Public Consultation on Transfer Pricing Matters

11-12 October 2016

OECD Conference Centre
2 rue André Pascal
Paris 16th, France
TUESDAY 11 OCTOBER 2016

09:30 - 09:50  I. DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS: GENERAL SCOPE, DIRECTION, OBJECTIVES

Speakers:
- Hans van Egdom, Co-Chair of Working Party No. 6
- BIAC (Will Morris)
- BEPS Monitoring Group (Sol Picciotto)

09:50 - 11:00  II. OVERARCHING ISSUES

This session will address the scope of the additional guidance; the approach under to be used in developing additional guidance (full AOA/partial AOA/other approaches); and whether the outcomes under Articles 7 and 9 should be aligned, especially with regards to risk. [Introduction by a member of Working Party No. 6]

Speakers:
- Approach to be used for the attribution of profits to PEs
  - USCIB (William Sample)
  - BEPS Monitoring Group (Sol Picciotto)

- Order of application of Articles 7 and 9
  - BEPS Monitoring Group (Sol Picciotto)
  - FTI (Marvin Rust)

- Consistency between Article 7 and 9 (especially for risk)
  - PwC (Sonia Watson)

Open Discussion

11:00 - 11:30  Refreshment Break

11:30 - 12:20  III. ATTRIBUTION OF PROFITS TO PES NOT COVERED BY THE EXCEPTIONS IN ARTICLE 5(4): EXAMPLE 5

This session will address the issues raised in Questions 15-20 of the Discussion Draft. [Introduction by a member of Working Party No. 6]

Speakers:
- Grant Thornton (Wendy Nicholls)
- National Foreign Trade Council (Cathy Schultz)
- Flick Gocke Schaumburg (Xaver Ditz)

Open Discussion
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| 12:15 - 13:00 | IV. Attribution of Profits to DAPEs: Example 1 | This session will address the issues raised in Questions 2-5 of the Discussion Draft [Introduction by a member of Working Party No. 6]  
Speakers:  
- BEPS Monitoring Group (Sol Picciotto)  
- EY (Ronald van den Brekel)  
- KPMG (Manal Corwin)  
Open Discussion |
| 13:00-14:00 | LUNCH                                             |                                                                        |
| 14:00 - 15:00 | V. Attribution of Profits to DAPEs: Example 2    | This session will address the issues raised in Questions 6-9 [Introduction by a member of Working Party 6]  
Speakers:  
- International Alliance for Principled Taxation (Mary Bennett)  
- Japanese Foreign Trade Council (Akira Inubushi)  
- Vienna University of Economics and Business (Raffele Petruzzi)  
Open Discussion |
| 15:00-15:30 | VI. Attribution of Profits to DAPEs: Example 4   | This session will address the issues raised in Questions 12-13 [Introduction by a member of Working Party No. 6]  
Speakers:  
- Software Coalition (Gary Sprague)  
- Keidanren (Ed McNally)  
- NERA (Guillaume Madelpuech)  
Open Discussion |
| 15:30 - 16:00 | Refreshment Break                                 |                                                                        |
| 16:00 – 17:00 | VI. Attribution of Profits to DAPEs: Example 4 (cont.) | This session will be devoted to the open discussion of Example 4. |
| 17:00 – 17:45 | VII. Approaches to co-ordinate the application of Article 7 and Article 9 | This session will address the issues raised in Question 21 [Introduction by a member of Working Party No. 6]  
Speakers:  
- BIAC (Matthew Hardy)  
- Silicon Valley Tax Directors Group (Rod Donnelly)  
- BEPS Monitoring Group (Sol Picciotto)  
Open Discussion |
| 17:45 – 18:00 | CLOSING REMARKS                                   |                                                                        |

Speakers:  
- Hans van Egdom, Co-Chair of Working Party No. 6  
- BIAC (Will Morris)
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| 09:30 - 10:00 | I. REVISED GUIDANCE ON PROFIT SPLITS: GENERAL SCOPE, DIRECTION, OBJECTIVES | Michael McDonald, Chair of Working Party No. 6  
Mark Bronson of Duff & Phelps  
KPMG International (Stephen Blough)  
Deloitte Tax LLP- USA (Philippe Penelle) |
| 10:00 - 11:00 | II. PROFIT SPLITS OF ANTICIPATED PROFITS / ACTUAL PROFITS | What two types of PS or two different methods? How should transactions be analysed to determine what profits should be split? [Introduction by a member of Working Party No. 6]  
Mark Bronson of Duff & Phelps  
KPMG International (Stephen Blough)  
Deloitte Tax LLP- USA (Philippe Penelle)  
Open Discussion |
| 11:00 - 11:30 | Refreshment Break               |                                                                        |
| 11:30 - 12:15 | IIIA. THE MOST APPROPRIATE METHOD | When is a transactional profit split of anticipated or actual profits likely to be the most appropriate method? What factors relating to the activities of the parties / the transaction / the market are relevant to consider? [Introduction by a member of Working Party No. 6]  
Taj (Julien Pellefigue)  
BDO International (Malcolm Joy)  
BIAC (Alberto Pluviano)  
Open Discussion |
| 12:15 - 13:00 | IIIB. UNIQUE AND VALUABLE CONTRIBUTIONS | What are ‘unique and valuable contributions’ for the purposes of determining whether a transactional profit split method is the most appropriate method? [Introduction by a member of Working Party No. 6]  
Speakers: |
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<td>13:00 - 14:15</td>
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| 14:15 - 15:00 | III. INTEGRATION                | Relevance of sequential / parallel integration to determining whether a profit split of actual or anticipated profits is the most appropriate method [Introduction by a member of Working Party No. 6]  
Speakers:  
- Deloitte LLP - UK (John Henshall / Alison Lobb)  
- FTI Consulting (Ruth Steedman)  
- Silicon Valley Tax Directors' Group (Rod Donnelly)  
- Gazprom Marketing & Trading Limited (Salma Rashid)  
Open Discussion |
| 15:00 - 15:45 | III. RISK SHARING               | Relevance of sharing of risks to transactional profit splits of actual profits. How to define 'sharing of risks' in this context? [Introduction by a member of Working Party No. 6]  
Speakers:  
- Japan Foreign Trade Council (Akiko Higa)  
- CMS Bureau Francis Lefebvre (Arnaud Le Boulanger)  
- USCIB (Bill Sample)  
Open Discussion |
| 15:45 - 16:15 | Refreshment Break                |                                                                         |
| 16:15 - 17:20 | IV. VALUE CHAIN ANALYSES; HOW TO APPLY A TRANSACTIONAL PROFIT SPLIT METHOD | Relevance of a value chain analysis to when and how to apply a transactional profit split method. Determining appropriate profit splitting factors. [Introduction by a member of Working Party No. 6]  
Speakers:  
- Pwc (Andrew Casley / Jonas van de Gucht)  
- Grant Thornton (Chaïd Dali-Ali)  
- Tax Executives Institute (Ben Shreck)  
Open Discussion |
| 17:20 - 17:30 | CLOSING REMARKS                 |                                                                         |
|          |                                  | Speakers:  
- Michael McDonald, Chair of Working Party No. 6  
- BIAC (Will Morris)  

Keidanren (Ed McNally)  
International Alliance for Principled Taxation (Caroline Silberztein)  
National Foreign Trade Council (Graeme Wood)  
EY (Ronald van den Brekel)
I. DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS: GENERAL SCOPE, DIRECTION, OBJECTIVES

Session I: General scope, directions, objectives

- AOA Assumptions — Makes much of DD irrelevant to most actual taxpayer situations
- Guidance on non-AOA article 7 should be developed by UNTC (which includes OECD experts)
- Priority to Article 7 — Article 9 analysis would often be unnecessary
- Examples — so simplistic they’re counterproductive
- An arm’s length payment to DAE is not a measure of DAPE’s profit
USCIB believes that the discussion draft should be modified to:

- More closely follow the AOA – the discussion draft does not identify nor determine the nature of the dealings between the PE and the non-resident enterprise, a necessary step in applying the AOA, nor does it discuss the selection of the most appropriate transfer pricing method in light of the nature of the PE;
- Provide additional guidance on how the 2008 version of the AOA would apply to the examples;
- Limit the ability to adopt the PE changes as part of the multilateral instrument to those countries that accept the AOA;
- Clarify the determination of the economic ownership of inventory – the discussion draft in places seems to apply a significant people function test, rather than the general rule for tangible property based on the place of use;
- Recommend the adoption of simplifying administrative practices.

The mandate under Action 7 is to provide additional guidance on how the rules of the Authorized OECD Approach (AOA) apply to the new forms of permanent establishment (PE) created by the BEPS changes to Article 5, without making substantive modifications to those rules.

USCIB believes it is important to frame the new guidance consistently with the existing guidance provided by both the 2008 and 2010 Reports on the AOA.

The OECD should use this opportunity to make clear that the operation of the AOA requires careful functional analysis to identify and determine the nature of the dealings between the head office and the PE and once that functional analysis has been performed and the PE has been so characterized, to identify the most appropriate transfer pricing method that will apply by analogy to the dealings between the head office and the PE. These steps have been omitted from the discussion draft.

Because the OECD’s mandate does not permit it to make substantive modifications to the AOA, it is difficult to see how the OECD could apply any other standard, since to do so would be to make substantive modifications to the AOA.
• Countries signing onto the PE rules in the multilateral instrument should publicly confirm that they have a common understanding of both the definition of a PE and the rules for attributing profit to those PEs.

• The usual negotiations that take place when treaties are modified bilaterally will not take place when countries modify their treaties by signing onto the MLI. This will lead to controversy unless it is very clear what the countries are agreeing to and the profit attribution standard to be applied.

• Countries are free to agree to another standard other than the MLI, but in the context of applying the OECD standards there are only two real options, the full AOA or the partial AOA.
II. OVERARCHING ISSUES

Session II Approach to be Used

- DD aims at 2010 OECD Convention & Commentary version of Art 7 "Authorised OECD Approach" (AOA)
- Most actual existing DTAs have not adopted AOA
  - actively rejected by many G20/OECD and most developing countries
- AOA places Art 9 ‘independent entity’ approach on a pedestal
  - especially inappropriate since a PE is part of the same legal person
- AOA focus makes much of DD irrelevant to most taxpayer situations
- AOA favours residence countries and does not prevent BEPS
  - especially as PE business risk is borne by whole entity
Session II Approach to be Used

- UN MC and most existing treaties retain Art. 7(1): limited force of attraction, & 7(3), 7(4) (fractional apportionment)
- Countries should not be pressurised to accept the AOA
- Guidance on implications of Action 7 changes to article 5 for non-AOA versions of article 7 should be developed in UN Committee of Experts (which includes OECD experts)

Examples—So simplistic they’re counterproductive

- Examples in this DD reflect assumptions in 2008 OECD report & 2010 OECD MC
  - limited people functions in source country
  - relevant to relatively small firms with cross-border sales
- DAE is very different from a DAPE which is actually a separate entity
  - need examples dealing with commonly used MNE business models
- MNE business models combine sales through internet platforms with local operations
  - customer support
  - rapid order fulfillment
  - inventory & order management
  - marketing/intellectuals (customer data)
- Such activities are more than ‘preparatory or auxiliary’
- Sales often credited to low-tax affiliate, attribution of only ‘routine’ profit to DAEs on functional basis facilitates BEPS

Best Method

- Applying functional analysis to a DAPE of a DAE is inappropriate
  - unrealistic: many functions are tied to sales
    - marketing, customer support, order fulfillment
  - F-A-R complex and subjective, cannot provide predictability
- Profit-Split likely to be best method
- Formula apportionment is also possible for treaties with article 7.4 (OECD pre-2008, or UN MC)
Session II Order of Application of Articles 7 & 9

- MNEs are centrally controlled worldwide businesses with integrated operations
  - Wrong to start with Article 9 analysis of transactions between affiliates
- Example 4 (most realistic) shows subjectivity of judgments required for Article 9 analysis
- Primary reason — Article 9 intercompany analysis takes focus away from the more important issue of how the MNE as a whole is factually conducting business within the host country
- First three steps of our Recommended Approach appropriately ignore the normally tax-motivated intercompany agreements on which intercompany transactions are based
- Identification of MNE group members that might have PE or DAPE in host country

Session II Order of Application of Articles 7 & 9

Recommended approach

- Step 1: analyse the business conducted and the activities performed in the host country of all MNE group members ignoring legal entity lines
  - Big picture helps identify non-resident affiliates which may have PE e.g. through splitting up of contracts (art. 5.3)
- Step 2: determine global profits of whole MNE for the relevant products and services sold into or provided to customers in that host country or that otherwise relate to activities in that country
- Step 3: determine profits attributable to MNE’s activities conducted in host country
- Step 4: article 9 analysis to decide AL charges & hence profits of DAEs and deductions to DAPE

Session II Order of Application of Articles 7 & 9:

Recommended approach

- Step 4 may not be needed:
  - Tax authority can determine the extent of any potential Article 9 issue by simply comparing the MNE’s profits from its business and activities actually conducted in the host country (Step Three above) with the profits already reported by the DAE that relate to its activities conducted on behalf of the DAPE. If small, no need for Step 4.
  - If branch remittance tax produces similar outcome, maybe no need for Step 4.
- Avoiding Step 4 saves both taxpayers and tax authorities significant time and expense.
- Summary:
  - Article 9 analysis as a first step means always conducting a terribly subjective analysis
  - The recommended approach will often eliminate any need for an Article 9 analysis

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Summary:
- Article 9 analysis as a first step means always conducting a terribly subjective analysis
- The recommended approach will often eliminate any need for an Article 9 analysis
Question 1:

Commentators are invited to express their views on whether the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC can affect the outcome and what guidance should be provided on the order of application.

Introduction to Question 1:

In the situations where an enterprise has in a foreign jurisdiction both, a dependent agent PE ("DAPE") and a dependent agent enterprise ("DAE"), could the order in which analyses under Articles 7 and 9 are applied affect the outcome?

What should be the order of application of Articles 7 and 9?

What guidance should be provided?

The outcome could be affected by the order of application:

<table>
<thead>
<tr>
<th>Related enterprise (Article 9)</th>
<th>Permanent Establishment (Article 7)</th>
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<tbody>
<tr>
<td>Perform functional analysis and calculate the arm’s length return</td>
<td>Identify significant people functions (&quot;SPFs&quot;) and attribute risks / assets.</td>
</tr>
<tr>
<td>Risks are assumed by the enterprise</td>
<td>Risks are attributed to the PE</td>
</tr>
<tr>
<td>Assumption of risks evidenced by contracts</td>
<td>Not an exact science and a range of interpretations could be envisaged</td>
</tr>
<tr>
<td>vanilla case: DAE performs functions either on its own behalf or on behalf of the foreign enterprise, and supporting paperwork is available</td>
<td>Commercial reality: often difficult to delineate on whose behalf functions were performed.</td>
</tr>
<tr>
<td>Room for subjective interpretation and differences in functional and factual analysis.</td>
<td>Where analyses are performed independently, possibilities of overlap, especially where risks were included in functional analysis more than once, and double-counting.</td>
</tr>
<tr>
<td>Some level of co-ordination in the order of application is, therefore, desirable.</td>
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Attribution of Profits to Permanent Establishments: Order of Application of Articles 7 and 9

The optimal order of application:
- The Attribution of Profits to Permanent Establishment Report (2010), para 234: "In calculating the profits attributable to the dependent agent PE it would be necessary to determine and deduct an arm’s length reward to the dependent agent enterprise for the services it provides to the non-resident enterprise (taking into account its assets and its risks if any)."
- In other words, remuneration of DAE should be deducted from DAPE profits.
- Why performing Article 7 analysis first, therefore, DAE’s profits would have to be approximated, and recalculated, as final figures become available.
- It would, therefore, be more practical and efficient to perform Article 9 analysis first.

Why this question is relevant:
- Proposed changes to the PE definition to lower the PE threshold: more circumstances in which a PE would be deemed to exist.
- In some cases, there could be very little or no profits attributable to the PE. Hence, potential risk of incurring disproportionate effort/cost to attribute very little profit with little tax revenue.
- If no clear guidance is provided and resulting calculation is different, opens up possibilities of challenge and/or different interpretations by fiscal authorities.
- The guidance should be commercial and pragmatic, and commensurate with the circumstances under enquiry.
### Article 7 (PE) versus Article 9 (TP)

**What drives the allocation of profits in the post-BEPS TP world?**

<table>
<thead>
<tr>
<th>Profit attribution - AOA</th>
<th>TP - BEPS actions 8-10</th>
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<tr>
<td>Concept of Significant People Functions (SPFs) to allocate assets and risks</td>
<td>Concept of &quot;control over&quot; risks/functions to allocate risk/intangible related returns</td>
</tr>
<tr>
<td>Functionally separate entity approach based on location of SPFs</td>
<td>Contracts remain starting point of analysis</td>
</tr>
<tr>
<td>SPFs are people who perform &quot;active decision making&quot; relating to the taking on and management of risks (Ch. 1, p. 22)</td>
<td>People with capability to make decisions to take on and manage risk (Ch. 1, p. 1.65)</td>
</tr>
<tr>
<td>Not limited to approval of strategy and may often be a level &quot;below strategic management&quot; (Ch. 1, p. 87)</td>
<td>&quot;Not necessary for a party to perform day-to-day mitigation&quot; as long as controlling the outsourced activities</td>
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### Thank you

**Sonia Watson**

- T: +44 (0) 20 7804 2253
- E: sonia.watson@uk.pwc.com

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Public Consultation on BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments

Attribution of profits to PEs not covered by the exceptions in Article 5(4)

Wendy Nicholls, Partner, Grant Thornton UK LLP

Introductory comments

• Simplicity and consistency
  – Mitigate the risk of controversy through a consistent application of AOA
  – Has the guidance achieved its specific objectives without creating additional unwelcome complexity?
• Clarity and definitions
  – E.g. “Streamlined”?

Financing: "investment" and "funding" returns

• Return on an investment asset
  – Should there be an "investment" or "funding" return even where there are no personnel of the non-resident enterprise operating in the PE?
  – If so, how should the return be determined?
    • E.g. WACC and comparable yield?
Significant people functions (SPFs)

• Is the concept of SPF relevant to the AOA?
• Force of attraction should not apply.
  – E.g. SPFs of other parties operating on their own account in the jurisdiction of the PE should not cause profits to be attributed to the PE.
  – The same applies if the other party is a related enterprise.
Example 5 – Scenario A

- **Dealing Between Head Office & the PE:**
  - Scenario A assumes that the PE is the recipient of the third-party customer fee revenues and that the PE reimburses the Head Office for intangibles and services.
  - An alternative construction would be for the Head Office to receive the third-party customer fee revenues and pay a fee to the PE for services and for use of the warehouse.
  - End result is the same: PE’s profit is limited to a routine return for owning the warehouse facility and for the functions performed at the warehouse.
  - Advantages of proposed alternative construction:
    - Avoids superfluous dealings and offsetting transactions within entities
    - Ensures that there can be no withholding taxes on deemed payments from source country

Example 5 – Proposed Dealings
Example 5 – Scenarios B & C

• “Streamlined Approach” in Scenarios B & C:
  – The “streamlined approach” is consistent with a dealing between Head Office and the PE whereby Head Office is deemed to make a payment to the PE that provides the PE with an appropriate return on its assets and activities.
  – This is consistent with the alternative construction under Scenario A noted above.
  – This could also be the appropriate approach in cases like Scenario A.
Comments on the Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments

Dr. Xaver Fritz
11 October 2016

Background
Profit allocation has to take into account the purpose of Sec. 5(4) OECD-MC
- Sec. 5(4) OECD-MC is designed to prevent an enterprise of one state from being taxed in the other state, if it carries on preparatory or auxiliary activities in that other state.
- This is because preparatory or auxiliary activities do not immediately have the purpose of generating a profit.
- As a result, only activities which create significant value for an enterprise should be taxed in the other state.
- Moreover, the purpose of Sec. 5(4) OECD Double Taxation Treaty is simplification.

Profit allocation to PE has to take into account the value created and significant people functions.
- PE is treated as a separate and independent enterprise.
- The profit of a PE depends on the (people) functions performed, assets used and risk assumed.
- Two-step approach
  - Identification of the PE's economically significant activities and responsibilities by using the significant people function concept.
  - Determination of the remuneration of dealings by using the arm's length principle.

Dealsings between WRU and its PE
- HO performs the significant people functions (sale of goods to third parties).
- Only HD obtains third-party revenues.
- PE should be compensated by WRU for operating the warehouse in W (routine function).
- Transfer price for services rendered by the PE should be calculated on a cost plus basis (arm's length markup: 5%-10%)

Economic ownership of assets
- HO is the economic owner of the intangible assets (specialized knowledge and software).
- PE is the economic owner of the tangible assets which the employees of the PE use.
Comments on example 5 (Scenario C)

Deals between WRU and its PE
- PE does not perform significant people functions
- PE does not create economic value
- Profits should be attributed to HO

Economic ownership of assets
- HO is the economic owner of the inventory
- Investment return should be attributed to HO
- As a result, the profit of the PE equals zero

Transactions between WRU and Wareco
- Wareco operates the warehouse on behalf of WRU
- Wareco gets the special and know-how and software from WRU (without compensation)
- Wareco receives a services fee from WRU
Session IV Attribution of profits to DAPEs: Example 1

- MNE commercial risk with respect to its activities in the host country is not being adequately reflected whenever a local commissionaire, agent, or other service provider earns a low commission or fee due to limited-risk intercompany agreements.
- The value of DAE’s activities to DAPE is much higher than the arm’s length remuneration paid to DAE; DAPE is bearing full risk of paying DAE for its functions, whereas DAE bears limited risk related to those DAE functions.
- DAPE’s profits cannot be the same as the limited risk commissions and service fees paid to DAE under its artificial limited-risk position.
- DAPE’s profits must reflect the commercial risk of conducting DAPE’s full business, which is much broader than those assumed by DAE.

Assumptions used in functional and factual analysis in example 1 are misleading and will result in continuation of BEPS tax motivated structuring.

- ‘Ability to select, monitor and make decisions on whether to continue, adapt or terminate the relations with the sales agent’ is meaningless in related party situations and should be removed as a factor.
- Centralised managements do not operate in a vacuum. Local country management and other employees contribute significantly to top-level functions.
- Example 1 should be rewritten to reflect at least a few of the real people functions that are being performed within the host country with a resulting amount of DAPE profit.
- Significant people functions likely to result in creation of local intangibles.
- Guidance should be provided to reflect significant people functions performed by DAE within commonly used MNE business models.
Public consultation on the Additional Guidance on the Attribution of Profits to Permanent Establishments
Questions 2-5 of the Discussion Draft
EY, Ronald van den Brekel – 11 October 2016

Attribution of external sale to the DAPE (Example 1 - question 2-5)

► Examples in general

► Functional and factual analysis seems correct

► Should dealing be characterized as buy-sell transaction?

► Criteria for attributing external sale to DAPE?

► Inconsistency with functional and factual analysis

Attribution of external sale to the DAPE (Example 1 - question 2-5)

► Practical implications from attribution of external sale

► DAPE profit should be zero, but what is effect of buy-sell transaction being attributed?

► Some countries may require a full accounting set-up for a DAPE (branch). If a buy-sell transaction is attributed, systems related costs are significantly higher than a hypothesized sales agency transaction

► Spillover effects (VAT / Customs) if DAPE is attributed the external sale
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Nature of the dealing / Existence of PE?

- Contrary to analysis in the DD, substance of arrangement shows Sellco is acting at its own risk (i.e., on its own account) in acquiring inventory and selling to customers.
- So no agent of Prima in Country B, and thus no DAPE.
- Substance of transaction between Prima and Sellco appears to be a purchase of the inventory by Sellco (on credit) from Prima and a resale to customers.
- Even if PE assumed to exist, likely no “dealing” with head office – more reasonable interpretation is head office personnel have directly engaged in transaction of selling on credit to Sellco.

Computation of profits?

- Example 2 assumes DAPE which has:
  - Purchased inventory from head office
  - Resold it to customers
  - Paid Sellco a commission reflecting Sellco’s bearing of bad debt and inventory losses and warehousing costs, and
  - Earned a “funding return” for funding the inventory.
- Better characterization of substance of arrangement is that:
  - Head office has concluded contract with Sellco by which Sellco effectively buys inventory on credit from head office (items set there)
  - Sellco earns customer sales revenue, less COGS (reflecting risks borne by Sellco) and less interest charge to head office
  - No DAPE or profits attributable to DAPE.
- DO’s characterization could involve negative commission by Sellco as sales agent – highly unusual.
What if Sellco lacks financial capacity to bear risks?

- Sellco could not be allocated inventory or credit risks under Article 9
- Those risks presumably remain with Prima under TPG 1.99 (unless tax authorities decide upon a more fundamental recharacterization of the arrangement)
- If form of transaction respected, Sellco should get its commission based on functions performed as sales agent (but without remuneration for bearing those risks)
- DAPE would be allocated risks and assets based on Sellco’s performance of significant people functions on Prima’s behalf

Approach other than the AOA?

- DD bases analysis on 2010 “full” AOA
- Much larger number of treaties, now and in foreseeable future, will be interpreted using 2008 “partial” AOA, and guidance should be expanded to address that
- Not within mandate for this group to provide guidance on possible non-AOA approaches to PE profit attribution
Points raised in Example 2

• “When the analysis under Article 9 has already been performed to allocate risk to Sellco, the analysis under Article 7 will not attribute the risk to the DAPE.” (Page 16 Footnote 10)

• “the significant people functions result in an attribution of risks to the DAPE which aligns with the assumption of risk by Sellco under Article 9.” (Page 18 Para57)

The outcome of analysis under Article 7 & 9

• Both the outcomes resulted from the functional and factual analysis under Article 7 (AOA) and the analysis under Article 9 should be consistent with each other.

  ➔ All Sellco activities are performed on its own account as its service providing activity. There should be no income attributable to the DAPE.

• AOA should be adequately adopted by all participating states to ensure same outcome with providing certainty to taxpayers.
Definition of PE and Reconsideration of Single Taxpayer Approach

• Practically, AEs will be compensated with Arm’s Length commissions or profits by Prima based on Article 9 considering both economic and funding return.
  → Very few benefits in calculating additional attributable profits under Article 7 for both taxpayers and tax authorities.

• Broadening definition of PE would likely create PEs with minimal or no additional profit attributed to PE.
  → More unnecessary administrative burden.
General background

- The introduction of the AOA has aimed at aligning the ALP under Art. 7 and Art. 9
- The main difference: contractual arrangements missing in Art. 7
- In a post-BEPS world, the new guidance under BEPS 8-10 provides less relevance to contractual arrangements (see delineation of actual transaction, analysis of risk factors, entitlement to intangibles related returns, impact of group synergies, impact of local market features), hence narrowing the "gap" between Art. 7 and Art. 9

Analysis Example 2

- The current application of the AOA (based on the "dual taxpayer approach") leads to taxation of Sellco on two layers:
  - Based on the risks undertaken on its own account (i.e. DAE) (pars. 41-44)
  - Based on the risks undertaken on behalf of the principal (i.e. DAPE) (pars. 46-55)
- When contractual assumption of risk (Prima) is not aligned with control over risks (Sellco) and financial capacity to assume risks (Sellco) \[ \rightarrow \] higher profits (and losses) to Sellco (in line with BEPS 8-10)
- However, based on the "dual taxpayer approach", these higher profits/losses are attributable partly to the DAE (for the extra-risks) and partly to the DAPE (for the funding activities)
- Nevertheless, this approach might lead to extra-administrative burden without significant increase of taxing rights in Sellco's country
- The "single taxpayer approach" could improve this situation
- If no distinction between (a) risks undertaken by Sellco on its own account and (b) risks undertaken by Sellco on behalf of the principal, the single taxpayer approach might lead to the same result (in terms of taxing rights) for Sellco's country.
Conclusions

- The application of Art. 7 and Art. 9 should be based on the same understanding of the ALP.
- Some minor differences might exist, as a natural consequence of the fact that the two articles (and related guidance) have been developed concurrently.
- To reduce deviations under the application of the ALP under the two articles, it should be clarified that:
  - The separate (legal) entity approach is the core principle.
  - Actual conduct of the parties and performance of significant people functions are similar concepts.
  - Capital allocation under Art. 9 and Art. 7 should be based on corporate finance methodologies, rather than on inflexible rules.
- The "dual taxpayer approach" should be replaced by the "single taxpayer approach".

Contact details

Department of Public Law and Tax Law
Institute for Austrian and International Tax Law
Welthandelsplatz 1, Building D3, 1020 Vienna, Austria
Dr. Raffaele Petruzzi LL.M.
T +43-1-313 5065
pf@wu.ac.at; www.wu.ac.at/dibt
raffaele.petruzzi@wu.ac.at; www.wu.ac.at/taxlaw, www.wu.ac.at/dibt
High Level Observations on Ex. 4
- Ex. 4 illustrates Arts. 9 and 7 interaction re risks / assets
- Points of agreement
  - risk allocated to Prima under these facts (TPG Ch. I)
  - no attribution of people functions in DAPE
  - value created in head office not attributed to DAPE
  - possibility exists of attributing losses to DAPE
- Points of concern
  - under what circumstances could Sellico have SPF attributing part of the risk to DAPE when risk not allocated to Sellico
  - are the functions of Sellico which assume the risk really “active decision-making” (per AOA para 21)
  - compliance issues; possibility of trapped losses in DAPE

Identification of Significant People Functions
- DD overall provides guidance on identifying significant people functions mostly by inference
- Distinction between “deciding” and “implementing” marketing strategy is useful guidance on attribution of marketing intangibles
- Ex. 4 sets low bar on facts for constituting SPF
  - approvals only below materiality threshold
  - must confer with Prima on all denials or exceptions
  - no authority re: large group member customers
  - receivables management and collection roles not high-value
  - Prima doing more than setting “general parameters” (AOA para 25)
Identification of the Dealing

- Articulation of the “dealing” is an essential step to apply the AOA
  - DD overall could be clearer in articulating the “dealing” in each example
- Ex. 4 dealing apparently is a credit guarantee arrangement
  - Important point that not all dealings arising from sales activities are reseller dealings (cf Exs. 1-3)
  - In DAPE context, comparables much more likely to exist for service dealings

Concluding Observations

- DD overall provides useful guidance in a very difficult area
- Ex. 4 illustrates a complex division of single type of risk
  - Relatively routine activities should not be SPF in normal case
  - Low bar under facts for SPF in Ex. 4 should be raised
  - “control” measure under TPG Ch. I should reallocate risk only in extreme cases
  - Articulating the dealing would considerably improve analysis of profit / loss splitting mechanism
- Coalition hopes that final guidance will be widely accepted and applied to all treaties
  - Pre-2008 as well as 2010 versions
Keidanren

Attribution of Profits to DAPEs: Example 4

Tuesday, 11 October 2016
Public Consultation on Transfer Pricing Matters
OECD Conference Center

General Comments on the Discussion Draft

• Keidanren agrees with the direction of the Discussion Draft in that an appropriate application of the AOA would in most cases result in reasonable amount of profits attributable to a PE.

• Rules on the scope of PE and profit attribution should be interpreted and implemented in a consistent manner across OECD members and non-members.

• If the multilateral instrument is used to modify a bilateral tax treaty, such modification should be accompanied by the adoption of this AOA-based Guidance. It is also important to incorporate effective MAP provisions into treaties.

• Activities with zero or extremely insignificant profit should not require the formal registration of a PE in the first place, in order to minimize compliance burdens. A kind of safe harbor approach would be helpful.

Comments on Example 4

From our standpoint that the analysis under Article 9 should be respected, it seems to be a double count by the host country in which Selco is situated. Having stated that, on the assumption that Article 7 analysis is necessary, we would like to raise three questions.

1. The Appropriateness of the Article 9 analysis

• To allocate 40% of the net risk return after the deduction of actual bad debt losses would be subjective and would not be consistent with the actual substance of the risk management of credit.

• TNMM would provide a much simpler solution.
<table>
<thead>
<tr>
<th>Comments on Example 4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2. The relationship between Examples 2 and 4</strong></td>
</tr>
<tr>
<td>• In Example 4, Sellco’s functions are less extensive compared to Example 2, but the amount of profits attributed to the PE in Example 4 can be larger than that in Example 2.</td>
</tr>
<tr>
<td>• Although we are not sure that it is correct to assume that, under the AOA, the amount of profits attributable to the PE will increase in accordance with the extent to which Sellco performs significant people functions on behalf of Prima, the result of Examples 2 and 4 is not consistent with the assumption.</td>
</tr>
<tr>
<td><strong>3. The way to calculate profits</strong></td>
</tr>
<tr>
<td>• The first thing we should do under the AOA would be to identify dealings between Head Office and PE, and then price them in accordance with ALP.</td>
</tr>
<tr>
<td>• We’re concerned that this kind of quasi profit split becomes a default method. It’s not clear whether the credit management cost is an appropriate allocation factor. An additional explanation on how the AOA would work in this example would be welcomed.</td>
</tr>
</tbody>
</table>
PUBLIC CONSULTATION ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

Discussion of Example 4

Guillaume Madelpuech
Principal, Paris
October 11, 2016

The views expressed in this document reflect the views of the authors and not those of NERA Economic Consulting

What is Example 4 all about?

- Functional analysis post-BEPS
- Risk allocation and attribution of consequences
- Loss for a PE
- Transfer Pricing & Attribution of profits to permanent establishments:

  "There may be functions that do not lead to the assumption of risk of a DAE under Article 9, but which are SPFs relevant to the attribution of risk to the DAPE under Article 7."

This notably stems from §1.94 of the Action 8-10 BEPS Report:

"The fact that other associated enterprises also exercise control over the same risk does not affect the assumption of that risk by the first-mentioned enterprise."

Our take as economists on Example 4

1. Where is the Value dimension? BEPS commands an extension of traditional functional analysis, from transaction and tested party to the broad context of joint value creation
2. Does the literal interpretation of §1.94 make any sense? May §1.94 contravene with the arm’s length principle?
3. If a contribution does not deserve a compensation under the ALP under article 9, could it deserve a compensation under the AOA, under article 7?
4. We believe that §1.94 has been drafted with different circumstances in mind than those set out in Example 4

Establishing a link with the new Chapter I Framework on Risks could certainly have proven useful from this perspective
Looking at the bigger picture: Is the DAPE Concept workable from an economist perspective?

- The BEPS work under Action 8-10 should enable Transfer Pricing practitioners to "flex the biceps of the arm’s length principle".

- Wouldn’t Article 9 therefore be now sufficient to address a number of BEPS situations which are addressed under Article 7 in the current draft?

- Is the DAPE concept workable for the purposes of practical profit attribution under the Separate Enterprise approach?
  - To the difference of a fixed-place PE, a DAPE may not correspond to an economic reality per se.
  - Is it workable outside of a narrow guidance in the DAPE Section (I-D-4) in the 2010 report?
  - More generally, does the DAPE concept make sense in a post-BEPS transfer pricing practice?

- A more consistent use of Value Chain Analysis is key in this perspective, for purposes of, respectively, Transfer Pricing (Article 9), PE assessment (Article 5) and PE profit attribution (Article 7).
OECD Public Consultation on Transfer Pricing Matters

VII. Approaches to Co-ordinate the Application of Article 7 and Article 9

Rod Donnelly
on behalf of SVTDG

October 11, 2016

COORDINATING APPLICATION OF ARTICLES 7 & 9

Risks

◊ The 2010 AOA Report description of the initial attribution, or the subsequent transfer, of risks to a PE under Art. 7 uses either —

(i) TPG provisions (dealing with risk) overhauled in the 2016 TPG; or

(ii) language essentially the same as that in 2016 TPG relating to control over risk.

Overlap ⇒ Art. 7 (AOA) risk attribution to DAPE should be consistent with Art. 9 allocation of risks to DAE if DAE has financial capacity to assume risks.

◊ This result is also supported by language of Art. 7(2), which refers to profits PE might be expected to make if it were acting at arm’s length, considering “risks assumed by the enterprise through the [PE]” — clear indication Art. 9 risk allocation (TPG) is relevant.

◊ Note — 2016 TPG addresses “shared risk” & multiple controlling entity situations.

◊ Consequences of aligning AOA with TPG: for risk —

(i) host country’s taxing rights over DAE & DAPE will in many cases be exhausted after application of Art. 9; and

(ii) Example 4 — Art. 7 risk allocation should align with Art. 9.

Intangibles

◊ Intangibles treatment has overlap between Articles:

• Art. 7 — 2010 AOA Report attributes economic ownership of intangibles by considering SPFs relating to intangibles risks.

⇒ ownership of intangibles can be split, Prima ↔ DAPE

⇒ some profits from intangibles may be attributed to DAPE

• Art. 9 — 2016 TPG respects legal ownership of intangibles but determines entitlement to return based on where D-E-M-P-E functions performed, assets provided, & risks are borne (no profits for mere title ownership).

⇒ return from intangibles can be allocated, Prima ↔ DAPE
Overlap ⇒ Art. 7 determination of profits attributable to DAPE from intangible attribution should be consistent with Art. 9 arm’s length return of DAE relating to intangibles.

◊ This result is also supported by language of Art. 7(2), which refers to profits PE might be expected to make if it were acting at arm’s length, considering “assets used . . . by the enterprise through the [PE]”—clear indication Art. 9 allocation (TPG) of return from intangibles is relevant.

◊ **Consequence**: for intangibles—host country’s taxing rights over DAE & DAPE will in many cases be exhausted after application of Art. 9.

---

**Concluding Remarks**

◊ Problems exist with how the 2010 AOA Report (Art. 7) and the 2016 TPG (Art. 9) are applied in the Examples (see comment letter)—these should be addressed.

◊ Amending/updating the AOA to be consistent with the 2016 TPG ⇒ often no material additional tax would be collected in a DAPE situation after Art. 9 application.

◊ Consequentially:
  * we respectfully suggest no valid policy goals are furthered, and cross-border commerce is hampered, by asserting the existence of a PE for the sake of primarily imposing compliance burdens (and perhaps penalties) on NREs; and
  * we ask you to consider our recommendation that Art. 5 be amended to permit the non-existence of a PE (and no NRE filing obligations or corporate tax liability) provided the host country can collect from an electing resident enterprise under an Art. 9 analysis the same total tax it would collect if a PE existed.
VII. APPROACHES TO CO-ORDINATE THE APPLICATION OF ARTICLE 7 AND ARTICLE 9

Session VII: Approaches to co-ordinate the application of articles 7 & 9

- Article 9 is applied under TPGs by starting from contractual allocations of risk, although 'recharacterisation' permitted following F-A-R analysis
- Terribly subjective analysis, creates uncertainty & conflict
- Article 7 analysis should look directly at MNE real people functions and activities in host country and overall profits
- Entire risk of business is born by the taxpayer so no need to start from intercompany agreements which are typically tax-motivated
- As explained in earlier Session II, under our Recommended Approach, often there will be no need for any Article 9 analysis
- More in line with aims of BEPS project to ensure that MNEs taxed "where activities occur and value is created"
DAY 2: REVISED GUIDANCE ON PROFITS SPLITS

12 October 2016
DISCUSSION DRAFT ON REVISED GUIDANCE
ON PROFIT SPLITS
A Framework for Analysis

Two Approaches, Two Different Sets of Considerations

- Profit splits applied to anticipated profits
  - Should not include all methods that utilize anticipated profits to set prices (i.e. certain valuation approaches)
  - Should only address circumstances where more than one party makes non-routine contributions
  - Should not be applied because (in isolation):
    » Parties are making routine contributions, but local market comparables are difficult to find
    » Circumstances that overlap with the considerations that govern the application of profit splits to actual profits (for instance, risk sharing / integration of activities).
  - Two “commonly used approaches” (Section C.4.1):
    » “Contribution analysis” - when only one party makes non-routine contribution, entire residual flows to that party
    » “Residual analysis” – similar result

Duff & Phelps

Two Approaches, Two Different Sets of Considerations

- Profit splits applied to actual profits
  - This profit split application specifically addresses joint sharing of risks under the accurately delineated transaction
  - Chapter I provides guidance on how to determine the allocation of risk for transfer pricing purposes.
  - This discussion draft focuses much attention on the integration of activities (see paragraph 8 of Section C.1), rather than the primary condition of interest – joint sharing of risk
  - Integration may be more likely to result in this type of joint sharing of risks, but it is not necessarily determinative
  - Should not be applied solely due to:
    » Lack of difficulty in finding comparables (paragraph 18)
    » Distinct of results derived from one sided methods (as implied by paragraph 13)
Figure 1
Applicability of PSM to Anticipated Profits

Does more than one party make non-routine contributions under the accurately delineated transaction?

Yes
No

Transactional PSM applied to anticipated profits is appropriate (and application to actual profits may be appropriate – see Figure 2).

Figure 2
Applicability of PSM to Actual Profits

Does the accurately delineated transaction indicate that both parties are necessarily jointly allocated economically significant risks?

Yes
No

Transactional PSM applied to actual profits is appropriate.

Transactional PSM applied to actual profits is not appropriate.

Contact

Mark Bronson
Managing Director
Duff & Phelps, LLC
Mark.Bronson@duffandphelps.com
(978) 666-0327
For more information about our global locations and services, please visit:
www.duffandphelps.com

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Example at Para. 4

Company A in Country A
- Licenses intangible X to Company B
- No further interest in Company B
- Controls all exploitation functions
- Make and sell Product W
- All exploitation in Country A

Company B in Country B
- Licenses intangible Y to Company A
- No further interest in Company A

Suggested Example 1 (Add to Para. 6)

Company A in Country A
- Controls all exploitation functions
- Make and sell Product W
- All exploitation in Country A

Company B in Country B
- Controls all exploitation functions
- Make and sell Product W
- All exploitation in Country B
Suggested Example 2 (Add to Para. 9)

Company A in Country A
- Development, Enhancement, Maintenance, Protection
- Controls manufacturing in A and B
- Makes and sells product W
- Sells in Country A

Company B in Country B
- Develops, EXPLOITS intangible Y
- Licenses intangible Y to Company A

Company B in Country B
- Controls marketing in A and B
- Makes and sells product W
- Sells in Country B

Suggested Example 3 (Add to Para. 9)

Company A in Country A
- Controls manufacturing in A and B
- Controls marketing in Country A
- Sells in Country A

Company B in Country B
- Controls marketing in Country B
- Sells in Country B

Company B in Country B
- Develops, EXPLOITS intangible Y
- Licenses intangible Y to Company A

Company A in Country A
- Develops, EXPLOITS intangible X
- Licenses intangible X to Company B
What are the circumstances where a profit split is likely to be the most appropriate method?

Dr. Julien Pellefigue

October 5, 2016

Question: In what circumstances would two independent parties enter into a profit split agreement?

Objective
* We want to identify the set of measurable economic circumstances where a profit split is the most appropriate transfer pricing methodology.
* We want to follow the arm’s length principle, according to which two subsidiaries should interact with each other exactly as if they were independent.
* Considering the arm’s length principle, a Profit Split between two subsidiaries A and B is appropriate if two independent firms, exactly similar to A and B, would freely enter into a profit split agreement.

Key Question
* The key question can thus be framed as follows: “What are the economic circumstances where two independent parties would enter their relationship through a contract with a profit split provision? In such circumstances, a profit split would be appropriate.”

This question is at the core of the economics of organization. It is an old, very well understood problem and a great deal of research, both theoretical and empirical is specifically concerned with this issue.

The next two slides give a very high overview of one strand of research (transaction cost economics) but it is only the tip of the iceberg.

Profit split would only be chosen in case of a market failure.

A and B would only enter into hybrid arrangement or merge if there is a market failure. This is generally related to the existence of a transaction specific asset (i.e., an asset that has no value outside of the specific relationship).
Other conclusions can be derived using the Transaction Cost Economics framework.

- It is very difficult to precisely identify circumstances where two unrelated parties enter into a profit split/contract, because independent third parties almost never do that.
  - "Profit" is hard to measure (particularly in a multiproduct firm) and can be easily manipulated by both parties.
  - Splitting profit while keeping management separate makes it possible for your partner to reduce your profit by making a unilateral bad decision.

- The second best strategy is to identify the circumstances where two independent parties would enter into the closest type of arrangement to a profit split: a JV or a merger.
  - Market failure that makes it impossible to contract over a spot market. This is generally due to the existence of a transaction specific asset.
  - Difficulties to measure (and contract) precisely the performance of each party if it is possible to measure the quality of the input of one party, a profit split is generally not the best solution.

- Asking whether or not a transaction between two subsidiaries could have taken place over a spot market is theoretically a better approach to determining when a profit split is appropriate than looking at "interdependence" or "unique contribution".
  - In the automotive industry, it is customary to have OEM install and operate their own asset in the production line, however they are generally compensated on a cost + basis.
  - In the telecom industry, a new entrant had to pay the historical operator to use the local loop to offer fixed line products. Even though local loop is unique, its access was priced on a cost + basis.
Most appropriate method: one-off and ongoing transactions

- Profit split methods should only be used in those exceptional circumstances where it is the most appropriate method to achieve an arm’s length result.

- BIAC considers that the introduction of separate categories for anticipated profits split vs. actual profits would require extensive analyses about different cases that may occur in practice at arm’s length, before finalising the new guidance.

- Mixed situations may occur at arm’s length (e.g. adjustment to anticipated profits based on actual profit only beyond a certain threshold), therefore the guidelines should avoid prescriptive terms if potentially preventing arm’s length approaches.

- Distinction between one-off vs. recurring transactions appears useful for developing enhanced analysis and potentially segmented guidance – each has different features and issues in case of split of anticipated or actual profits.

One-off transaction (e.g. sale of an intangible)

**Anticipated profits**

- How to ensure that the criteria established to calculate the anticipated profits will be respected?

- Concerns about the reference in par. 20 of the discussion draft to the guidance on intangibles for which valuation is highly uncertain.

- Use of valuation techniques would require more detailed guidance.

**Actual profits (or losses)**

- How to ensure that the criteria established to measure actual profits will be respected?

- Reasonable “cut-off” criteria should be allowed, leaving future unanticipated risks and results to the transferee.
### Ongoing transaction (e.g. sale of goods)

<table>
<thead>
<tr>
<th>Ex-ante definition of the profit splitting formula</th>
<th>40%-60%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price setting (based on forecast of actual profit)</td>
<td></td>
</tr>
<tr>
<td>Actual profit at the end of the year</td>
<td>30%-70%</td>
</tr>
</tbody>
</table>

**Anticipated profits**
- No adjustment should be made, but...
- Guidance would be required on conditions under which ongoing differences in actual results should be respected as arm’s length.

**Actual profits/losses - adjustments**

**Alternatives:**
- Retrospective adjustment (less likely to be arm’s length).
- Difference built into the following year’s pricing.
- Define threshold above or below which a retroactive adjustment will be made.

---

### Most appropriate method: residual profit splits

- Example in Annex II to Chapter II not mentioned in the discussion draft:
  - It represented a useful practical reference.
  - If deleted, it would be important to explain why and replace it with new examples.

- New wording in discussion draft focuses on global profit splits:
  - BIAC would recommend the development of very clear guidance on this point in order to prevent misinterpretation as an endorsement of global methods above residual methods.

- Residual profit split methods often more appropriate:
  - Value drivers in a transaction are normally including “routine/benchmarkable” elements.
  - Focus on global value chains would further emphasize this feature (although at arm’s length the parties are likely to focus on splitting profit related to the specific transaction rather than global).
Unique and Valuable Contributions

Wednesday, 12 October 2016
Public Consultation on Transfer Pricing Matters
OECD Conference Center

General Comments on the Discussion Draft

• The transactional profit split method is difficult to apply, and could make transfer pricing rules based on the arm’s length principle ambiguous.

• The Discussion Draft seems to suggest that the circumstances to which the transactional profit split method is applicable remain extremely limited. We appreciate this stance.

• We support the statement that reads "A lack of comparables alone is insufficient to warrant the use of a transactional profit split of actual profits." (para 18)

• We urge each country to recognize once again “references to profits should be taken as applying equally to losses.” (para 1)

Unique and Valuable Contributions

Contributions...will be “unique and valuable” in cases where (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) their use in business operations represents a key source of actual or potential economic benefits.

In this case, both Companies may be making unique and valuable contributions and jointly control the development risks, and share in the combined profits resulting from their contributions.
In our view, Contributions made by Subsidiaries M and D may be unique, but less valuable compared to those made by Parent Company.

Intangibles at the contract manufacturing and marketing stages of a supply chain are different from intangibles at Parent Company, in terms of contents and significance of risks associated with those intangibles.

In a scenario where different parties contribute an intangible at each stage, there is not necessarily the sharing of economically significant risks.

We welcome the statement in paragraph 51 that indicates that risks at the development stage are higher than those at the improvement stage.
"Unique and valuable contributions" ≠ "Important" functions, assets or risks that "contribute to the creation of value":

- All entities within MNE are expected to contribute to the creation of value.
- What is "important" is far too subjective to be the threshold for the selection of the most appropriate transfer pricing method.
- A more solid standard is needed to select the most appropriate method:
  - Unique contributions = not observed in comparables ⇒ warrant remuneration above comparables ("above routine")
  - Valuable = relative to the transaction concerned; need to understand business transaction to determine what the valuable contributions are.
  - Functions: Clarify significance of DEMPE functions (e.g., "exploitation" by a manufacturer or distributor of a foreign owned intangible).
  - Assets: Better align discussion of intangibles with new Chapter VI definition of intangibles versus comparability factors.
  - Risks: Refine guidance (not all risks warrant a share of residual profits).

Need to refine draft guidance on risk and TPS (not all risks warrant a sharing of residual profits) with a transaction specific analysis:

1. A specific risk may be only one of the contributions to value, and may or may not be among the most important ones.
   - Example: operational risk of contract R&D versus risk of failure of the R&D.
2. Not all risks warrant returns above those of comparables. Need to identify those risks that are "above routine".
3. Risk may be more or less significant to a particular transaction:
   - Key in some financial transactions and some R&D activities (ability to take on and fund the risk associated with the success or failure of the R&D is core value driver).
   - In combination with intangibles. E.g., one party contributes unique, valuable technology and multiple parties contribute funding and associated financing risk.
   - Only one element of the transaction, while contributions in the form of unique and valuable intangibles are the key generator of profit (or loss) / differentiating factors. E.g., situations involving manufacturing of products using a valuable technology that belongs to a foreign associated enterprise, or distribution of branded products using a valuable trademark that belongs to a foreign associated enterprise.
Need to clarify significance of performing DEMPE functions

- Example 1: Company A owns brand. Company A licenses brand intangibles to Company B. Company B distributes branded products in Territory.
  - Company A exploits the brand intangibles as licensor?
  - Company B exploits the brand intangibles as licensee?
  - Company A exploits the brand intangibles as licensor?
  - Company B exploits the brand intangibles as distributor?
- Same examples for manufacturing intangibles.

=> Need to clarify that TPS is not the default method any time an entity “exploits” foreign owned intangibles.

Need to better align discussion of intangibles with new Chapter VI definition of intangibles versus comparability factors

- Example: Contract R&D team that evolves over time from basic testing or development activities to higher value research activities, and assemble a valuable team of employees.
  - ¶1.152 of Actions 8-10 Final Report: existence of such workforce may lead to a comparability adjustment, that is a higher return for the contract R&D provider than the one of unadjusted comparables.
  - It would not however lead to the selection of a TPS as the most appropriate method if the contract R&D provider does not share the risk of failure of the R&D process.

Thank you for the opportunity to comment.
caroline.silberztein@baker-mckenzie.com,
on behalf of the International Alliance for Principled Taxation.
Profit Split Appropriate only if Risks Shared

- A profit split of actual profits is likely appropriate only where both parties to a transaction
  - share in economically significant risks, and
  - make unique and valuable contributions.
- A party that does not share in economically significant risks should not be allocated actual profits resulting from those risks
  - See OECD TPG ¶ 1.106 as amended by 2015 Deliverable ("A party which ... does not assume the risk, nor contributes to the control of that risk, will not be entitled to unanticipated profits (or required to bear unanticipated losses) arising from that risk.").

Party Making Unique Contribution May Not Share in Risk

- Contribution must be:
  - Unique: contribution cannot be easily benchmarked; and
  - Valuable: contribution is material to the transaction and a “key source of actual or potential economic benefits” (¶ 22).
- There is not necessarily a correlation between making unique and valuable contributions and sharing economically significant risks.
  - Example: Licensor may license unique and valuable intangible in exchange for a revenue-based royalty
  - Licensee may bear most of the economically significant risks in its market, and may have and exercise the functional capacity to manage or control such risks.
Other Methods May Be More Appropriate

- Other methods are likely more appropriate where one of the two parties either does not share in economically significant risks or does not make unique and valuable contributions.

- If parties share in economically significant risks but do not each make unique and valuable contributions:
  - Risk can be priced
  - Results of party that is not making unique and valuable contribution can be benchmarked against results of comparables that bear similar risks.

- If parties each make unique and valuable contributions but do not agree to share risks (or to undertake risk management or control functions related to such risks):
  - Actual returns from risk may be allocated to party that has borne risk and/or undertaken activities related to management or control of risks in its market.
Asset synergies: introduction

► Asset synergies may arise from economies of scale or from combination of complimentary assets

► Example (for illustrative purposes): combination of different enzymes in the pharmaceutical industry
  ► Party A (jurisdiction A); owns enzyme X; worth 30
  ► Party B (jurisdiction B); owns enzyme Y; worth 40
  ► Combined value of enzyme X and Y: 300

► Profit split may be an appropriate method to split the value attributable to the asset synergy (230)

Asset synergies: UVCs

► Assets can be unique and valuable contributions (UVCs) as such
  ► No need for ongoing UVCs after creation of the synergy
  ► Sharing of economically significant risks is not necessarily the case

► Implementation
  ► Anticipated vs. actual profits
  ► One-off compensation versus regular / periodic payments
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III C. DISCUSSION DRAFT ON REVISED GUIDANCE ON PROFIT SPLITS—INTEGRATION

3. Degree of integration: sequential/parallel integration

Rod Donnelly
on behalf of SVTDG
October 12, 2016

MOST APPROPRIATE METHOD—DELINEATING THE TRANSACTION

◊ PDD suggests delineation of transaction involves determining form of consideration (see PDD, ¶ 17).
   Comment: potential circularity—applicability of TPSM Actual turns on form of consideration, determined when transaction is delineated ⇒ outcome-dependent consideration form thus ensures conditions for TPSM Actual would be met. This should be clarified.

◊ PDD lacks precision discussing actual (controlled) transaction, integrated business operations, and value chains (containing parallel or sequential integration).
   Comment: consequentially, MNEs are potentially subject to tax authority assertion that TPSM Actual / Anticipated is warranted based on “high degree of integration” in global value chain from aggregation of transactions. This potential should be eliminated.

MOST APPROPRIATE METHOD—INTEGRATION OF OPERATIONS

Assertions made in PDD, § C.3, ¶¶ 19 & 21—

◊ sharing of risks by parties to a transaction may be accompanied by a high degree of integration of functions;

◊ highly integrated business operations may involve sharing functions, where the outcome of the transaction depends on two or more parties making contributions that are interlinked and thus cannot be evaluated in isolation;

◊ a high degree of integration means the way one party to the transaction performs functions, uses assets, and assumes risks is interlinked with, and can’t reliably be evaluated in isolation from, the way another party to the transaction does.

Comments: these assertions are potentially confusing:

◊ While sharing of risks may be accompanied by integration of functions, integration of functions/operations doesn’t necessarily mean “interlinked” risk assumption, nor shared assumption of significant risks (so TPSM Actual inapplicable).
MOST APPROPRIATE METHOD—INTEGRATION OF OPERATIONS

Comments on assertions: [cont’d]

◊ The fact that two or more parties make interlinked contributions doesn’t necessarily mean contributions can’t be evaluated in isolation.

Example—modern manufacturing supply chains can involve interlinked contributions of MNE entities and third-party vendors, which can be evaluated (and priced) in isolation:

contributions from MNE associated enterprises

3rd parties

* service providers
* CMs

* component vendors

* contract manufacturers ("CMs")

* distributors
* ad agencies
* media

Sequential v. Parallel Integration

Assertions made in PDD, § C.3, ¶ 21—

◊ high degree of commonality in functions, assets, risks is more likely to be the case where there is parallel integration, rather than sequential integration, by associated enterprises in the value chain.

Comment: integration concept is misleading; sharing of significant risks doesn’t necessarily follow from integration of functions performed & assets used.

◊ the mere fact that associated enterprises focus on different steps of the value chain says nothing about the degree of integration or that TPSM is most appropriate method;

◊ key to whether TPSM is most appropriate method should be whether each party to transaction contributes unique or valuable intangibles, or assumes risks, not comparable to those found in uncontrolled party transactions in comparable circumstances and that are a material source of profits.
OECD Consultation: Revised Guidance on Profit Splits
Sequential integration of unique and valuable contributions
12 October 2016

Highly integrated operations

- Key themes in determining whether a profit split may be relevant
  - Highly integrated operations
  - Unique and valuable contributions
  - Parties sharing economically significant risks
- Interaction between the key criteria and relative significance of each in determining whether PSM is most appropriate to be determined by reference to the value chain analysis

Highly integrated operations — parallel vs sequential
- Risk of presumption that parallel integration requires PSM and sequential integration does not
- Business models likely to include elements of both to varying degrees
  “In the case of sequential integration, in which parties perform discrete functions in an integrated value chain, it will often be the case that it is possible to find reliable comparables for each stage or element in the value chain since the functions, assets, and risks involved in each discrete stage may be comparable to those involved in controlled arrangements.”

Sequential integration of unique and valuable contributions

- Profit split method may be relevant in the case of sequential integration where functions, assets or risks are:
  - So closely linked even though they take place at different stages of the value chain
  - Highly “unique and valuable”
- Applies in respect of functions and risks as well as assets e.g.
  - Maintenance of intangibles after development
  - Closely linked functions
  - Unique risks on both sides
- To be defined using the key profit drivers of the business (through functional analysis and market analysis)
Revised Guidance on Profit Splits

IIID. Risk Sharing

1. Relevance of risk sharing to determining the most appropriate method

OECD Public Consultation
12th October, 2016

一般社団法人 日本貿易会
Japan Foreign Trade Council, Inc.

Points to raise

• The application of a transactional profit split reflects a relationship where the parties either share the same *economically significant risks* associated with the business opportunities or separately assumed *closely related risks* associated with the business opportunity and consequently should share in the resulting profits or losses. (Para 16)

  — Definition of “Risk Sharing”
  — Points necessary to consider for determination of the most appropriate method

Definition of “Risk Sharing”

• Clarifications of “economically significant risks” and “closely related risks” are necessary.
• Without further clarification, the interpretation of “economically significant” and “closely related” could be different by each tax administration.
• There is a concern that the transactional profit split method could be applied too broadly.
Points necessary to consider

- Even if there is a lack of comparables, “risk sharing” should not immediately result in application of the transactional profit split without verifying other factors (i.e. functions and assets, the existence of significant intangibles, etc.)
- It is beneficial to consider other methods even if each party to a transaction owns significant intangibles.
- One of practical solutions would be provided by development of adjustments within the transactional net margin method.
Sharing information and Sharing Risk

**Sharing Risks**

- It is logical that if parties are to share their profits, they should share their risks also (effectively, as described in the revised Section D of Chapter 1 of the OECD TPG).
- This is equally true whether the profit split is based on actual or anticipated profits.
  - Profit split based on actual profit: the parties share in outcome, and the risks are mainly attached to fluctuations of outcomes.
  - Profit split based on anticipated profit: the parties share in anticipated outcome, and the risks are mainly attached to discrepancies between anticipated and actual outcomes.
- It can be difficult to precisely identify/materialize the intent of the parties to share risks.
- It is possible for a party to have the ability to influence a risk without, in fact, sharing it.
- It is also possible for two parties to make valuable contributions without sharing risks.

**Sharing information (1/3)**

- Sharing profit implies that both parties know it, measure it, agree on the measuring tools, and share above information (amount of own profit, how it is measured) with each other.
- Unless such information is shared, no profit sharing is possible.
- Transactional Profit Split implies sharing information of each party’s transactional profit.

**The sharing of risks is a fundamental criterion, but it must be very carefully assessed to be useful.**
Sharing information (2/3)

Unrelated parties very rarely share transactional profit-related information

- Avoid sharing information on one's own profit to avoid hurting bargaining power
- Avoid sharing information to comply with other regulations other than tax
  - Sharing such information may be illegal for unrelated parties (e.g., competition law)
- Transactional profit is not publicly available data
  - Between unrelated entities, access to the other party's (transactional) profit is usually limited to one's own best estimate
    - Requires both entities to have sufficient knowledge and understanding of the other party's business
    - More often the case if both entities have similar profiles
  - Ability to build one's own best estimate (of the other party's profit) is key
    - Even if PSM is viewed as a "proxy" to the outcome of a transaction between unrelated parties (instead of a process used by unrelated parties to reach an agreement), that "proxy" assumes that each party has the means to know or assess profits of the other.

Sharing information (3/3)

- Having access to (or being able to estimate) the other party's profit-related information is necessary to justify splitting profits
  - Parties unable to access the other party's profit will not likely accept split profits
  - Once profit is split, parties must be able to reliably assess that
  - The assumptions they based it on were correct
  - The other party's transactional profit "makes sense" and is accurately measured
  - Requires specific competencies at the level of each party to a PS

- Access to such information, while necessary, is not in and of itself sufficient to justify splitting profits
  - E.g., the consulting industry: auditors, tax advisors, accountants, consultants, etc., usually have access to the other party's profit-related information, but do not often enter into profit splitting arrangements (even for high-valued added services)

It would be helpful:
- Emphasize that unrelated parties very rarely choose to share profits because they very rarely share information about their own profits
- Add a new criterion in deciding if the PSM is the most appropriate method: can both parties reliably assess each other's profits? (do they have the relevant competencies?)
Guidance on Profit Splits

Risk Sharing: Shared Assumption of Risks, Shared Control of Risks

Bill Sample, Chair, Tax Committee, USCIB

• Risk sharing should be a necessary precondition to the use of the transactional profit split method, but sharing of risk alone is insufficient to justify its application.

• We agree, therefore, with paragraph 10 that “It would be contrary to the guidance of Section D of Chapter 1 to apply a transactional profit split of actual profits where the functional analysis demonstrates that one party does not exercise any degree of control over those risks, since to do so would assign to that party the impact of risks it does not control.”

• This standard should also apply to profit splits of anticipated profits because if one party does not exercise any degree of control over any risks then a profit split would not be the most appropriate method. The discussion draft should make clear that control of risk by both parties to the transaction is also necessary to the proper application of an anticipatory profit split.

• The existence of risk does not, however, mean that comparables are not available. Many risks taken on by related parties are similar to risks that exist between unrelated parties and can be priced appropriately using other methods.

• It is USCIB’s view therefore, that in most cases risk can be priced accurately without resorting to the transactional profit split method unless both parties make unique and valuable contributions. The existence of unique and valuable contributions, in virtually all cases implies the use of non-routine intangibles.
**Transactional Profit Split Of Actual Profit: Most Appropriate Method**

- **Company A in Country A**
  - Develops movie
  - Estimated Cost: $100 Million

- **Company B in Country B**
  - Develops all P&A materials
  - Estimated Cost: $100 Million

- **Company A in Country A**
  - Worldwide Theater exploitation
  - Uses Movie and P&A intangibles

- **Company B in Country B**
  - Worldwide VOD, DVD, Other Media exploitation
  - Uses Movie and P&A intangibles

**License Agreement**: Agreed to share combined net profits 50%-50%

**Development, Enhancement, Maintenance and Protection of Intangible Assets**

**Exploitation of Intangible Assets**

**Transactional Profit Split: Not Most Appropriate Method**

- **Company A in Country A**
  - Develops Intangible X
  - Licenses Intangible X to Company B
  - No further interest in Company B

- **Company B in Country B**
  - Develops Intangible Y
  - Combines Intangibles X and Y in Product W

- **Company B in Country B**
  - Controls all exploitation functions
  - Makes and sells Product W
  - All exploitation in Country B

**License Agreement**: LICENSE X

**Development, Enhancement, Maintenance and Protection of Intangible Assets**

**Exploitation of Intangible Assets**
Much of what is said about VCA in Para 25-27 reads like functional analysis (vide Para 26). But it does imply something more (vide Para 26(ii)). And that ‘something more’ is rooted in industry, the economics of the business and other factors such as regulation.

These are all things that are covered, or at least mentioned as potentially relevant, elsewhere (eg Ch.1) - functional analysis, economic circumstances etc.

Para 26...

(i) consideration of the economically significant functions, assets and risks, which party or parties perform the functions...

(ii) how the functions, assets and risks of the parties may be interdependent or otherwise interlinked; and

how the economic circumstances may create opportunities to capture profits in excess of what the market would otherwise allow...the analysis should also consider whether such value creation is sustainable, for instance, whether market advantages are potential due to barriers to entry or potential competitors or the output of valuable intangibles...

This looks a lot like functional analysis.

This relates it to Profit Split.

This is something more.

What is ‘new’ or ‘special’ about value chain analysis?

What is it to do with Profit Split specifically?

What are the dangers?

What does the OECD mean by ‘value chain’?

- It looks at activities (and processes);
- organised by ‘business unit’ (or ‘lines’); and
- tracks increases in ‘value’ (think ‘cost + profit = price’) of goods through the system.

The relevance of such an approach to the OECD focus on ‘value creation’ may be attractive. But where the activities are in legal entities manufacturing goods, distribution is not often meaning that value is...transforming.

And the OECD TP Guidelines become very sophisticated in terms of how to do value chain analysis within an MNE group.

Note:
- ‘competitive advantage’; and
- ‘activities’.

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Note:
- ‘competitive advantage’; and
- ‘activities’.
What does a separate VCA section add to the TP Guidelines?

Activities will probably need to be broken down into processes. Sometimes these are broken down further into subprocesses. It can get very detailed. It can make functional analysis look like light reading.

Porter also recognises value chain at an industry level as well as the level of the individual firm. The things the current draft calls for are rooted in the need for a comparison (eg 'profits in excess of market'). The term 'competitive advantage' (economic advantage) implies the application of real world data. There is often good third party evidence which can be applied. Evidence usually excluded from traditional comparables analysis. Data from industry should be a key part of VCA being useful for transfer pricing.

How to address any confusion: things WP6 might consider adding

VCA generally

Refer to the established Porter framework, the relevance of 'competitive advantage' to 'value creation' and the importance of looking at the industry as well as the company itself.

Explain that good third party data may be available to evaluate or compare, eg as evidence of the profitability of different parts of the value chain or identifying 'unique and valuable contributions'.

Note that activities and processes may need to be broken down further but may not eg if it is carried out in one place or by one entity.

Where two or more entities are integrally involved in one activity, identifying the nature of the interaction helps with the selection of method.

VCA in relation to the Profit Split method

When VCA departs from objective data or the economics of the business, there is a real danger it becomes precisely what the profit split method is not (a subjective split of an aggregate system profit).

Industry data applied in VCA may be very useful in applying Ch. II.C.4.4 (splitting profits) as evidence of 'an economically valid basis...that would have been...reflected in an agreement at arm's length'.

The draft already notes that it may be a good way to identify the relevant profits or factors. The emphasis should be on the evidence it can yield - it is not a TP method. It may also provide evidence of how to measure them or what weightings to give them.

Cautions that 'more granular it gets, the more subjective it is likely to become.'
VALUE CHAIN ANALYSES:

Determining when and how to apply transactional profit split methods

Chaid Dali-All, Partner, GT Société d’Avocats - France

General comments

• "The VC consists of value activities and margin...[it] is a basic tool for examining all activities a firm performs and how they interact...[it] cannot be understood by looking at a firm as a whole. It stems from the many discrete activities a firm performs..." Michael E.Porter;

• This concept seems suitable for TPSM, particularly for contribution but also for residual analyses;

• VC analysis might be relevant for determining both when to apply a TPSM (qualitative approach) and how (quantitative step);

• However, notably due to a certain level of subjectivity and potential complexity inherent to VC analyses, it should not lead to a wide and systematic use of TPSM (global formulary apportionments), irrespective of:
  - The intensity and of the level of value contributed (OECD § C2-11 on simple/routine functions); and
  - Mere lack of comparables (OECD § C3-18);

When to Apply TPSM – "Qualitative VC"

• As a VC analysis is all about
  - Identifying value creation factors spread out over the MNE; and
  - Analysing "the way they interact"…

• …It is a useful tool for determining both
  - Unique and/or valuable contributions; and
  - Highly integrated activities / transactions

• VC analysis must clearly focus on:
  - Key value drivers only (functions, assets and economically induced risks); and/or
  - Activities that cannot be conducted if not really integrated knowing that all groups show a minimum level of integration / synergies

• Flexibility: avoiding prescriptive lists / definitions of key drivers as they strongly differ from an industry to another, and from a firm to another within the same industry.
How to Apply TPSM – Quantifying Contributions to the VC

- The ultimate goal of a VC analysis is measuring / quantifying the respective weight of each key factor within the global VC and / or the respective contribution of different entities to same key factors (e.g. nature of the integration, Vertical Vs Horizontal, Parallel Vs Sequential);

- Depending on multiple factors (e.g. industry, strategies, nature of integrations...) quantification of respective contributions, and corresponding profit / loss allocations, might range from:
  - Relatively “easy”: e.g. CapEx, wages/salaries...; to
  - Very complex: e.g. Bargaining power / “game theory”, combination of measures/allocation keys

- Flexibility: no prescriptive methods but rather a general principle by analogy to TP guidelines for selecting relevant PLIs i.e. the profit/loss allocation key must reflect the qualitative VC analysis;

- No encouragement to complexity (disputes & uncertainty)