-sided method is used, or if the floor/ceiling range is incorporated into the profit split, the boundaries of the range should be established by reference to the risk profile of the party. Such an approach could be useful as long as there was consideration of an appropriate return for an industry. A blanket baseline return of 7%, for example, would be excessive in some industries and de minimis in others. As noted above, costs as well as profits of a particular company must be taken into consideration in arriving at an appropriate transfer price.

21. The current guidelines provide two circumstance in which the transactional profit split method may be the most appropriate method: (i) where both parties provide unique and valuable intangible assets to the transaction where the comparables are not available, and (ii) where the group operates on an integrated basis, comparable transactions can be identified, but the total operating profit of the group is higher or lower than the operating profit implied by the comparable benchmarks, in particular global trading is identified as case in which a profit split may be the best method.

22. The discussion draft would benefit from a discussion that value drivers can be industry- or sector-specific. In certain cases, the value of production might not be an appropriate value driver if it incorporates expensive inputs and very little added value. In other cases, combining production capacity and headcount through a weighting approach might be misleading if the production processes across enterprises are drastically different. If one is uncertain about the most reliable allocation key, the process for selecting one should start with the analysis of the relevant industry and market factors. Once the industry value drivers have been identified, the selection of the allocation key will be more reliable.

23. If factor weighting is necessary, one needs to review their relative contribution to value. For example, in a simple capital/labor framework, there could be the optimal ratio of capital and labor inputs into the production process, even if these factors are owned and operated by different entities. Such optimal ratios might become the foundation for determining the split. The factors ignore the value of intellectual property investments that each participant may have brought to the transaction. Because an asset is not reflected on a corporate balance sheet does not mean that it does not have value that ought to be compensated or accounted for in the allocation keys.

Scenario 6.

24. Paragraph 42 appears to suggest that personnel is the primary value driving factor that affects other value drivers but none of the other value drivers are mentioned. The analysis of profit splitting factors can be supplemented by the analysis of market characteristics and organizational constraints which will help determine which factors play an active role in profit generation and which factors are a dead weight.

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25 OECD TPG, paragraph 2.109, page 93. We agree that in some cases integration may be a factor in determining whether profit split is the best method. However, global trading is a highly integrated function and providing that the profit split method may be the best method in such a case is very different from providing that profit split is or may be the best method any time there is any benefit from integration in an MNE global value chain.

26 This scenario seems inconsistent with the discussion draft on risk and recharacterisation which require carefully analysis of risk. That discussion draft would seem to prohibit the behavior described in paragraph 42, that is “risks and assets were not considered separately as they were considered by the MNE group to be embedded in the processed that managed them.” Discussion draft, paragraph 43, page 11.
25. A framework for a multifactor profit split analysis can certainly be developed, but the reliability will decline with the complexity of the transaction. As the number of factors increases, certain factors might become endogenous to the process which means that parsing out individual factor effects for purposes of the split might become subjective. In scenario 6, Companies A and B operate within a set of constraints, and the ultimate profit pool depends on the decisions made by A and B, where the decisions are not necessarily concurrent. For example, the decision on business and development strategy by A may be made first, followed by B’s development of the manufacturing process and procurement decisions. Company A’s decision is made given the (potential) technological capability of B, whereas B’s decision is made within the narrower choice set constrained by the previous A’s decision. Theoretically, one could use real options valuation approach by employing binomial lattices, but each step in a decision tree will be affected by market characteristics and organizational constraints, and will suffer from data limitations. The way to approach a multifactor analysis is to keep it uncluttered. Do not use a factor unless absolutely necessary. Try to avoid the factors whose outcome is tied to another factor because the profit to that factor may be double-counted. For example, if one factor is management of IP whereas the other factor is sales, the sales factor is likely to be the outcome of the use of the management IP factor, and the allocation of profit based on both factors may inflate the management IP factor. For complex structures, break the operation into large sub-modules and analyze the profitability of each module as a stand-alone entity. Determine the value driver(s) within each module. Determine the best realistic alternative for each module. Compare the sum of profits for each module to the total operating profit of the transaction. If the sum of parts is larger, consider which module was most likely to underperform given the market characteristics. Determine whether the underperformance was due to the module’s own actions or whether this was the result of the decisions made by other modules. Based on the determination, adjust either the underperforming module or the other modules involved in the decision. Clearly, this process will get very complicated.

26. Particularly relevant is the discussion in ¶2.133 regarding reliance on data from comparable uncontrolled transaction – specifically, that co-marketing and co-promotion agreements can be used for guidance – and Section C.3.4.4 on reliance on data from the taxpayer’s own operations.

Scenario 7.

27. This fact pattern raises numerous questions: Is the development of the two components sequential or concurrent? What are the differences in technology embedded/used to manufacture each component? For example, one technology might be simple chemical batch production whereas the other is manufacturing product with very specific characteristics. The risk of failure/cost overrun will vary with the technology. Can any development work be outsourced to unrelated parties? Is any information on success/failure rates in this industry publicly available? If so, one might be able to use them to construct the risk-adjusted split.

If the profit split agreed to by the parties is appropriate to the anticipated results, the profit split should also be appropriate for unanticipated results unless such results are due to information asymmetry. Having a look back rule to account for information asymmetry (such as commensurate with income) may be appropriate in limited
circumstances. However, such a rule should only apply if the actual results are outside of a band of reasonable returns and the taxpayer should have an opportunity to demonstrate that the unanticipated results were due to external factors beyond the taxpayer’s control, in which case the negotiated profit split should be respected. Losses should also be split in the same manner as profits.

Scenario 8.

28. In this scenario, if the combined operating margin remains stable year after year, and if the ex ante 80/20 split is not challenged, then the royalty rate will remain constant. For example, if sales = 1000, operating profit = 100, OM=10%, 80/20 split = 80/20, and company P’s royalty rate is 8%. If sales increase to 2000 while OM = 10%, OP = 200, 80/20 split = 160/40, and company P’s royalty rate is still 8% (160/2000). If the sales/profit path is not constant but predictable, a fixed royalty rate can be calculated so that it produces the same income stream on a net present value basis. When the sales/profit path is not predictable with any degree of certainty, then that is when the fixed royalty rate will be problematic. However, the problem is not just with the royalty rate: the entire 80/20 split would have to be re-examined.

Scenario 9.

29. This might happen if the losses occur during a startup phase when the IP was not fully developed and the split can be done on the basis of contributed capital. Then once the IP becomes the primary value driver and is able to generate positive operating results, the split can be done on the basis of relative IP contribution. Profits and losses should be split on the same basis unless there are unusual factors weighing on either that would dictate a different result.

30. Yes – if the loss was the result of the actions of one party which actions were not incorporated into the ex ante split. For example, one party brings to the transaction patented technology whereas another party contributes marketing IP/customer relations. If the first party is found infringing on a patent causing severe deterioration of sales which results in operating losses, the ex ante split would have to be revisited because the marketing party to the transaction should not have to bear the losses caused by patent infringement.

31. Among other practical difficulties is that the transactions are becoming increasingly complex, the value drivers are commingled making it exceedingly difficult to determine their individual influence on profit generation. One of the (so far underused) tools at practitioners’ disposal is regression analysis which can be applied to parse out individual value components. At times, several methods might have to be used to determine the correct income allocation. The profit split analysis similarly has to be scrutinized to determine that the specification of allocation keys is robust.
Commentary regarding the OECD Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains (BEPS Action 10)

Dear Mr. Hickman,

Thank you very much for the opportunity to provide our comments on the OECD’s Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains (hereinafter referred to as “discussion draft”) as of 16 December 2014 for the revision of chapter II of the OECD’s transfer pricing guidelines 2010. We appreciate the effort to provide guidance on this important topic.

First of all we would like to provide general comments regarding an appropriate application of a two sided transactional profit split method (“PSM”). Then we would like to comment on the specific scenarios and questions addressed by the OECD in its discussion draft.

A. General comments regarding an appropriate application of a two sided transactional profit split method

1. General comments, advantages and disadvantages of the transactional profit split method in practice

According to the OECD Guidelines 2010 always the most appropriate transfer pricing method (“TPM”) should be selected. Hence, no strict hierarchy in the selection of a TPM exists but if “…a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method.”

1 Para. 2.3 OECD Guidelines 2010.
Furthermore, the results of the parties should only depend on the functional profile and therefore be the same independent of the applied TPM.

The traditional transaction methods as well as the transactional net margin method ("TNMM") are one sided methods (hereinafter together referred to as “one sided methods”) which in principle only need to reflect the functions and risks of the party which is classified as routine entity or tested party. Thus, the tax authority in the country of the routine entity does not need extensive information regarding the functions and risks of the other party (entrepreneur) to analyze the appropriateness of the TPM applied and the resulting transfer prices. The PSM on the other hand always needs to reflect the contribution to the value chain and the functions performed, risks borne and assets used of both parties (two sided method). Thus, the implementation and calculation of the PSM is considerably more complex than for the one sided methods, increases the necessity of a close cooperation between the involved tax authorities and ultimately the risk of double taxation.

Especially the complex application of the PSM and a rather subjective (value chain / contribution) analysis and less objective attribution of the profits may result in a standpoint much open to interpretation and may have the effect of limiting the circumstances under which the PSM is practicable. In addition, a broader application of the PSM could be misused to expand profit shifting.

Due to its complexity, the PSM should rather be seen as a complementary TPM and only be applied in cases where no other TPM can be applied in an equally reliable manner.

Further revision of the discussion draft: We would like to ask the OECD to introduce a clear guidance regarding the requirements and execution for the application of the PSM, to not soften the worldwide successfully applied approach of selecting the most appropriate TPM and clearly classifying the PSM as TPM which should best be applied in cases where no one sided method could reliably be applied (as already outlined in para. 2.3 OECD Guidelines 2010).

2. Implementation of the transactional profit split method (definition and sharing of the profits)

Especially the implementation of the PSM and an appropriate attribution and sharing of the profits generated with each individual controlled transaction under examination regularly result in significant issues in practice. Both parties need to prove that their share of the profit is arm’s length.

The calculation usually starts with the combined profit gained by the parties minus the remuneration of any routine contributions, transactions and entities (residual profit). The remaining residual profit has then to be split between the parties based on the individual transactions. Determining this combined respectively residual profit on transactional basis in distinction to the other activities performed by each party is often the first major obstacle. Reference is made to circumstances where the parties involved are also engaged in numerous other functions which are not or may not be covered by the application of the PSM on a transactional basis. The main question is on which basis respectively factors (especially allocation key) an appropriate attribution of the residual profit between each individual intercompany and external transaction and activity of all involved parties should be made.
In a second step the **residual profit on transactional basis** has to be **split between the parties**. This should be made by conducting a functional analysis respectively a transaction based value chain analysis for each transaction which is generally a subjective procedure. Again, the main question is on which basis respectively factors an appropriate attribution on transactional basis between the parties should be made.

The determination of appropriate factors and allocation keys for the attribution of the profits to each transaction as well as for the attribution of the transactional profit to each party is often randomly, based on less objective assumptions and could give an easy opportunity to shift profits.

In addition, the PSM also has to consider differences in local accounting standards, currencies etc.

**Further revision of the discussion draft:** We would like to ask the OECD to introduce a clear guideline regarding the implementation of the transactional PSM (especially regarding the determination of combined profit, the attribution to the individual transactions and the allocation between the parties). This should explicitly cover the extraction of the residual profits on transactional basis from the combined profit of all involved entities. If no OECD wide accepted approach is implemented, each tax authority could subjectively interpret the implementation and calculation of the PSM and the risk of double taxation would significantly increase.

3. **Application of transactional profit split method for routine functions and entities?**

Generally, the two sided PSM could be more appropriate than traditional transaction methods e.g. in cases where each of the parties makes valuable and unique contributions in relation to the controlled transaction, meaning both parties contribute unique intangibles.\(^2\) In other words, in cases where one of the parties does not contribute significant intangibles etc. and thus can be classified as routine entity a one sided method should be more reliable, appropriate and more easy to implement.

Regarding the contribution of intangibles, every global multinational enterprise ("MNE") is unique and gains due to its specific organization group specific synergies. That a MNE entity renders or benefits from such synergistic effects should not lead to the (re-)qualification of such an entity as non routine. The revised discussion draft on transfer pricing aspects of intangibles\(^3\) e.g. clarifies that MNE group synergies are principally not assumed as intangibles.\(^4\)

In many of the scenarios described in the present discussion draft one of the parties rendering or benefiting from synergies has rather to be classified as routine entity not contributing significant intangibles to the controlled transaction. A one sided method is assumed to be more appropriate instead of the PSM. In addition as further example, every (routine) distribution entity owns a more or less valuable customer base. But this alone should never be a reason to neglect a routine classification.

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\(^2\) See 2.4 and 2.109 OECD Guidelines 2010.

\(^3\) Published on 30 July 2013.

\(^4\) Section D.8. of the revised discussion draft on transfer pricing aspects of intangibles.
Hence, we would rather recommend staying to a broader and / or more refined definition of a “routine function respectively entity” reflecting current economic developments instead of requalifying routine entities to (semi-)entrepreneurs which seems the approach in some of the proposed scenarios. Staying to a broader routine concept seems to be the only practicable approach instead of a more extensive application of the PSM and to be in line with the arm’s length principle.

Furthermore, we also understand the need to reflect some of the more valuable functions performed of the parties in the outlined scenarios but we do not see any need to requalify most of these parties from classical routine entities to entrepreneurs. Instead of a requalification their remuneration should be adjusted, e.g. by remunerating them with a (gross / net) profit margin rather on the upper end of an appropriate range.

In a MNE group it is common practice to split certain functions, e.g. production and sales, between several entities and each of these functions does have a certain (unique) contribution to the value chain. However, this alone does not justify classifying the PSM as the most appropriate TPM.

The main area of application of the PSM should rather be cases where one function is split between several entities, e.g. a multistage production process whereby each production entity contributes a significant share to the value chain, bears significant risks and uses valuable intangibles.

Furthermore, the application of the PSM and the attribution of profits for parties performing different functions should not be reliably possible from an objective standpoint due to hard to quantify allocation keys (please refer to our comments in section A.2.).

**Further revision of the discussion draft:** We would like to ask the OECD to introduce a clear and broader definition for routine entities for which the one sided methods are preferable and on the other side to introduce a clear and general definition for cases where the PSM seems to be the most appropriate TPM under the given facts and circumstances.

**B. Comments on the specific scenarios and questions addressed by the OECD**

In the following, we have summarized what, in our view, are the main points submitted by the discussion draft. Against most of these points we provide our comments.

1. **Scenario 1 – Questions 1 to 4**
   - 1. *Can transactional profit split methods be used to provide a transfer pricing solution to this scenario? If so, how?*

The pooling of stewardship functions or management services is a standard approach of MNE groups. Hence, management functions should in no way be qualified as entrepreneurial. Generally, this pooling takes place in international or regional holdings. Hence, only because that this pooling takes place across certain entities this does not justify the PSM to be the most appropriate TPM. Thus, we assume the application of a one sided method to be more appropriate in scenario 1 and to apply e.g. a cost sharing agreement between the three OEM enterprises for the stewardship functions of the leadership board instead.
2. What aspects of Scenario 1 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?

The main function respectively core business activity in this scenario seems to be the manufacturing. The leadership board should be qualified as routine function. This function is performed by each OEM enterprise on its own. To classify the PSM as the most appropriate method only the pooling of main functions should be relevant e.g. pooling of a multistage production process. Please refer to our general remarks in section A.

3. Is the application of a transactional profit split method more useful than other methods for dealing with particular aspects of value chains, such as highly integrated functions, and the sharing of risks?

No, we propose to use a one sided method here. Please refer to our general remarks in section A.

4. What guidance should be provided to address the appropriate application of transactional profit split methods to deal with these aspects of value chains?

Please refer to our general remarks in section A.

2. Scenario 2 – Questions 5 to 6

5. Can transactional profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how?

From our perspective this scenario represents a classical scenario for applying the PSM. Both parties contribute in the development of software as the key value driver. Hence, the entrepreneurial function is split between both parties. Furthermore, all other parties benefit from all local development services. In addition, the local adaptation and development is a key factor for the success of the product.

However, the local distribution can be established as a routine distribution function and be remunerated accordingly. The residual PSM should be applied for the transaction software development and adaption.

6. What aspects of Scenario 2 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?

The functions performed should be analyzed in detail. In case none of the functions could be qualified as routine function, the PSM would be more appropriate.

Please refer to our general remarks in section A.

3. Scenario 3 – Questions 7 to 10

7. Does the way in which “unique and valuable” is defined for intangibles assist in defining the term “unique and valuable contributions” in relation to the transactional profit split method?

The definition is very abstract, not specific and gives a lot of space to interpret. In some kind of way every activity can be defined as “unique and valuable” as generally no perfect matches exist. E.g. every “routine” distributor has a customer which is “unique and valuable” for its business, at least from the subjective view of the “rou-
tine” distributor. A more specific and objective definition for intangibles would be preferable.

- **8.** What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method?

Please refer to our general remarks in section A.

- **9.** Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm’s length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?

As the outlined scenario is a classical routine distributor case, the resale price method or the transactional net margin method should be applied. To reflect the deep customer relationship of the distributor its remuneration could rather be oriented towards the upper end of comparable remunerations but should not be sufficient to requalify the function to an entrepreneurial function.

- **10.** What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3?

From our perspective, we see no practical advantages in applying the PSM. Company P is the clear entrepreneur and should earn the residual profit.

Please refer to our general remarks in section A.

4. **Scenario 4 – Questions 11 to 16**

- **11.** In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks?

The PSM could be an alternative for sharing the risks in the outlined scenario. However, this would also mean to include sharing any losses respectively costs incurred since the beginning of the development phase and future losses if the development of a new product is not successful.

A more convenient approach, which is mainly adapted in practice e.g. by joint ventures, would be that each party bears its individual risks and in case of a successful development licenses its intangibles to the users respectively beneficiaries (in the case at hand company A). This would also correspond with a scenario with only one developer. Additionally, if any further party uses the intangibles, this party would have to pay an appropriate license if the intangibles are not otherwise remunerated. The amount of the license fee should take into account the higher risk of the developer.

- **12.** Would a one-sided method produce more reliable results?

The results should in no case depend on the TPM applied. The application of a one sided method (e.g. contract R&D) as described above should be less complex in practice in comparison to the PSM and with regard to timing aspects.
13. What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?

To apply a one-sided method respectively to determine an appropriate value of the intangibles developed of each party, the functions performed, risks borne and significant assets used need to be clearly identified and allocated to each party.

When the analysis shows a split of one integrated function, the PSM could be the most reliable TPM.

14. Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how?

The outlined scenario should better be solved by applying one-sided methods. If e.g. the development of those intangibles is outsourced, contract R&D structuring would be appropriate and the funding should be seen as additional separate function independent of the function respectively activity to be funded.

15. Can transactional profit split methods be used to provide reliable arm’s length transfer pricing solutions for fragmented functions? If so how? Can other methods address the issue of fragmentation, and, if so, how?

A fragmentation of the value chain is a standard approach of MNEs. This alone is no rationale for applying the PSM. The determination of the most reliable TPM should also be based on the characteristics of each transaction and not on characteristics like the fragmentation of a MNE. A fragmentation rather justifies one-sided methods since it is not likely that one of the fragmented functions qualifies as entrepreneurial function.

16. What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?

Fragmentation alone should not be a characteristic for determining the most reliable TPM. No further aspects need to be elaborated.

Please refer to our general remarks in section A.

5. Scenario 5 – Questions 17 to 23

17. How can comparables be found and applied in scenario 5? What method is likely to be appropriate for determining an arm’s length remuneration for the activities of the group companies?

Generally, the local and regional business could be split in two different functions and transactions and the respective most reliable TPM applied. For the local business the RPM or the TNMM should be applied. For the regional business also a sales commission could be feasible depending on the individual case.

To find (distributorship) comparables we assume the in paragraph 29 described approach as most reliable (broadening the search to further, comparable markets and products). The potential differences of the regional and global sales functions could be covered by choosing the appropriate margin within the range.
Additionally, introducing certain safe harbors for defined functions and transactions could be an alternative approach in cases respectively countries and regions which often show a lack of comparables.

18. How can comparables be found and applied in scenario 3 (or to any other relevant scenario in this discussion draft)?

Please refer to our comments above and to question 9.

19. What aspects of scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?

The basis for the decision of the most reliable TPM is always a functional analysis. At the case at hand the local distribution entities seem to be routine distributors. Hence, a one sided method should be applied on the respective sales and/or costs. Defining the sales and/or costs will be the crucial task in this endeavor. A lack of local comparables should never be a rationale to apply the PSM as most reliable TPM.

Please refer to our general remarks in section A.

20. In what circumstances, if any, might an approach described in the last sentence of paragraph 32 be appropriate?

The level of consolidated profits or sales should not be an indicator for an appropriate remuneration of the routine entity. Such an approach would contradict the concept of routine entities. The entrepreneur bears all risks etc. and should therefore always earn the residual profit as well as he would have to bear most of the losses. However, depending on the functional analysis a remuneration of the routine entity at the upper end of the range could be justified.

21. More generally, in what circumstances would a transactional profit split approach be useful in supporting the application of other transfer pricing methods, and what guidance would be useful to develop for the supporting use of such approaches?

Again, the results should in no case depend on the TPM applied but on the attribution of functions and risks. The PSM could always be used as secondary method to verify the results generated with a one sided method. Thus, a clear guidance how to apply the PSM is crucial.

22. In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?

23. What guidance is needed on weighting of factors?

Any factor, importance of a factor or the weighting of factors depends on the individual evaluation of the involved parties, of the companies as well as of the respective tax authorities. Hence, to avoid any random definition and weighting of allocation factors a clear guidance is crucial.
This guidance clearly has to set factors to be used for the allocation. The choice of the factors has to be strict and generally applicable to all industries and not to individual cases. Furthermore, this guidance also has to be accepted by all (OECD) countries. If a weighting of factors is applied, this weighting also has to be very strict and cannot take into consideration any special circumstances.

Please refer to our general remarks in section A.

6. Scenario 6 – Questions 24 to 26

- 24. How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for example approaches based on concepts of bargaining power, options realistically available, or a RACI-type analysis of responsibilities and decision making)?

In this scenario no a single main function is split between two entities but two main parts of the value chain are split between two entities. This is a general approach MNEs follow. However, in this case both entities (company A and company B) act as entrepreneurs. Hence, the application of the PSM between them both is reliable after compensation all other (routine) entities with one sided methods.

A prudent business manager would also consider the outlined other approaches in estimating an appropriate remuneration. Hence, these other approaches could be used as part of the functional analysis but will always contain subjective elements.

- 25. Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an MNE operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate?

Please refer to our comments above to questions 22 and 23.

- 26. What specific aspects of transactional profit split approaches may be particularly relevant in determining arm’s length outcomes for transactions involving hard-to-value intangibles?

The valuation of intangibles and the determination of license fees for intangibles are depending on each other (the arm’s length license rate can determine the value of the intangibles or vice versa). In both cases the PSM is applicable. Hence, it has to be defined which step has to be conducted at first, based on the specific situation.

Furthermore, comparable to the valuation of the intangibles respectively the determination of an appropriate remuneration, the perspective of both transactions partners has to be reflected by applying the two sided PSM, and both approaches should be consistent.

7. Scenario 7 – Question 27

- 27. How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?

The allocation of the residual profits on actual costs is generally not seen as appropriate allocation key and is contrary to the discussion outline in paragraph 44. The
risk of cost elevations has to be reflected in the allocation keys. In this way both parties take their own risk and should therefore bear their own cost deviation.

Hence, the allocation of the residual profit should be based on a functional analysis and further factors as outlined in questions 23 and 25 above and our general remarks in section A.

8. Scenario 8 – Question 28

- 28. Is the application of a transactional profit split method to calculate the royalty in Scenario 8 or in other circumstances to set a price, helpful? What are the advantages and disadvantages?

Applying such a royalty should also reflect the risk that the product will not successfully be developed in the end and also costs for other products which development was unsuccessful on an earlier stage.

The discussion of the usage of the PSM for the valuation of intangibles and determination of appropriate royalty fees should rather be made in interim guidance on Chapter VI.

The application of a royalty (external CUP) has the numerous advantages of a one sided method as discussed above.

9. Scenario 9 – Questions 29 – 32

- 29. In what circumstances might it be appropriate under the arm’s length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss?

To avoid such distortion factors should always be chosen which are not influenced by the consolidated profit or loss results. They have to be agreed on an ex ante perspective. PSM contracts not regarding a “loss” situation should not be regarded as arm’s length.

- 30. Are there circumstances under the arm’s length principle where parties which would share combined profits, would not be expected to take any share of combined losses?

As the key requirement for the application of the PSM is that all parties are entrepreneurs such circumstances should not exist.

Only in circumstances with routine entities and by applying one sided method circumstances for not sharing losses are given.

- 31. Paragraph 2.114 of the Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?

Please refer to our general comments in section A.
32. Finally, what further points would respondents wish to make about the application of transactional profit split methods not covered by previous questions?

From our perspective there should be no further point. The main requirement for a successful application of the PSM is a clear and precise guidance by the OECD accepted by all (OECD) countries.

We hope our comments are helpful for you and would like to thank you once again for the chance to comment on the discussion draft.

We welcome any feedback of the OECD and the other commentators on this discussion draft.

Kind regards

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