

Base Erosion and Profit Shifting (BEPS)

COMMENTS RECEIVED ON
PUBLIC DISCUSSION DRAFT

BEPS Action 8-10

Revised Guidance on Profit Splits Part I

8 September 2016



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5 September 2016
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RE: Discussion Draft on the Revised Guidance on Profit Splits

Dear Sirs,

Federazione Nazionale Imprese elettrotecniche ed Elettroniche ("ANIE") thanks the OECD for the opportunity to provide comments in response to the OECD Centre for Tax Policy and Administration's Discussion Draft on the Revised Guidance on Profit Splits (hereinafter also referred to as the "Discussion Draft").

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

General Comments on the Revised Guidance on Profit Splits

ANIE welcomes the fact that the OECD Discussion Draft takes a balanced view of the transactional profit split method, indicating both strengths and weaknesses of the method and providing examples of where the use of the profit splits method might or might not be appropriate.

As recognized in Par. 7 of the Discussion Draft, while in any transaction between independent parties, the price set affects the allocation of profit or loss from the transactions, the parties generally run their business activities separately and the use of (actual) profit splits is not very frequent. Therefore, as the purpose of the OECD Guidelines is to replicate what would happen between independent parties, the use of the profit split should not be frequent in assessing arm's length conditions.

Anticipated profit split and actual profit split

The OECD Draft clearly illustrates the difference between the anticipated and the actual profit split methods but does not seem to provide clear indications on the criteria to be used for the selection of these methods. We invite the OECD to consider providing additional guidance on the selection criteria, with particular reference to the value of contractual arrangements and allocation of risk.

Definition of business integration and risk sharing

Given the approach adopted within the Discussion Draft, additional guidance on what is meant by “*business integration*” and “*sharing of risks*” among the participants to the profit split set up, would be very valuable. For example, we understand that the profit split represents a viable and reliable method also in relation to situations where each participant provides unique and valuable contribution to the creation of the overall value. In such situations, however, there may not be direct sharing of risks or business integration between the parties, as the participants to the transaction may take care of different parts of the value chain. Further clarification on this point may be helpful.

Subjectivity in the implementation of the profit split methodology

The implementation of the guideline proposed by the OECD would necessarily rely on certain subjective evaluations; indeed, measuring each party's contribution to the generation of the combined profit/loss is not straightforward, and therefore the selection of different proxies (costs incurred, assets, etc.) may result in different splitting proportions. We believe that the further guidance proposed within the draft, helps in reducing the level of subjectivity allowing for a more objective application of the methodology.

Questions to commentators

1 Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular:

1. Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear?

Overall, the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits appears to be clear.

Our understanding is that both anticipated and actual profit split methods should be applied to the profit/loss arising from a transactions, profit/loss which would result from the combination of the activities and results of the entities participating into the transaction.

However, according to the wording of Par. 4 and Par. 5, it may seem that while the anticipated profit split method can be applied only to split the profit of “an enterprise”, the actual profit split can be applied to split the “combined profit of the enterprises”, hence the profit of the whole transaction. Therefore, clarification on the wording of Par. 4 and 5 would

be useful since, based on the current wording, it may seem that the anticipated profit split cannot be applied on combined profits.

2. Is the distinction between the two profit split approaches described useful?

From a theoretical perspective the distinction appears to be clear, but it remains unclear what may be the situations in which the anticipated or the actual method should be applied. The provision of additional examples will prove useful in order to clarify such distinction.

2 Comments are also invited on the link between integration of business activities (and thus the sharing of risks) and the appropriate application of a transactional profit split of actual profits.

We agree with the rationale behind the link between the integration of business activities and sharing of risks and the appropriateness of the transactional profit split of actual profits.

We deem that further guidance on the meaning on Integration of business activity would be useful.

On this point, it is important to note that in most MNE environments there is always a certain degree of business integration determined by the fact that each entity of the group, even if responsible of certain functions, is subject to a common control and share the same strategy and objectives of the Group as a whole. However, the type of integration which would require the use of a profit split method should go beyond the general integration of activities due to the fact that the entities belong to the same group.

- In addition, Paragraph 10 states that *“a key indicator for the appropriateness of a profit split of actual profits is that the parties continue to share in the outcomes of the business activities and the risks associated with those subsequent outcomes. It would be contrary to the guidance in Section D of Chapter I 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.”* However, one of the situations where the application of the transactional profit split is more appropriate, is the case where multiple parties to the transaction make unique and valuable contribution to the outcome of the operation itself (see C.3.2., §22). In such case, it may happen that one party contributes with a brand performing the relevant and strategically critical advertising activities, while the other contributes with a unique patent, essential in order to complete the product. In this case, neither party has a direct control on the risks associated with the activities performed by the other entity. However, since both assets are essential for the commercialization of the products and generation of the profits, the entities share the overall market risk associated with the activities.

3 Examples of scenarios where each approach to splitting profits would be the most appropriate (together with a brief explanation as to why) are also requested.

No comments to be provided

4 Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarised?

Yes, important strengths and weaknesses appear to have been described.

5 Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses? If so, what are they?

Actual Profit Split

An additional weakness of the Actual profit split method arises from the fact that in certain jurisdictions, profits/loss necessarily need to be recorded in the year in which they arise. By definition, the split of the actual profit can be performed only several months after the year end, once the final financial data of the year become available and the data are analyzed and segmented for the relevant transaction subject to the profit split. At that time the result of the profit split analysis is completed, it may be too late to record the profit/loss into the accounts of the year, which have been closed.

Anticipated Profit Split

- in case its application resorts to valuation techniques, the outcome will incorporate all the criticalities associated with such methodologies; and
- the actual results, may deviate from the original intentions of the ex-ante approach and this might increase the risk of challenge by the Tax Authority.

6 The discussion draft introduces the sharing of economically significant risks as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method.

1. Do commentators have any suggestions for clarifying the notion of risk sharing in this context?

We find the concept of risk sharing particularly complex, due to the fact that there is a strong interaction between risk sharing and transfer pricing method. In particular, in an economic transaction, the risk borne by each party would necessarily depend (among other factors) on the actual pricing arrangement in place.

Therefore, the correct analysis of the risks borne necessarily needs to start from the actual pricing arrangement put in place by the parties, unless that arrangement is inconsistent with the guidance provided on Chapter 1 of the Guidelines.

2. Do commentators find the draft helps to clarify the circumstances where the transactional profit split method is the most appropriate method? Please provide explanations and/or examples supporting your views.

Yes.

- 7 **The discussion draft notes that a transactional profit split of anticipated profits can be used in conjunction with certain valuation techniques. Examples showing the application of a transactional profit split of anticipated profits are sought.**

One case in which this approach could be validly applied is when a royalty payment is to be established between two related parties. In this case, in order to reach a proper allocation of profit between them, a projected DCF could be set up and a royalty rate inferred. The excess profit approach may prove useful in this case since it allows to assess the value of the intangible to be remunerated.

- 8 **Is the distinction between parallel and sequential integration of business operations a useful refinement in determining when the transactional profit split method is likely to be the most appropriate method?**

Given the description provided in the Draft, it appears that the representation given of the sequential integration is more likely to depict a value chain composed of routine functions that can be isolated and tested on a discrete base, probably applying other OECD methods. Therefore, the conclusions of the Draft *"In cases of parallel integration, it may be the case that the accurate delineation of the actual transaction determines that each party shares economically significant risks, and a transactional profit split, using an approach which splits actual profits, may be found to be the most appropriate method"* appear to be reasonable.

- 9 **If so, how should the concept of parallel integration be further defined?**

We believe that other forms of business models may exist. Therefore, we suggest that section C.3.1. be considered only as providing some examples of business models and not a comprehensive list.

- 10 **Comments are invited on the relationship between the making of unique and valuable contributions by both (all) parties to a transaction, and the sharing of economically significant risks.**

In general, the contribution of each element of the value chain is valuable and often unique, but this does not imply that a profit split is the correct method to replicate arm's length conditions. For example, among independent parties, it is not unusual that a key component of a product is manufactured by an unrelated party and, in such case, the pricing method agreed between the parties is not a profit split.

- 11 **Are there situations where all the parties make unique and valuable contributions to a transaction, but they do not share the economically significant risks associated with the outcomes of that transaction? If so, what guidance on the appropriate use of profit splits in such a situation should be provided?**

No comments to be provided

- 12 The Final BEPS Report on Actions 8-10 noted that group synergies were to be addressed in the guidance on profit splits. The approach taken in this discussion draft is to make reference to the incremental or marginal system profits arising from the group synergy, which would then be shared amongst the relevant associated enterprises. The analytical framework suggested in the draft, based on an accurate delineation of the actual transaction, would not support the combining and splitting of total system profits on the basis of group synergies alone. Comments on this point are invited.

We agree that group synergies alone will not support the application of the profit-split method that should be applied only to potential incremental or marginal profits.

- 13 Does this section properly describe a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit split method is appropriate?

We agree that this section properly describes a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit-split method is appropriate.

- 14 If commentators see a value chain analysis as serving a greater purpose in relation to profit splits, then please provide an explanation for that view together with examples.

No comments to be provided

- 15 What further guidance or clarification of existing guidance would be helpful in these sections? Please provide practical examples in support of the response.

As indicated in the Draft, the correct application of the profit split method would require to use a common basis as to accounting standards.

In order to ensure consistency and simplify the application of the profit split method, in case a taxpayer, at a group level, uses a common accounting standard based for example on IFRS, that common standard should be the basis for the application of the profit split, and the taxpayer should not be required to reconcile or align data starting from the local GAAP that may be used by each legal entity.

- 16 The discussion of profit splitting factors sets a requirement that the factors must be capable of being measured in a reliable and verifiable manner. Do commentators believe that useful ways of splitting profits have been excluded? If so, please describe these factors and explain how they meet the requirement of reliable and verifiable measurement.

We agree with the necessity that splitting factors should be measurable in a reliable and verifiable manner. However, since splitting factors represent proxies for companies' contribution to the overall profit generated, it should be clear that there may be a tradeoff between the need for measurability/objectivity and the precision of the proxy selected.

In addition, where no appropriate quantitative drivers are available, companies should be allowed to perform a profit split based on the result of a value chain and of a functional analysis.

17 What further guidance would be useful in this section relating to identifying and measuring profit splitting factors? Please illustrate your response with examples.

No comments to be provided

18 More generally, examples are requested of scenarios where a transactional profit split of actual profits or of anticipated profits are applied, together with a brief explanation as to why the method and the approach to applying the method, is considered to be the most appropriate in the circumstances of the case.

No comments to be provided

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

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

Yours sincerely,

Maria Antonietta Portaluri



About ANIE

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

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

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

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BEPS Actions 8-10 Revised Guidance on Profit Splits

Dear Sir or Madam,

We highly appreciate OECD's invitation to comment the discussion draft "BEPS Actions 8-10 Revised Guidance on Profit Splits". We thank the authors for the work they have done, and also we would like to thank the OECD for continuing the work on this topic. We very much welcome any further clarification about the application of profit split methods (PSM) in particular the transactional profit split method (TPSM) and that this guidance will be part of the OECD Transfer Pricing Guidelines in the course of the next update.

General comments

However given the focus on value creation in the final BEPS Action 8-10 reports it is important that the scope of application of any PSM will be clearly defined and limited in the proposed PSM guidance. In the current discussion draft particularly points 11, 16-18 could provide such guidance. Additionally an introductory statement would be desirable, clarifying that TPSM is (still) only applicable in specific cases and will not be the "default" method. The wording in the draft could be more explicit in making the point that profit split methodologies should not replace the Transactional Net Margin Method (TNMM) even where (for example) comparables for operating profit data (or other relevant profit level indicators) are hard to come by.

In general it should always be kept in mind when discussing about "profit split methods" and "value chain analyses" that the global allocation of entrepreneurial tasks and risks within an MNE is at the free discretion of the MNE. Tax rules have to follow these decisions and need to ensure that governments use coherent measures to tax a fair share related to the

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local footprint. If there are no clear rules high risks of double taxation will occur.

It should be kept in mind that in third party contracts the parties will have different bargaining power, different options available to them, and generally would not be dealing with all of the parties in a value chain; just those either side of it. This should also be reflected by the TPSM.

With respect to the value chain analysis it is not entirely clear why this section shall be located in the TPSM guidance, since a value chain analysis does not only help to decide on applicability of the TPSM but e.g. also of any one-sided method. Therefore, it should be considered whether the value chain analysis part should be placed in the sections of the OECD Transfer Pricing Guidelines dealing with the functional and risk analysis. Additionally BDI would like to recommend to discuss any value chain analysis with caution since the notion of “value” or “value drivers” is not consistent among countries and can give rise to contradictory interpretations. Further, any respective paragraph on the value chain analysis needs alignment with the entire risk control framework introduced with the BEPS project.

Specific answers to the questions in the draft

1. Split between actual and anticipated profits

In our understanding the splitting of actual profits should be the preferred method in situations where both parties to the profit split are sharing the significant risks (paragraph 2). As the OECD points out key indicator for the appropriateness of a profit split of actual profits is that the parties continue to share in the outcomes of the business activities and the risks associated with those subsequent outcomes (paragraph 10). Furthermore the OECD notes that “under a transactional profit split of actual profits there is a greater sharing of the effect of uncertainty resulting from risks, since the profits or losses that are split are the actual profits or losses, and since additional risks are likely to be shared depending on the level at which the profits are split.” (paragraph 6)

However the OECD concedes that when “examining arrangements between associated enterprises, it may be difficult for a tax administration to determine whether the accurately delineated transaction represents, for example, a fee arrangement, or is an arrangement in which two or more associated enterprises share economically significant risks”. (paragraph 10) Additional guidance would be appreciated with respect to these uncertainties.

We would generally like to ask for further explanation of the anticipated profit split and when it should be applied. Here could be explained how the TPSM differs from a conventional Comparable Uncontrolled Price (CUP) royalty analysis.

The BDI agrees with the OECD that the PSM should basically be the same for profits and losses. However, when changing from profitability to losses previous ex-ante calculations can be an anachronism. We would like to ask for more guidance in such situations.

2. Integration of business activities and the appropriate application of a transactional profit split of actual profits

The integration of some parts of a business does not necessitate the use of a profit splitting method; all MNEs will share some top-level strategic management and therefore could, under the broadest interpretation of the term, be considered to be “integrated”. Additionally sharing of risk alone is not sufficient to justify the application of the TPSM. This depends on the existence of an appropriate comparable.

4. Strengths and weaknesses of the transactional profit split method

We basically agree with the summary of the strengths and weaknesses.

5. Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses?

As the discussion draft explains in paragraph 6 risks are shared differently when splitting up anticipated or actual profits. Therefore the split of anticipated profits should not be used in highly volatile environments since it may not be able to capture the changes.

6. Sharing of economically significant risks as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method

Sharing of economically significant risks may be a factor indicating that a profit split of actual profits may be the most appropriate method. However, we would like to propose that sharing of a control function with regard to economically significant risks may better define situations where profit splitting is the most appropriate method.

8. Distinction between parallel and sequential integration of business operations

The draft distinguishes between sequential integration within a value chain (for which there should be comparables available for each function) and parallel integration, where parties are contributing value into the chain at the same stage (e.g. intangibles). This is very useful. However there should not be any presumption that parallel integration necessarily requires the profit split method where sequential integration does not.

9. Should the concept of parallel integration be further defined?

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In our opinion the discussion draft would benefit from direct consideration of when value is generated in relation to each economically significant function, asset or risk.

10. Unique and valuable contributions by both (all) parties to a transaction

We agree with the assumption that unique contributions are a key source of economic advantage and therefore significant risks are more likely to be shared. We would like to ask for a clarification that only those profits, in excess of profits made from routine functions, should be subject to profit splitting.

11. Are there situations where all the parties make unique and valuable contributions to a transaction, but they do not share the economically significant risks?

If the parties do not share the risks although there are intangibles this does not indicate – as in general – that the TPSM is the most appropriate method. It always depends on the individual case so other methods should also be taken into consideration.

12. Group synergies

We basically agree with the approach taken in the discussion draft that group synergies alone would not support the combining and splitting of total system profits.

13. Value chain analysis as a tool in helping to delineate the actual transaction

As mentioned in the general comments a value chain analysis is a useful tool for all pricing methods and it can also provide guidance on which method to apply.

14. Value chain analysis as serving a greater purpose in relation to profit splits

Regardless of the PSM applied a value chain analysis should provide information when value is generated in relation to each economically significant function, asset or risk.

15. What further guidance or clarification of existing guidance would be helpful?

It should be clarified that the profit split method only applies to those residual profits over and above compensation for routine functions.

16. The discussion of profit splitting factors sets a requirement that the factors must be capable of being measured in a reliable and verifiable manner

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While agreeing that the profit split factors must be measurable we do not recommend to generalize any findings. Typically those factors vary significantly across industries and businesses.

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

Yours sincerely



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5 September 2016

Dear Sirs

Discussion draft on revised guidance on profit splits

BDO welcomes the opportunity to comment on the OECD's Discussion Draft on the Revised Guidance on Profit Splits issued on 4 July 2016 ('the Discussion Draft').

We support the OECD's efforts to develop rules to achieve effective guidance on the application of profit split methods. We believe this will be helpful to address situations where other methods do not appropriately reflect the integrated nature of the functions, assets and shared risks arising in business conducted by multinational enterprises. We appreciate the consideration the OECD has given from the previous round of consultation on this matter.

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

General comments

The increasingly interdependent nature of the value drivers and core business activities of multinational enterprises means that it becomes more likely that the transactional profit split will be determined to be the most appropriate method following an analysis of the functions, assets and risks of a transaction. As such, it will be important for the OECD's Transfer Pricing Guidelines ('the Guidelines') to clearly set out and support:

- The conditions which might lead to the application of the transactional profit split method;
- The reasonableness of the use of the transactional profit split method under these conditions; and
- Acceptable parameters for the effective application of the transactional profit split.

The Discussion Draft goes a long way to addressing these requirements. Of all the transfer pricing methods set out in the Guidelines, the transactional profit split method is likely to be the most challenging to fully delineate and potentially the most subjective to apply. As such we agree that the principles-based approach to its application currently adopted by the Discussion Draft is considered to be the most practical and robust means to present effective guidance.

In this context, areas which the OECD may wish to consider in further detail to increase the effectiveness of this guidance might include:

- The practical application of the transactional profit split of anticipated profits and whether a distinction between a split of anticipated profits and actual profits is helpful;
- The types of activities whose functions, assets and risks might fall within the transactional profit split parameters;
- Whether royalties are a helpful illustration in this context;
- The importance of residual profit split in practice and whether this may be emphasised more strongly;
- The level of guidance provided around the mechanism for splitting profit, including the most appropriate profit level at which a split may be made, for example gross profit compared to operating profit; and
- Numerical examples to illustrate the application of the profit split in various scenarios.

We discuss these areas in more detail below.

Transactional profit splits of anticipated profits

At a theoretical level, the distinction between the two profit split approaches is clear in that the transactional profit split of anticipated profits relies upon a calculation based wholly on information known at the time the policy is determined, while the transactional profit split of actual profits may upon implementation rely on hindsight in its calculation once the outcome of the transaction is known.

Where the relationship between the parties is ongoing, this distinction becomes less clear in practice. When considering how each approach might be implemented our observation is that the approaches appear more akin to two stages of a single method.

The Discussion Draft acknowledges that both approaches would set their profit split policy *ex ante* (paragraph 5 and paragraph 30, third bullet). As such, in either case the policy would be expected to be determined based on financial and other information available at that time. In their policy setting decisions, both approaches follow the model of the transactional profit split of anticipated profits.

The entities within the transactional profit split will determine the profit position at the end of a given period by reference to the actual results of the relevant business. This will be the case for a transactional profit split based on anticipated results or a split of actual results using profit splitting factors set out in C.4.5.

An ongoing transaction based on anticipated profits still requires reference to actual amounts. It is unlikely that third parties entering into a transaction based on anticipated profits would not review the outcomes periodically for reasonableness and, if necessary, seek to renegotiate or exit the arrangements. There will always be variances against forecasts which parties must accommodate, either in shortfall of revenue or profit or the perception that the other party benefits disproportionately. This is acknowledged under Chapter VI where it is recognised third parties may include price adjustment clauses or re-negotiate in circumstances where unforeseen subsequent developments arise in the pricing of intangibles.

It is also likely that many actual profit calculations continue to contain elements of the anticipated profits approach. Estimated accruals and some provisions will be recognised on an

anticipated basis and could well reverse the following year. This further blurs the usefulness of the distinction.

It's common for joint venture arrangements to have clauses for variations to take account of actual outcomes being different to anticipated. Variations (both positive and negative) are generally borne by the joint venture partner contributing to that aspect of the project. So the concept of variation clauses similarly could be built into a profit split arrangement.

As such, in the calculation of the result and payments to be made both approaches rely on the actual amounts, or at the very least at arm's length would refer to these actual amounts periodically.

As every transactional profit split would be prepared based on anticipated profits and implemented based on actual results, the OECD may wish to consider whether it might be most appropriate to present the transactional profit split as a single approach with key stages:

- Policy setting, based on anticipated profits;
- Payment at the end of a given period - at a maximum an accounting period - based on actual results;
- Periodic consideration of the ongoing appropriateness of the policy.

It is difficult to identify examples of when a transactional profit split based wholly on anticipated profits (i.e. with no later reference to actual outturn) might arise. This would involve the parties to the transaction placing significant trust in the effectiveness of forecasts. If one party is likely to be less active in the transaction, for example if it contributes intellectual property, it could be dependent on the cost control of its counterparty over which it would have no influence. It would be helpful for the guidance to provide clarity on how variances would be treated; we presume that these would be ignored and the anticipated arrangements upheld in any payments to be made.

It may be that a transactional profit split of anticipated profit is intended primarily to set a price for a one-off transaction, for example the disposal or long term alienation of hard to value intangibles. This is alluded to by the Discussion Draft, for example in its consideration of valuation techniques in paragraph 5, although in a context which leaves open the potential for an ongoing relationship between the parties.

This may be valid in the case of a one-off transaction, as there may be no opportunity at arm's length for subsequent review or alternation of arrangements. If this is the OECD's expectation, then it would be helpful to state this explicitly. Doing so would add clarity to when it is most appropriate to rely on anticipated profits and so illustrate the distinction between transactional profit splits based on anticipated and actual profits. References to other potentially relevant guidelines, for example Chapter IX, might also be included. The OECD may also wish to consider whether this kind of pricing might be best addressed in its discussion of intangibles in Chapter VI.

If the pricing of one-off transactions is the intention of the OECD in this instance, consideration should be given to how the requirements of the Guidelines might interact with national legislation around the valuation of assets on disposal to ensure either that consistent principles are applied or that guidance is provided on how best to address any differences which may arise.

The OECD may also consider including guidelines to address circumstances in which a significant variation to anticipated profits arises.

Activities where a transactional profit split might be most expected

A determination that the transactional profit split is the most appropriate method is more subjective than for other transfer pricing methods. This is essentially as it can be a negative decision - the relevant activities of parties involved must not be routine or somehow identifiable as comparatively 'simpler' - rather than a positive selection. As such, this creates a higher risk of controversy as the same conclusion may not be reached by the taxpayer and all of the relevant taxing authorities with respect to the transaction. It will therefore be important for the Guidelines to be as clear as possible regarding when a profit split might be appropriate and how this decision might be expected to be supported.

The principles-based approach adopted by the Discussion Draft is helpful, and likely to be the only effective way to address what will be highly specific facts and circumstances. The provision of some examples would nonetheless be useful to manage the expectations of both taxpayers and taxing authorities and provide a starting point for policy setting or enquiries.

We support the OECD's focus on a robust analysis of the value chain and the functions, assets and risks undertaken as a basis for determining whether a transactional profit split is appropriate. In this, the markers set out by the OECD in the Discussion Draft provide signposts for the application of a profit split, but these may be expanded upon:

- The integration of business risks, and so the sharing of "the same economically significant risks associated with the business opportunity...", as an appropriate indicator for the application of a transactional profit split method effectively casts the transactional profit split more widely than purely a means of addressing the presence of intangibles on both sides to the transaction. This is consistent with business models we are seeing, for example, where management models are dispersed between entities and location.
- The integration of business activities, either sequential or parallel; although to this might be added the 'umbrella' of senior management activities discussed above.
- The balanced interdependence of activities across locations, for example in the parallel integration between entities which combine software and algorithms with customer and market data to form a new value driver which would not otherwise be able to exist.
- The sharing of business risks should not be conclusive to the decision as to when to apply a profit split arrangements. Franchise arrangements are a well-known practice and have risk sharing between the franchisor and franchisee. However, in this situation it is usually only one party (the franchisor that is making a unique and valuable contribution). A contribution can be made in a more passive or routine sense, for example by a licensor of intellectual property whose return is subject to the sales of the licensee with often little management of that risk beyond a floor to the royalty payment. The sharing of economically significant risks suggests a position where both upside and downside risks can be transmitted to all parties, and where the management of those risks is similarly shared. Again, this ties in with the presence of common management, which is itself an indicator that the business activities are highly integrated, and so can serve as a useful pointer towards the transactional profit split method.

Providing additional illustration adds practicality when making and supporting policy decisions. This might also address:

- Providing guidance on whether such sharing (or the assumption of closely related risks) must be explicit or if it could legitimately be interpreted by a tax authority as taking place implicitly; what kind of evidence would be required if explicit sharing of risks is required?
- Illustrating the limits of this kind of sharing, for example by developing the discussion in paragraph 15 around a global manufacturer (which might operate as a principal) and a regional distributor; with distinct roles, would these entities necessarily prompt a transactional profit split or could their activities and associated risks be sufficiently distinct that other methods may be more appropriate?

Where the Discussion Draft refers to economically significant risks or value chain analysis, reference might be made to those parts of the Guidelines which set out their meaning and intention in detail. This may prevent confusion between a full discussion and the brief summary currently incorporated within the transactional profit split paragraphs.

Use of royalties as an example

Regarding the example in paragraph 6 of a royalty as an illustration of a transactional profit split, the OECD may wish to consider whether this is the most appropriate concept to use in this instance. Royalties for the provision of intellectual property between third parties are typically set as a percentage of relevant sales, rather than a profit level which is affected by a cost base that the licensor cannot easily influence. Royalty rates are often set and supported based on CUP or CUT data, drawn either from internal or external sources, and rely primarily on that method rather than the transactional profit split. While there are examples in case law which consider how much profit a licensee might forgo in return for the benefits of the right to the asset, at best these provide a rule of thumb and so would not normally be expected to drive the transfer pricing analysis of a transaction.

Residual profit split

In practice it is very rare to see a transactional profit split applied to the whole profit of a transaction. Generally, there are at least some aspects for which an appropriate comparable may be found.

For example, in a software business an appropriate return may be identified for:

- The local sales team
- The contract R&D centre
- Back office support
- License fee for the software intellectual property

A balance of profit or loss will generally remain to be allocated after this point where the management of the business is not confined to one entity or location, for which a transactional profit split can be appropriate.

The Discussion Draft currently deals briefly with residual amounts. This might usefully be expanded to validate the use of the transactional profit split to appropriately attribute amounts that remain after other transactions have been identified and priced. Examples along the lines of that shown above might be provided.

Group synergies

We agree and acknowledge that in general, group synergies should be shared based on contributions to creation of the synergy and it is not necessary to split total profits. However, it is noted that in certain situations, the concerted group actions are the driving factor for deriving a benefit. For example, cash pooling arrangements are arrangements that only exist within groups, and the benefit gained by setting up a cash pool arrangement is the result of the concerted group action and group synergies. A transactional (residual) profit split approach may often be the best way to allocate this benefit taking the contributions of various group members into account. It may be useful to identify examples where splitting a system profit is more appropriate.

Mechanisms for splitting profit

We agree that a value chain analysis should be the starting point to both determine whether a transactional profit split is appropriate and the factors influencing how that profit is divided.

Clarity would be helpful regarding how an allocation might best be determined, for example based on:

- Functional analysis of the importance of different activities, for example if the management of intellectual property is split across locations the relevant share of profit attributable to that asset might itself be divided based on the relative importance of the DEMPE functions and where each is performed;
- A weighting based on relative importance to the business of key management roles, based again on functional analysis and RACI-style considerations;
- A similar weighting but using salaries (and bonuses) or equivalent staff costs as a proxy for value to the business.

A profit split methodology is likely to be more subjective than using a TNMM methodology which could create more disputes between the taxpayer and tax authorities. Clarity would be helpful on how this subjectivity could be reduced and consensus reached between both parties.

The level of profit to be split should also be a focus. For example how might a business distinguish between less- and more-integrated transactions? Some transactions might best split profit at the gross margin level (such as where there is discretionary marketing spend by each party that should fall below the line) and others where the level of common cost (or cost control) is greater where the split should be made at the net margin level.

The attention paid by the Discussion Draft in paragraph 40 to the selection of profit measure is welcome. This is important as while parties may sign up to share profits from a venture they will be reluctant for their reward to be subject to factors beyond their control, for example if one party to the transaction overspends through lax cost control then the other party would be penalised. There is the risk of moral hazard where the downside risk of overspending is partially offset for one party by its impact on the profit share of another.

Paragraph 41 currently illustrates this helpfully. It could go further to show that the point at which profits are split need not be limited to the gross and net profit levels, but could be at a point in between to be determined through the functional analysis. Costs under common oversight or control would be 'above the line', while costs which are not would fall 'below the line'. To obtain more clarity in this respect, a numerical example would be helpful to illustrate the impact of picking either the gross or net profit levels as the point to split.

The OECD should consider expanding C.4.5 Profit splitting factors with some additional discussion on the merits of using a multi factor approach. Reliance on a single factor could give rise to an inappropriate allocation. For example in the event of losses arising applying a singular sales remuneration factor would not result in a commercially realistic outcome. Similarly using only sales volumes could give rise to an inequitable allocation where one location simply achieves higher sales as a result of charging a lower margin. Consideration should be given to a multi factor approach where situations can be envisaged that an individual factor will not always be a profit level indicator.

Concluding remarks - supporting the use of the transactional profit split

Broadly, the Discussion Draft provides helpful principles in support of the use and application of the transactional profit split. We have set out above how these may be expanded upon to add greater specificity in the expectations of both taxpayers and taxing authorities to align expectations.

As these expectations will come together over the transfer pricing documentation, the OECD might also wish to consider:

- Placing the comments around potential difficulties regarding measuring combined revenue and costs (paragraph 14) in the context of the new documentation guidance, including expectations of what might need to be provided in a financial analysis to show both the assumptions or expectations behind the policy and the calculation of the amounts involved;
- Making reference to what information tax authorities might reasonably expect to obtain to assess a transactional profit split method, and how this information might be requested and shared between tax authorities (paragraph 15). This will be helpful to manage the expectations of business regarding materials which should be produced and maintained, and prevent excessive demands for information from tax authorities (either directly or through sharing of information) in relation to the audit of prior periods.

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

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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**Comments on the Public Discussion Draft on
REVISED GUIDANCE ON PROFIT SPLITS**

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

GENERAL REMARKS AND SUMMARY

We applaud the continued interest of the OECD and Working Party 6 in its work to make the profit-split approach a more viable and important tool in intercompany pricing.

In this submission we propose the development and use of defined allocation keys and weights to apply the profit-split method to actual profits of common business models (see Appendix). In our comments to the specific questions we point out that the examples in the discussion draft assume, without explicitly saying it, that the various business units of a multinational enterprise (MNE) are normally independently managed, albeit with common ownership and some top-level management over policy and direction. In contrast to this assumption, we believe that most MNEs operate as centrally-managed unitary businesses performing core functions and using intangible property in multiple countries. We therefore suggest that it is appropriate to apply the profit-split method to actual profits in these cases. Nevertheless, if Working Party 6 takes a different view, due to their belief that some level of integrated risk sharing is required for application to actual profits, the profit-split method with defined allocation keys and weights could be applied to anticipated gross profits or other measure appropriate for the specific business model. Whether our recommended approach or this alternative is chosen and inserted into the Guidelines, it would greatly simplify things for taxpayers and tax authorities alike.

SPECIFIC COMMENTS

1. Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular:

1. Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear?

2. Is the distinction between the two profit split approaches described useful?

Response:

We believe that the section C.1. draft explains very well the background and rationale for the actual versus projected profit approaches. The discussion is both clear and useful.

As is described later in our comments, we consider that many MNEs use common business models that generally involve central management coordinating key functions and the development and exploitation of intangibles, which actually take place through the MNE's various entities in multiple countries. In these cases, if Working Party 6 were to provide within the Guidelines concrete allocation keys and weightings for these common business models, then the profit-split method could provide a true simplification for both taxpayers and tax authorities. The Working Party could also articulate the principles on which concrete allocation keys and weightings should be determined so that appropriate allocation keys and weightings can be determined for new business models as they are developed and used in the future.

2. Comments are also invited on the link between integration of business activities (and thus the sharing of risks) and the appropriate application of a transactional profit split of actual profits.

Response:

We agree with the logic of focusing on the link between integration of business activities (and thus the sharing of risks) and the appropriate application of a transactional profit split of actual profits.

Although we agree with the concept, we believe that many MNE situations do not involve independent businesses, though commonly owned, but rather a set of centrally directed and managed integrated operations that have been attributed to various legal entities not due to compelling operational reasons, but often primarily for tax-motivated planning purposes. It would be particularly helpful in discouraging MNE BEPS planning and in providing useful guidance to tax authorities to include examples in this discussion of situations where a centrally managed business has organised itself through a number of separate legal entities, each of which may be performing a defined function, but where each is a part of a unitary business. In such cases, application of the profit-split approach on an actual profit basis would be an acceptable approach, or indeed the most appropriate method.

3. Examples of scenarios where each approach to splitting profits would be the most appropriate (together with a brief explanation as to why) are also requested.

Response:

We understand and agree with the principle that a profit-split of actual profits requires a high level of integration of activities. The examples in the discussion draft are good in illustrating this. However, these examples assume, without explicitly saying it, that the various business

units are independently managed, albeit with common ownership and some top-level management policy and direction.

MNEs generally do not operate in this manner, so that this assumption for them is simply not valid. Rather, they operate as a set of centrally directed and managed integrated operations, with core functions being conducted and intangibles being used and exploited in multiple countries. The organisation of this operation into separate legal entities is often not due to compelling operational reasons, but rather for tax-motivated planning purposes.

For example, many companies have value chains spanning multiple locations and countries, including many core functions such as R&D, raw material and product sourcing, production, marketing and sales, customer support, etc. Each entity for its portion of the whole conducts itself based on centrally coordinated decisions regarding business opportunities and risks, and deploys applicable portions of the MNE's intangibles. This is not just common ownership and some top-level management over policy and direction. Rather, it is central management and decision-making coordinating how the business is to be conducted (e.g. the specific products and services, production processes, sources of raw materials, production quantities, marketing approaches, customer support, etc.). For such MNEs that operate what is effectively a unitary business, the profit-split method as applied to actual profits is not only appropriate, it is normally the most appropriate method.

4. Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarised?

Response:

From page 7: "14. [2.114] A weakness of the transactional profit split method relates to difficulties in its application. On first review, the transactional profit split method may appear readily accessible to both taxpayers and tax administrations because it tends to rely less on information about independent enterprises. However, associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates. In addition, it may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions, which would require identifying from the financial records of the parties to the transaction the revenues, costs, and profits arising from the transaction and separating them from the parties' other activities."

In today's world of centrally managed MNEs with highly integrated and computerized accounting and control systems, true difficulty in accessing information from foreign affiliates or in obtaining combined revenue and costs will be rare. Most instances of claimed difficulty will be taxpayer intransigence and should generally be given short shrift by tax authorities. In addition, one of the major achievements of the BEPS project is establishing common templates for Country-by-Country Reporting and Transfer Pricing Documentation. Implementation of these will be a great stride forward in remedying problems of access by tax authorities to adequate information about the MNE group as a whole and the relationships of its various parts. This stated "weakness" should either be eliminated from the Guidelines or its rarity should be noted with the burden of proof of such difficulties clearly on the shoulders of the MNE involved.

Paragraph 15 also comments on potential difficulties of calculating combined profits from the particular transaction or transactions concerned, finally noting: "The required financial information may be difficult to access, the required interpretation of the data can be difficult for the taxpayer to perform, the analysis of the data may require reasonable assumptions to be made based on knowledge of the business, and in most cases a tax administration will not be

able to perform the analysis or verify the information without full co-operation from the taxpayer.”

Judgment and careful work is required in any transfer pricing analysis. The calculation of combined profit is no different. In any case, again, with today’s centrally managed MNEs with highly integrated and computerized accounting and control systems, the issue should normally be the application of sound judgment and not the difficulty of obtaining the information or making the analysis. We believe that this current language only encourages taxpayer intransigence and should be eliminated or appropriately changed so as to place the burden of proof of any difficulties clearly on the shoulders of the MNE involved.

5. Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses? If so, what are they?

Response:

A particularly important strength is that the profit-split method has the potential, especially with standardized allocation keys for common business models, of being a very easily implemented method for taxpayers and tax authorities, especially those tax authorities from developing countries. See further discussion later herein regarding standardized allocation keys and weightings for common business models.

A further point to make is that many of today’s business models rely on proprietary technology and specialized knowledge of the MNE’s products and services that make production and distribution activities qualitatively different from traditional businesses that manufactured a widget and then sold it through various distribution channels. In those traditional businesses, contract manufacturing and limited-risk distribution arrangements were practical possibilities due to the nature of the products. In today’s high-tech environment, though, both production and distribution functions require personnel to have specialized knowledge of the MNE’s products and services that go far beyond what was needed for the traditional production and sale of widgets. Hence, there will typically be no unrelated comparables for such specialized and proprietary activities. With this being the case, application of the profit-split method will often be the most appropriate method.

6. The discussion draft introduces the sharing of economically significant risks as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method.

1. Do commentators have any suggestions for clarifying the notion of risk sharing in this context?

2. Do commentators find the draft helps to clarify the circumstances where the transactional profit split method is the most appropriate method? Please provide explanations and/or examples supporting your views.

Response:

A number of today’s business models rely on proprietary technology and specialized knowledge of the MNE’s products and services that create an integrated worldwide business. This is very different from the traditional manufacture of a widget where the various production and distribution functions were more normal and did not vary much with the substitution of some other type of widget.

Most if not all MNEs now coordinate businesses through internet platforms. For example, a submission from BASF to an earlier BEPS consultation explained its system as follows:

"Quality management and controls relating to the risks, functions and assets employed are to a wide extent part of corporate procedures which are generally valid group-wide and are fully integrated in the business processes. The research and development process is managed by electronic systems which track the allocation of projects to specific research centres, the adherence to budgets, the sign-off processes and the registration of IP rights. "Control" is therefore to a large extent built in to group-wide guidelines and operating systems, and can therefore be performed anywhere as such systems enable a decentralised, collaborative organisation."¹

These MNEs may sell both hard and soft products and/or provide various services (e.g. sale of third party products, advertising, cloud services, taxi and limousine services, finding accommodations, etc.). Many of these MNEs must maintain in many countries where significant customers are found staff dealing with marketing and sales, operations, and local support. Because of the proprietary nature of the products and services and the highly trained local personnel whose knowledge of the MNE's products and services is a core part of the customer experience, a transactional profit-split method of actual profits is often likely to be the most appropriate method.

We recommend that section C.3. on Most Appropriate Method be expanded to include discussion of such business models.

Also, whilst we agree that a lack of comparables alone is insufficient to warrant the use of a transactional profit split under the arm's length principle, where significant assumptions are used in the adjustments and interpretation of the inexact comparables, we consider that the transactional profit split should be used as corroborative test to support the arm's length nature of the transaction. Where the outcomes of the transactional profit split and the adjusted inexact comparables are significantly different, the difference should be analysed in arriving at the arm's length outcome.

7. The discussion draft notes that a transactional profit split of anticipated profits can be used in conjunction with certain valuation techniques. Examples showing the application of a transactional profit split of anticipated profits are sought.

Response:

Where the assumption inherent in the various discussion draft examples exists (i.e., that an MNE's business units are independently managed, albeit with common ownership and some top-level management over policy and direction), then we agree that the profit-split method as applied to actual profits should be limited to those situations where a sufficient level of integration or risk sharing exists. However, this assumption inherent in the discussion draft is simply not true for most MNEs. As such, this focus on a sufficient level of integration or risk sharing is no longer appropriate for these MNEs.

Accordingly, we recommend that the Guidelines distinguish these MNEs and provide that it is not necessary to demonstrate this integration/risk sharing for an application of the profit-split method to actual profits, as it can be assumed in such cases.

In addition, we recommend that the Guidelines include concrete allocation keys and weightings for common business models (see Appendix), a number of which would include these types of MNEs. If Working Party 6 believes that some level of integration and/or risk sharing is still required to be demonstrated even for these MNEs before there can be application of the profit-split method to actual profits, then the profit-split method with

¹ BASF Submission to the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, September 2013.

defined allocation keys and weights could be applied to anticipated gross profits or another measure appropriate for the specific business model. Whether our primary recommended approach or this alternative is chosen and inserted into the Guidelines, it would greatly simplify things for taxpayers and tax authorities alike.

8. Is the distinction between parallel and sequential integration of business operations a useful refinement in determining when the transactional profit split method is likely to be the most appropriate method?

Response:

We agree that this distinction is appropriate for many traditional businesses and that new paragraph 21 provides excellent guidance. However, as explained in our response to question 6, we believe that many more recent business models involve highly integrated operations that have characteristics different from the traditional vertical and horizontal integration that paragraph 21 discusses. We suggest that this section C.3.1. be expanded to cover this integration in such new business models where the transactional profit-split method will be the most appropriate method.

9. If so, how should the concept of parallel integration be further defined?

Response:

See response to question 8.

10. Comments are invited on the relationship between the making of unique and valuable contributions by both (all) parties to a transaction, and the sharing of economically significant risks.

Response:

The example in this paragraph 22 assumes, without explicitly stating it, that the developer and manufacturer of one key component together with the developer and manufacturer of the rest of the products are independently managed, albeit with common ownership and some top-level management over policy and direction. (This assumption also seems to be made in other examples throughout the discussion draft.) This, however, is not how most MNEs operate. Rather, they operate as a set of centrally directed and managed integrated operations with core functions being conducted and intangibles being used and exploited in multiple countries.

We recommend that this Section 3.2.2 be expanded to explain that these other MNE business models will also be examples of the contribution of unique and valuable contributions by all parties.

11. Are there situations where all the parties make unique and valuable contributions to a transaction, but they do not share the economically significant risks associated with the outcomes of that transaction? If so, what guidance on the appropriate use of profit splits in such a situation should be provided?

Response:

To continue our response to question 10, we believe that many MNEs, especially those that have value chain structures, operate with core functions being conducted and intangibles being used and exploited in multiple countries, although centrally directed and controlled. Often in such cases, intercompany contract manufacturing arrangements and limited-risk service arrangements will understate the value added by the activities conducted and

intangibles used within the countries where these entities are located. The highly trained personnel who conduct their work using proprietary business models, trade names, technology, etc. are seriously undervalued under these stripped risk models. The same will often be true of cases involving entrepreneur MNE group members that contract with customers, but also work with other operating group members for not only R&D services and staff support functions (e.g. finance, legal, accounting, tax, etc.), but also for basic business operational needs (product procurement, management of contract manufacturing, inventory control, etc.), without which the entrepreneurial member could not conduct business.

We recommend that the Guidelines make clear that the profit-split method may be the most appropriate method for business models exhibiting these sorts of arrangements.

12. The Final BEPS Report on Actions 8-10 noted that group synergies were to be addressed in the guidance on profit splits. The approach taken in this discussion draft is to make reference to the incremental or marginal system profits arising from the group synergy, which would then be shared amongst the relevant associated enterprises. The analytical framework suggested in the draft, based on an accurate delineation of the actual transaction, would not support the combining and splitting of total system profits on the basis of group synergies alone. Comments on this point are invited.

Response:

We agree with this point that group synergies alone will not support application of the profit-split method. Having said that, though, we do believe that some newer business models create significant group synergies through their centrally managed structures that involve proprietary products, services, and technology. These other factors will often mean that the profit-split method should be the most appropriate method.

13. Does this section properly describe a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit split method is appropriate?

Response:

We agree that this section properly describes a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit-split method is appropriate. Having said this, though, we believe that the serious difficulties for both taxpayers and resource-constrained tax authorities of establishing arm's length prices under one of the traditional transaction methods, and the typical inapplicability in many value chains of the transactional net margin method, mean that the profit-split method should be clearly recognised within the Guidelines as a practical and frequently applicable approach. Especially if our simplifying approach to establishing concrete allocation keys with specified weightings for common business models were accepted and put into effect, the profit-split method could become a truly viable and often used method that would be appreciated by MNEs and tax authorities alike. We stated the following in our 6 February 2015 "Comments on BEPS Action 10: The Use of Profit Splits in the Context of Global Value Chains":

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’.

In this 2015 submission, we recognized that there must be a trade-off between the fine-tuning of the transfer pricing result in each specific case with simplicity of application. 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.

The expression “value chain” is often a nice way of saying that an MNE has legally fragmented its activities across various countries, typically with tax minimization and profit-shifting being the primary motivator for the specific legal and contractual structure chosen. With this in mind, Part I, Paragraph 85 of the “BEPS Action 8, 9 and 10: Discussion Draft on Revisions to Chapter 1”, stated:

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.

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 and application of one or more of the traditional transaction methods will, due to its inherently subjective nature, only result in a very wide range of possible profit allocations. Transfer pricing practitioners are very aware that this is often the case. The use of simple-to-apply concrete allocation keys and weightings 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.

14. If commentators see a value chain analysis as serving a greater purpose in relation to profit splits, then please provide an explanation for that view together with examples.

Response:

We do absolutely see a greater purpose and role for the profit-split method. Following the submission on 6 February 2015 of our “Comments on BEPS Action 10: The Use of Profit Splits in the Context of Global Value Chains”, one of the authors of those comments went into more detail with specific examples in the article that is attached as an Appendix to this submission. This article, “Expansion of the Profit-Split Method: The Wave of the Future”, dated 30 March 2015, was published in Tax Notes International (77 TI 1183). It is also available at: <http://ssrn.com/abstract=2593548>

15. What further guidance or clarification of existing guidance would be helpful in these sections? Please provide practical examples in support of the response.

Response:

Paragraph 28 appropriately states, in part:

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

This is no doubt true. What is also true, though, is that the analysis described in the second sentence is even more essential for any of the traditional transaction methods and the transactional net margin method.

We of course believe as described herein and in the Appendix that a concrete profit-split method approach should be mandated in the Guidelines for all common business models and that it should be the burden of the MNE to establish that another method is more appropriate. Recognizing that Working Party No. 6 might not choose to go this far, we suggest as a compromise of sorts that the Working Party identify common business models used by MNEs and include in the Guidelines for these models concrete allocation keys and weightings. Then, in any case where one or more tax authorities believe that a taxpayer has not sufficiently presented the above-described analysis that supports an accurate delineation of the transaction and application of the pricing used by the taxpayer, the tax authority could apply the profit-split method using the concrete keys and weightings.

Not including concrete allocation keys and weightings will only encourage MNE to set the allocation keys and weightings to their advantage. To limit arbitrariness, we consider that the Working Party should set specified allocation keys and weightings for a number of common business models, with the burden of proof on the MNE to prove that the use of different allocation keys or weightings would be more appropriate to its business model.

Section C.4.2 discusses issues regarding the determination of profits to be split. We of course agree that various judgment and computational issues will have to be faced in any case where less than the total activities of each of the parties are the subject of the profit split. However, this Section C.4.2 over-exaggerates the difficulties. In today's reality of centrally managed and integrated accounting systems that take into account financial accounting, management accounting (including cost accounting), and statutory/tax accounting, concerns expressed by MNEs about the difficulty of obtaining information from affiliates should be disregarded. MNEs and the applicable tax authorities can discuss and agree on the various judgment issues that will affect the determination of profits to be split (including those described in Section C.4.3). The tenor of Section C.4.2 should be rewritten to change this stress on the difficulties and to direct taxpayers and tax authorities to work together to seek appropriate results.

16. The discussion of profit splitting factors sets a requirement that the factors must be capable of being measured in a reliable and verifiable manner. Do commentators believe that useful ways of splitting profits have been excluded? If so, please describe these factors and explain how they meet the requirement of reliable and verifiable measurement.

Response:

See the simplified concrete factor approach described in the Appendix.

17. What further guidance would be useful in this section relating to identifying and measuring profit splitting factors? Please illustrate your response with examples.

Response:

Paragraph 50 in Section C.4.5.1 comments on intangibles. Paragraph 49 notes that asset-based or capital-based factors can include intangibles.

Intangibles are terribly hard to value; the potential for disputes between taxpayers and tax authorities, and between tax authorities, is high. As such, including the value of intangibles as a possible allocation factor in a centrally managed MNE is simply making the process difficult to implement and a lightning rod for disputes. Also, in practice development, enhancement and exploitation of a firm's know-how takes place as both a continuous and dispersed process, with many contributions from different parts of the business. Attributing value to a specific legal right is just a reification of this process, and facilitates BEPS behaviour.

As an example, 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 (i.e. not including the value of intangibles) 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.

Say that the transferee is an associated enterprise that truly carries on its own activities through its own competent and capable personnel so that the transferor is only minimally involved or even no longer involved (and therefore would not have activities picked up by the applicable concrete allocation keys). In this situation, paragraphs 52 and 53 note the ability to use accumulated expenditures in appropriate cases. As a last resort, so to speak, the country of the transferor is also protected by new Section D.4. in Chapter VI in the event that the original transfer of the intangibles was undervalued.

18. More generally, examples are requested of scenarios where a transactional profit split of actual profits or of anticipated profits are applied, together with a brief explanation as to why the method and the approach to applying the method, is considered to be the most appropriate in the circumstances of the case.

Response:

See the Appendix to this submission.

APPENDIX

Expansion of the Profit Shift Method: The Wave of the Future

Jeffery M. Kadet

Tax Notes International, 77TI1183, 30 March 2015²

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

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

BACKGROUND

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

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

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

² This MS Word version of the article as published in Tax Notes International (TNI) does not include stylistic changes made by the TNI editors.

- The Separate Entity Principle—Internationally, pretty much all countries accept each legal entity as being a separate legal person for tax purposes, independent of its owner(s) and related entities, including those who control it and direct its activities. It doesn't matter whether the country of formation is a major country, an island tax haven, or someplace in between.
- Fragmentation—Similar to an artist who starts with a blank canvas, an MNC's in-house tax personnel and its outside advisors start with a blank sheet of paper. On that sheet of paper, they can create whatever legal entities they choose to create and they can define exactly what functions and activities each entity will conduct, what assets each will own, and what risks each will bear. In so doing, they minimize profits in higher tax countries and maximize profits in low or zero-tax countries. The [*Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines \(including Risk, Recharacterisation, and Special Measures\)*](#) ("DD8-10"), issued 19 December 2014, recognizes this by saying in paragraph 21:

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

DD8-10 goes on to say in paragraph 85:

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

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

- Respect of Related Party Contracts—As a corollary to fragmentation, tax authorities and courts have for the most part fully respected related-party contracts, despite their having been carefully drafted to a large extent to achieve profit shifting goals.
- The Arms' Length Standard ("ALS")—The ALS, which has been for the past few decades the guiding principle in transfer pricing, has required that the pricing between related parties reflect the pricing that would occur between unrelated parties considering the functions, assets, and risks relevant to each group member. By its nature, and despite all the detailed discussion in the 2010 [*OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*](#) ("Guidelines"), transfer pricing analyses under the ALS approach normally only provide highly subjective ranges of acceptable pricing. So, in addition to using fragmentation to shift profits out of higher taxed countries, MNCs will also seek to set pricing within the subjectively-determined ranges that further skew profits into low or zero-tax countries.
- Inability to Effectively Audit MNC Transfer Pricing—The Guidelines require a serious analysis of matters that include (i) the various legal effects of forms of intangible property concerned, (ii) the various commercial and legal effects of any

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

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

THE PROFIT SPLIT METHOD

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

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

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

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

Paragraph 2.135 makes this objective basis clear by stating:

In practice, allocation keys based on assets/capital (operating assets, fixed assets, intangible assets, capital employed) or costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) are often used. Other allocation keys based for instance on incremental sales, headcounts (number of individuals involved in the key functions that generate value to the transaction), time spent by a certain group of employees if there is a strong correlation between the time

spent and the creation of the combined profits, number of servers, data storage, floor area of retail points, etc. may be appropriate depending on the facts and circumstances of the transactions.

Further discussion in the Guidelines provides various approaches to splitting the combined profits amongst the relevant group members. While these approaches need not be detailed here, the point to make is that the approaches set out and discussed required a facts and circumstances case-by-case analysis before they can be implemented.

A SIMPLIFIED APPROACH

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

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

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

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

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

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

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

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

Specifically, we suggest that the Guidelines include clear guidance stating concrete objective allocation keys and relative weightings for all business models now commonly being used. Anticipating the likely emergence of new business models, the Guidelines should also

articulate the principles on which concrete objective allocation keys and weightings should be determined. There would be no facts and circumstances case-by-case analysis.

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

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

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

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

To provide an idea of how this simplified approach would work, the box beginning on page ___ includes examples of allocation keys and weightings for two business models.

EXAMPLES OF ALLOCATION KEYS AND WEIGHTINGS FOR TWO COMMON BUSINESS MODELS

Example 1

This example is taken from DD10's Scenario 2.

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

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

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

Simplified Allocation Keys

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

- Users

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

- Operating Expenses

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

This key would include categories of expenses such as:

Salaries and bonuses of all operations personnel (allocated by location of personnel)

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

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

Example 2

This example is taken from DD10's Scenario 3.

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

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

Simplified Allocation Keys

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

- Sales (weighted at 25%)

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

- Marketing and Distribution Expenses (weighted at 25%)

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

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

Advertising expenses (allocated by market that advertising targets)

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

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

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

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

This key would include categories of expenses such as:

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

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

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

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

Note that neither risks nor intangibles (e.g. patents, manufacturing processes, trade names, knowledge of market channels, etc.) are directly included. Consistent with the guidance in the Guidelines regarding objective allocation keys and given the integrated nature of the

associated companies' businesses and the fact that both parties are contributing their own unique and valuable intangibles, it is both appropriate and simpler to ignore these risks and intangibles as separate allocation keys. Both are, however, indirectly included through the other factors. For example, to the extent that risks and intangibles are related to manufacturing that is solely conducted in the home country or elsewhere outside the source country, then the higher-weighted allocation key (50%) for all expenses other than those for marketing and distribution will reflect them. Such expenses include on-going R&D, the bulk of which will be in country P. As for marketing risks and marketing intangibles, the marketing and distribution expenses factor will similarly reflect them. For example, if relatively higher paid marketing executives in country P make sales and credit decisions regarding buyers, then relatively more profit will be allocated to Company P and relatively less to Company S, thereby reflecting the risk that is being managed from Company P. On the other hand, if sales personnel in Company S are performing important functions such that they are paid bonuses based on their productivity, then the value they add will be reflected in their bonuses with relatively more profit allocated to Company S.

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

Expansion of the Profit-Split Method: The Wave of the Future

by Jeffery M. Kadet

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VIEWPOINT

Expansion of the Profit-Split Method: The Wave of the Future

by Jeffery M. Kadet

Jeffery M. Kadet was in private practice for more than 32 years, working in international taxation for several major international accounting firms. He now teaches international tax courses in the LLM program at the University of Washington School of Law in Seattle.

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Recognizing the reality that multinational corporations are centrally managed and not groups of entities that operate independently of one another, the OECD base erosion and profit-shifting project is considering expanded use of the profit-split method. This article provides background on why expanded use of the profit-split method is sorely needed. In particular, resource-constrained tax authorities in many countries are unable to administer or intelligently analyze and contest transfer pricing results presented by multinational groups. Most importantly, this article suggests a simplified profit-split approach using set concrete and objective allocation keys for commonly used business models that should be welcomed by multinational groups and tax authorities alike.

December 2014 saw the OECD issuing several base erosion and profit-shifting discussion drafts, one of which was titled “BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains” (DD10). Issued on December 16, DD10 is a response to both BEPS concerns about value chain planning articulated in action 10 of the 2013 BEPS action plan and transfer pricing issues raised in “Addressing the Tax Challenges of the Digital Economy,” issued on September 16, 2014, in connection with action 1 of the BEPS action plan. As a discussion draft, DD10 is not a final document and only invites responses about how current transfer pricing

guidance might be amended. The guiding principle of DD10 is how the profit-split method can achieve the G-20 mandate, which states, “Profits should be taxed where economic activities deriving the profits are performed and where value is created.”

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

Background

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

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

To provide more background, a combination of factors has strongly motivated the highly successful tax structures that have significantly lowered the effective tax rates of multinational corporations (MNCs) and eroded the tax bases of many countries. The existence

of these factors means that some of the transfer pricing methods are a part of the problem; they are not a part of a solution. These factors include:

- *The Separate Entity Principle:* Internationally, almost all countries accept each legal entity as being a separate legal person for tax purposes, independent of its owner(s) and related entities, including those who control it and direct its activities. It doesn't matter whether the country of formation is a major G-20 country, an island tax haven, or someplace in between.
- *Fragmentation:* Similar to an artist who starts with a blank canvas, an MNC's in-house tax personnel and its outside advisers start with a blank slate. On it they can create whatever legal entities they choose and define exactly what functions and activities each entity will conduct, what assets each will own, and what risks each will bear. In so doing, they minimize profits in higher-tax countries and maximize profits in low- or zero-tax countries. The "Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures)" (DD8-10), issued December 19, 2014, recognizes this by saying in paragraph 21:

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

DD8-10 goes on to say in paragraph 85:

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

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

- *Respect of Related-Party Contracts:* As a corollary to fragmentation, tax authorities and courts have for the most part fully respected related-party con-

tracts, despite their having been carefully drafted to achieve profit-shifting goals.

- *The Arm's-Length Standard:* The arm's-length standard, which has for the past few decades been the guiding principle in transfer pricing, has required that the pricing between related parties reflect the pricing that would occur between unrelated parties considering the functions, assets, and risks relevant to each group member. By its nature, and despite all the detailed discussion in the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, transfer pricing analyses under the arm's-length standard approach normally only provide highly subjective ranges of acceptable pricing. So, in addition to using fragmentation to shift profits out of higher taxed countries, MNCs will also seek to set pricing within the subjectively determined ranges that further skew profits into low- or zero-tax countries.
- *Inability to Effectively Audit MNC Transfer Pricing:* The guidelines require a serious analysis of matters that include (i) the various legal effects of forms of intangible property concerned, (ii) the various commercial and legal effects of any contractual terms concerning those intangibles, and (iii) the functions performed, assets owned, and risks 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 job it is to understand and protect the MNC's interests. Most MNCs also engage outside counsel, tax advisers, economic analysts, and other specialists as well. On the other hand, the tax authorities of most (if not all) countries have neither the sophisticated specialists nor the budgetary resources to truly conduct the work necessary to critically review the integrated and complex structures of most MNCs. This is particularly true for developing countries. Note that recent reporting has indicated that even the U.S. 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.
- *What the Capital Markets Value:* Capital markets reward successful reductions in an MNC's effective tax rate through higher share prices.
- *Personal Motivation and Greed:* The management teams of MNCs are highly motivated to minimize effective tax rates because of equity-based compensation based wholly or partly on share price.

The Profit-Split Method

Expanded use of the profit-split method would counteract and seriously discourage the profit shifting that has been so prevalent and successful, and which is

so dependent on the separate entity principle. What is the profit-split method, and why would it discourage BEPS behavior?

Paragraph 2.108 of the OECD transfer pricing guidelines gives a concise statement of what the profit-split method is. It states:

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

Additional guidance in the existing guidelines (paragraphs 2.132ff) makes clear that the criteria or allocation keys on which the combined profits are split should be “independent of transfer pricing policy formulation.” Hence, these criteria and allocation keys “should be based on objective data (e.g. sales to independent parties), not on data relating to the remuneration of controlled transactions (e.g. sales to associated enterprises).” Paragraph 2.135 makes this objective basis clear by stating:

In practice, allocation keys based on assets/capital (operating assets, fixed assets, intangible assets, capital employed) or costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) are often used. Other allocation keys based for instance on incremental sales, headcounts (number of individuals involved in the key functions that generate value to the transaction), time spent by a certain group of employees if there is a strong correlation between the time spent and the creation of the combined profits, number of servers, data storage, floor area of retail points, etc. may be appropriate depending on the facts and circumstances of the transactions.

Further discussion in the guidelines provides various approaches to splitting the combined profits among the relevant group members. While these approaches are not detailed here, the point is that the approaches that were set out and discussed require a facts and circumstances case-by-case analysis before they can be implemented.

A Simplified Approach

The guidelines require a facts and circumstances case-by-case analysis for determining the most appro-

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

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

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

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

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

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

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

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

Specifically, the guidelines should include clear guidance stating concrete objective allocation keys and relative weightings for all business models now commonly being used. Anticipating the likely emergence of new business models, the guidelines should also articulate the principles on which concrete objective allocation

keys and weightings should be determined. There would be no facts and circumstances case-by-case analysis.

Such a simple, clear approach would be easy to administer, and could greatly reduce conflicts between tax authorities and companies, and among different tax authorities. They would make an enormous step toward achieving the goal set by the G-20 that “Profits should be taxed where economic activities deriving the profits are performed and where value is created.” An obvious question is whether such a simplified allocation approach would achieve reasonable results that governments and taxpayers can be comfortable with. I strongly believe the answer to this is “yes.”

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

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

To provide an idea of how this simplified approach would work, the appendix includes examples of allocation keys and weightings for two business models.

Examples: Two Common Business Models

Example 1

This example is taken from DD10's Scenario 2:

The RCo Group provides a number of internet services (for example, search engines, email services, and advertising) to customers worldwide. On one side of the business model, advertising services provided through an online platform are charged to clients for a fee that is generally based on the number of users who click on each advertisement. On the other side, online services are offered free of charge to users, whose use of the

services provides the RCo Group with a substantial amount of data, including location-based data, data based on online behavior, and data based on users' personal information. Over the course of years of data collection, refinement, processing, and analysis, the RCo Group has developed a sophisticated technology that enables it to offer to its clients the ability to target specific advertisements to users. The more extensive the online services, and the greater the extent of the associated data, the more valuable and attractive the other side of the business model becomes for clients wishing to advertise.

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

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

Simplified Allocation Keys

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

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

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, and so forth 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 be excluded.

Example 2

This example is taken from DD10's Scenario 3:

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

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

Simplified Allocation Keys

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

- *Sales (weighted at 25 percent).* The inclusion of sales as one of the allocation keys reflects the importance of each market and its customers to the global business of companies P and S. The country of sale should be determined by the location of the customer and not the legal terms of the sales contract. (See further comment below concerning this sales allocation key.)
- *Marketing and Distribution Expenses (weighted at 25 percent).* Total marketing and distribution expenses make an excellent allocation key that reflects the amount of resources 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 the 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, or after-sales service and support activities. These payments economically include all personnel costs, office and warehouse costs, and so forth of the legal entity performing the marketing or distribution functions for the taxpayer. Payments to any related parties whose profits are included in the combined profits for the profit split would be excluded.
- *Expenses Other Than Marketing and Distribution Expenses (weighted at 50 percent).* 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, and so forth.

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 concerning 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 in which 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, and so forth 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 be excluded.

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

Note that neither risks nor intangibles (for example, patents, manufacturing processes, trade names, and knowledge of market channels) are directly included. Consistent with the guidance in the guidelines regarding objective allocation keys, and given the integrated

nature of the associated companies' businesses and the fact that both parties are contributing their own unique and valuable intangibles, it is both appropriate and simpler to ignore these risks and intangibles as separate allocation keys. Both are, however, indirectly included through the other factors. For example, to the extent that risks and intangibles are for manufacturing that is solely conducted in the home country or elsewhere outside the source country, then the higher-weighted allocation key (50 percent) 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. However, if sales personnel in Company S are performing important functions such that they are paid bonuses based on their productivity, then the value they add will be reflected in their bonuses with relatively more profit allocated to Company S.

Finally, an alternative approach would be to eliminate the "sales" allocation key and then equally weight the remaining two keys. This would leave the "sales" key to be used only when there has been a meaningful creation of value because of 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. ♦

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September 5, 2016

Ref: DISCUSSION DRAFT: BEPS ACTIONS 8-10 – “REVISED GUIDANCE ON PROFIT SPLITS”

Dear Jefferson,

Thank you for the opportunity to comment on the Discussion Draft: BEPS Actions 8-10 – *Revised Guidance on Profit Splits* (Discussion Draft) issued on 4 July 2016. We acknowledge and thank the OECD for the time and effort put into this draft.

Overall, BIAC thinks the Discussion Draft is directionally sensible and we greatly welcomed the acknowledgements throughout that profit splits should only be used in those limited circumstances where the actual transaction under consideration is one that would be subject to a similar methodology when negotiating with unrelated parties. However, we did feel that the guidance in the Discussion Draft was somewhat undeveloped and lacked the detail necessary to avoid disputes arising in a number of key areas, in particular with respect to when exactly the various types of profit split should be used. If the guidance is not sufficiently clear and objective, and to the extent that profit splits become more common, there is a significant risk that users of the guidance could reach substantially different conclusions. This will not only impact taxpayer-tax authority relationships, but also relationships between tax authorities themselves through difficult MAP conversations.

BIAC notes that the original profit split guidance was the result of many years of hard work and, while we do acknowledge that changes are required, we must be careful to ensure that those changes are delivered with due consideration of the practical implications of these changes, therefore we urge the OECD to further develop this guidance, providing greater detail and more examples, so that it can be applied consistently.

As BIAC has noted previously, the arm's length principle (ALP), properly applied by both taxpayers and governments, still offers the best prospect of classifying transactions according to “real-world” economics, and equitably and consensually dividing income between countries based on economic activity. If this is not clearly articulated, and practical supporting guidance is not provided, then we are concerned that we will see an acceleration in a worrying trend (already apparent in the transfer pricing audit practices of 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.

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

Sincerely,



Will Morris, Chair
BIAC Tax Committee

General Comments

1. BIAC believes that the ‘most appropriate method’ approach, under the ALP should be preserved, and that the profit split should not be automatically applied in situations where one-sided methods can provide a reliable result. We therefore very much support the assertion in paragraph 18 that “lack of comparables alone is insufficient to warrant the use of a transactional profit split of actual profits under the arm’s length principle”. The wording however could be more explicit in making the point that profit split methodologies should not replace the Transactional Net Margin Method (TNMM) even where (for example) comparables for operating profit data (or other relevant profit level indicators) are hard to come by.
2. The OECD 2010 Transfer Pricing Guidelines (TPG) make clear that “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” (Chapter 3, A4, 3.39) and that “[a] transactional profit split method might in appropriate circumstances be considered without comparable data”. Accordingly, we consider that the word “alone” should be struck from paragraph 18 to remain consistent with the overarching principles of the TPG.
3. For completeness, we would also consider it useful if the OECD could provide additional guidance explaining what should be done when it is not appropriate to apply profit split methodologies, otherwise, there is a risk that none of the OECD endorsed transfer pricing methods are seen as appropriate for some transactions. This additional guidance could reference paragraph 3.38 of the TPG, to make the point that pragmatic solutions are needed in order to apply comparable data.
4. The Discussion Draft makes the point that in all transactions, especially in global value chains, but also between unrelated parties, there are global profits, which each contributor to the chain will earn a part of. Any business negotiation is effectively two or more parties deciding how to split their combined share of the whole chain’s profits. However, the parties will have different bargaining power, different options available to them, and generally would not be dealing with all of the parties in a value chain; just those either side of it. That said, sometimes third parties do engage in “profit split” pricing. In such scenarios, they will generally only be sharing the profits that relate to their own leg of the transaction, plus the profits of those either side of them in the chain, who may themselves have limitations on the levels of remuneration that they can agree with the other parties they engage with.
5. Accordingly, we agree that pricing negotiations between parties will typically take into account the profits each expects to derive from the transaction (paragraph 7), but this does not necessarily mean that a “profit split” methodology is appropriate. In reality, arm’s length parties do not ordinarily have explicit knowledge of the other party’s profitability.
6. The Discussion Draft presents a global profit split approach (whereby all profits or losses are divided between the relevant parties). However, BIAC believes that the splitting of residual profits (or losses) represents a more appropriate framework in most cases. This latter

method takes into account one-sided methods to price routine or ‘benchmarkable’ transactions before residual profit or losses are split between unique contributions. Further, it ensures that those entities performing routine functions with no (or limited) risk management capacity are not able to share in profits with to which they have no economically justifiable entitlement (or, conversely, subjected to sharing in any losses over which they have no control). We would welcome reinforcement of this point in the final draft.

7. Although we recognise that the diversity of the non-financial sector renders the exercise more complex, BIAC would welcome similar industry-specific context, as was included in the profit attribution papers the OECD has issued for financial institutions. That would clearly draw the line between the concepts of residual profit split, gross profit splits and formulary apportionment. Although we note that these papers are intended to be used in an Article 7 rather than an Article 9 context, they provide extremely useful context on how value is generated in different financial services sectors.
8. Although we understand that there is not a model answer to transfer pricing problems, as each situation is unique and solutions must be tailor made, we were hoping that there would be some directional quantified examples in the draft guidance. We ask that some numerical examples are included in the next draft. Such examples should include an explanation on how the gross and actual profits should be split, taking into account, for example, how Selling, General and Administrative Expenses should be apportioned in the calculation.

Actual versus anticipated profits

9. The Discussion Draft implies that the splitting of actual profits should be a preferred method to splitting anticipated profits in situations where both parties to the profit split are sharing the significant risks. However, an *ex post* approach of splitting actual profits would not generally be considered consistent with the ALP. Additional guidance would be appreciated in respect of this point as, in some cases, splitting actual profits will be too complex to be practicable. For instance, in cases where there is a sale of IT infrastructure, but also an ongoing relationship (such as related licenses) the actual splitting of profits is extremely difficult.
10. Further, the draft does not make it clear if, and in which circumstances, a different approach should apply to “one-time” vs. “recurring transactions”. For example, the new Chapter VI makes clear a distinction between “transfers of intangibles or rights in intangibles” and “transactions involving the use of intangibles in connection with sales of goods or performance of services”. If profits are accrued on an ongoing basis, BIAC cannot see how it could be justified to split anticipated profits, as calculated in advance of the transaction, without any adjusting mechanisms.
11. Additional clarity and guidance on the availability of a method to split profits on an ongoing basis would be welcomed. This will be particularly necessary in cases where the parties to a split have different accounting periods.

12. The draft should include a clear statement that the split of actual profits can be implemented via “self-adjusting” mechanisms. In other words, if the pre-set parameters imply the use of actual results to set the prices of the next period in such a way that, on a rolling basis, they ensure a reasonably precise split of actual profits over a certain period of time, these should be respected. This is likely to represent an arm’s length approach, arguably more so than retroactive adjustments.

Valuation techniques

13. Valuation techniques are underexplored in the draft guidance.
14. Unique and valuable contributions need to be addressed more thoroughly in the guidance as this is an area of significant uncertainty and dispute. It should be clarified in which circumstances valuation techniques should be used and how they should be applied (note point below re examples in Annexes II and III).

Profits and losses

15. It's important to reiterate that "reference to profits should be taken as applying equally to losses" as stated in paragraph 1 of the Discussion Draft. The inconsistent selection of transfer pricing methods should be strictly refrained from. An example of such practice is, with regard to Multinational Enterprises’ (MNE) controlled transactions, applying the profit split methodology 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.
16. Experiences during the financial crisis, where institutions that had previously been profitable began to make losses, demonstrated that there can be odd results using *ex ante* agreed methodologies developed during profitable periods. More clear guidance on how to deal with such situations would be welcomed.
17. An arm’s length approach may involve consideration as to why actual profit varied from anticipated profits, and if necessary, consequential renegotiation of the arrangement; consistency with the ALP would entail contemporaneous decision making and ideally forward looking adjustments.
18. Although the method should be the same with respect to profits and losses, the allocation factor with respect to each may be different, especially if the control over different types of risk are different or where the risks embedded in the assets contributed are significantly different.
19. An example of the point above is in the following real world situation in a liquefied natural gas (LNG) business. In the scenario, the gas provider is required to share additional profits on its sales to the ultimate customer when the cargoes of the LNG trader are not delivered to the anticipated harbour, but at another to realise a higher profit. The gas provider has no control on the sale but wants to benefit from the extra profit realised by the LNG trader.
20. Another example is that of the sale of complex assets (i.e. those that are distressed or have a limited market). A third party intermediary would not accept terms that could result in them

sharing in any losses in such circumstances. They would, however, accept terms resulting in receipt of a percentage of the profit realised above a pre-defined threshold. In situations analogous to this, it would therefore not be sensible to split all profits and losses, but just those profits above a pre-defined threshold level.

21. The guidance ought to include an explanation of potential different profit and loss allocations, and some indication of when each type ought to be used.

Annexes II and III to Chapter II

22. The draft does not confirm whether or not the “Example to Illustrate the Application of the Residual Profit Split Method” (Annex II to Chapter II) will be kept within the TPG. If this example is retained, it should be adapted to align with the language of this guidance; in particular, with regards to the selection and method of risk, as these are not a factors in the current example. BIAC would also appreciate, if the example is retained, it being expanded to provide details of i. how the rewards of risk could be factored into the model; ii. how a split of actual profits would differ from a split of anticipated profits (including an example of a split of actual profits based on “self-adjusting” mechanisms rather than retroactive adjustments); and iii. how valuation techniques should be used within a profit split calculation.
23. The draft is also silent on whether or not Annex III to Chapter II (“Illustration of Different Measures of Profits When Applying a Transactional Profit Split Method”) will be kept within the TPG. This annex is just an example of mechanics, but BIAC requests that, if it is deleted, the OECD provides an explanation as to why this has been done in order to prevent misinterpretation.

Specific Questions

C. Transactional profit split method

1. Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular:

1.1. Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear?

- BIAC understands that an anticipated profit split refers to a joint project where forecasts of the anticipated profits from the project of both parties are used as a means of determining a non-actual profit based compensation for one party on a basis and level which (based on the anticipated profits) is expected to provide both parties with an acceptable project return. An example would be where this methodology is used to arrive at a royalty rate or an agreed schedule of fees for future services. This would mean that the split is not based on actual profits (other than, potentially, some residual profits as agreed *ex ante*).
- However, while we agree that risk sharing should be a necessary precondition to the use of the transactional profit split method, sharing of risk alone is not sufficient to justify its application.

The existence of risk does not 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 BIAC'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.

- In particular, we do not believe the Discussion Draft clearly articulates how the anticipatory profit split differs from a conventional CUP royalty analysis. At arm's length, when the parties seem to be applying a transactional profit split of anticipated profits (by determining a royalty rate for one of the parties to the transaction) there are often adjustment clauses based on performance or milestone payments that bring the transactional profit split of anticipated profits closer to a transactional profit split of actual profits.
- Additional clarity would therefore be welcome in respect of the definition of the anticipated profit split mechanism. However, we would caution against any attempt to include a prescriptive form of allocation keys with particular weightings as the appropriateness of these weightings would vary significantly across different industries and business models.

1.2. Is the distinction between the two profit split approaches described useful?

- It is clear from the draft that either *anticipated profits* or *actual profits* can be split, based on *ex ante* information.
- Although the Discussion Draft notes that the facts of the case should guide the choice of which method to apply, it would be helpful for the draft to provide for situations where the most appropriate method would be for certain routine profits to be compensated in one way with only residual amounts being subject to either type of profit split.
- In addition, and as noted above, we would welcome more guidance on the role and importance of risk as a prerequisite rather than a determining factor.

2. Comments are also invited on the link between integration of business activities (and thus the sharing of risks) and the appropriate application of a transactional profit split of actual profits.

- It is clear that the integration of some parts of a business does not necessitate the use of a profit splitting method; all MNEs will share some top-level strategic management and therefore could, under the broadest interpretation of the term, be considered to be "integrated". The examples correctly assume that decision-making in complex MNEs is divided and fragmented across different entities and therefore, even in those instances where there may be factors that justify the use of the profit split method in respect of some parts of the businesses, the method should not be extended to apply beyond those parts.
- This is a complex area and, in unrelated party transactions, the integration of activities is not always a proxy for whether a profit split type mechanism should be used to share returns.
- For example, where a large MNE in the consumer goods sector engages with two separate third parties to distribute its branded products in different markets, it may engage on different terms. The MNE could charge a distributor in one region a large fixed royalty that takes the lion's share

of the profit. In such a scenario the MNE would always make a positive return (as long as there are sales in the region). The MNE could simultaneously agree with a different third party distributor in a different region that they will split the actual profit, negotiating the mechanism so that they each get half of the residual profit (or bear half of the residual loss).

- In the above two instances, the difference in outcome is likely to be due to the relative bargaining power of the parties.
- The guidance should recognise that in related party situations there will not ever be a truly definitive comparable; it will always be necessary to assume a certain bargaining power relationship between two related parties, in order to reach a conclusion on whether the profit split method is appropriate or not.
- One example where arm's length parties may agree to split actual profits is joint venture (JV) arrangements. JV parties often bring different assets or expertise/function to an arrangement, but choose to share risks and profits in accordance with agreed mechanisms. Once again, however, it should be recognised that the prospect of identifying an appropriate comparable is limited, and providing guidance in this area would likely be too broad to be of use.
- Therefore it is not simply a case of defining a certain threshold of integration above which a transactional profit split mechanism would be applied.

3. Examples of scenarios where each approach to splitting profits would be the most appropriate (together with a brief explanation as to why) are also requested.

- A profit split based on anticipated profits is more likely to be applicable in circumstances where there is a joint project¹, but one in which the contribution of the parties to the project are either sequentially or otherwise separable –in particular, with respect to cost aspects. The nature of the arrangement thus gives one party compensation determined *ex ante* based on anticipated profit assumptions, and the other a residue based on actual profits and a deduction for this expense. For example, if the compensation is in the form of a royalty, then this results in risks of errors in revenue projections being shared between the parties but each party bearing its own risk of errors in its cost assumptions. This form of agreement might for example arise where there is a staged development and exploitation of an intangible as set out in paragraph 4 of the Discussion Draft.
- At a simpler level the nature of a franchise agreement is essentially a modified form of an anticipated profit split (i.e. for a particular franchise project the franchisor receives a revenue based franchise fee and bears its own costs/risks with respect to the business format and broader brand franchised, while the franchisee retains the remaining revenues and bears its own costs/risks of the business operating under franchise). The reason we refer to this as a modified form of anticipated profit split is because, in direct terms, only the anticipated profits of the franchisee are considered –but the required rate of franchise fee will reflect both marginal cost assumptions and required rates of contribution to profit.

¹ For example, where a joint enterprise includes continuing shared risk and control aspects with respect to both revenues and costs.

C.2 Summary of strengths and weaknesses

4. Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarised?

- BIAC generally agrees with the summary of strengths and weaknesses outlined in the Discussion Draft. We welcome the OECD's recognition at paragraph 14 that "a weakness of the transactional profit split method relates to difficulties in its application". However, we believe that the Discussion Draft does not go into sufficient detail on the practical difficulties of profit splits. For example, there are complexities in identifying the profits (or losses) that need to be split, systems issues, and management of the broader tax implications of adjustments to profit splits (especially in cases where they interact with indirect taxes and WHT), which are not fully acknowledged.
- Companies do not generally keep financial records that track the relevant transactions. Therefore, these records will need to be created on a case-by-case basis and it is likely that the creating the records for one year will not necessarily provide a framework for subsequent years. Creating financial information separate and different from the taxpayer's normal operating financial reporting will require subjective judgments with respect to cost allocation and segmentation issues, leading to higher risk for controversy and double taxation.
- It is not clear what the "benchmarked profit" in paragraph 13 of the Discussion Draft is referring to. If this refers to one-sided testing based on comparables, then transfer pricing methods based on benchmarked profits will, in fact, be the most appropriate method in the majority of cases. Most companies in a MNE do not earn premium returns and the routine profit attributable to those activities can, in fact, be "benchmarked".
- Additionally, the generic comments made in paragraphs 12 to 14 in respect of the anticipated profit split mechanism are very broad and we would welcome further clarification. Forms of an anticipated profit split mechanism are used in both related and unrelated party transactions; as noted above, the use of a royalty rate or a franchise fee are types of anticipated profit splitting. Given anticipated profit splits cover a wide variety of transactions, and accordingly we do not consider that the factors set out in paragraphs 12 and 14 are relevant for all cases.

5. Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses? If so, what are they?

- The relative strengths and weaknesses of each method will depend on the context in which they are being considered and the circumstances to which they are supposed to apply. The anticipated profit split methodology has a broader analytical role in support of other methods (as discussed above), rather than just as a primary method of apportioning taxable profit in a given case.
- However, it should be noted that in the profit split of anticipated profits, the use of valuation techniques will introduce additional uncertainties driven by various factors (e.g. growth rates, discount rates, useful life, and the reliability of these forecasts), as described in section 2.6.4 of

Chapter VI. This will make the set-up of the methodology more difficult for taxpayers, the audit activity more difficult for tax authorities and the outcome of tax audits more uncertain. The weakness of the methodology (and its usefulness an inherent uncertainty in this regard) should not be underestimated.

- We therefore believe that the anticipated profits split mechanism may be most useful when there is a single contributing factor that is not expected to be volatile, which can be isolated and valued.
- We also note that unrelated parties often incorporate performance clauses that allow them to align actual performance with anticipated performance – there is a truing up at year-end. This also can be and is done in related-party transactions.

C.3 Most appropriate method

6. The Discussion Draft introduces the sharing of economically significant risks as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method.

6.1. Do commentators have any suggestions for clarifying the notion of risk sharing in this context?

- BIAC agrees with paragraphs 16 and 18 that lack of comparables is not a valid basis for selecting the transactional profit split method, but rather significant business integration as described in section C.3.1 and unique and valuable intangibles as discussed in C.3.2 are required.
- However, although "sharing of economically significant risks" may be a factor indicating that a profit split of actual profits may be the most appropriate method, we suggest that "sharing of a control function with regard to economically significant risks" may better define situations where profit splitting is the most appropriate method.
- Constituent entities of a MNE group share business outcomes to some degree, but sharing business outcomes does not always mean sharing economically significant risks. Our concern is that tax authorities will first look at business outcomes and then determine that there is sharing of economically significant risks, without looking at how that risk is managed.
- Further, the draft introduces new wording on "risk-weighting" to paragraph 51. It is unclear whether and how, in addition to risk being a factor for choosing to split profits, risk should be a factor in determining the split itself.
- Finally, we believe it would be helpful to take into account which party bears the *ex ante* "common risk". For example, where companies A and B engage in a project where the risks are sequential, and where A engages in R&D, and B engages in marketing. If the product is successfully marketed during year 1., but in year 2 another company enters the marketplace with a competing product leading to a decline of combined profit of A and B, it is unclear which party should be responsible for the decline of profit, nor how the the relative exposure should be evaluated if the risk should be shared in such a scenario.

6.2. Do commentators find the draft helps to clarify the circumstances where the transactional profit split method is the most appropriate method? Please provide explanations and/or examples supporting your views.

- JVs are an example where unrelated parties may be performing different functions and separately managing different risks of the business, but share actual profits. E.g. in iron ore mining, one party would typically hold the tenement but no mining expertise so they form a JV with a party that can provide the mining expertise and together, the tenement can be developed and the value extracted.

7. The Discussion Draft notes that a transactional profit split of anticipated profits can be used in conjunction with certain valuation techniques. Examples showing the application of a transactional profit split of anticipated profits are sought.

- We believe that such an approach is appropriate in circumstances where an existing business format or brand is to serve as the platform for modification or further development to meet the needs of a new market, or to help fill a gap in that market. Anticipated profits of the developer can be used in conjunction with valuations of the platform IP arrived at using Chapter VI methods, to determine a suitable development royalty or alternative compensation to be paid by the developer to the owner of the platform IP.

C.3.1 Highly integrated operations

8. Is the distinction between parallel and sequential integration of business operations a useful refinement in determining when the transactional profit split method is likely to be the most appropriate method?

- There is a long paragraph on highly integrated operations, which distinguishes between sequential integration within a value chain (for which there should be comparables available for each function) and parallel integration, where parties are contributing value into the chain at the same stage (e.g. intangibles).
- The distinction between ‘parallel integration’ and ‘sequential integration’ is a useful distinction in our view, because it helps explain when the profit split methodology could be the most appropriate method (and importantly when it is not the most appropriate method).
- There should not however be a presumption that parallel integration should necessarily require the profit split method where sequential integration should not; the focus should always be on the analysis of specific facts and circumstances of the case. Business operations are complex and interlinked and will not necessarily fall neatly into a category of purely “parallel” or “sequential” integration models.
- This paragraph appears to conflict with statements made in paragraph 18, where it is made quite clear that a lack of comparables should not be the sole factor in determining the most appropriate methodology.

9. If so, how should the concept of parallel integration be further defined?

- We believe that the Discussion Draft would benefit from direct consideration of **when** value is generated in relation to each economically significant function, asset or risk. It may be that two functions generate value at the same stage of the value chain but at different times and this should inform their entitlement to anticipated or actual profit.
- For example, an allocation of anticipated profit to a product development function that provides a design would be most appropriate where the effectiveness of other functions in manufacturing and selling the product will drive actual profits. It is where the product development function supports the product through its lifetime (e.g. proposing ongoing refinements in response to customer demands) that an allocation of actual profit seems more reasonable.
- If there was a reasonable basis for splitting anticipated profits, there must be substance behind its replacement by actual profits. Substance implies economically significant functions performed or risks addressed through the period to the ultimate outcome.
- As noted above, we are concerned that relying too rigidly on the parallel integration concept is unhelpful, as in reality business models can incorporate features of both parallel and vertical integration, and even with parallel integration, the risks may differ, for example, were the parties bring separate component IP into the supply chain.

C.3.2 Unique and valuable contributions

10. Comments are invited on the relationship between the making of unique and valuable contributions by both (all) parties to a transaction, and the sharing of economically significant risks.

- The paper suggests, quite sensibly, that unique contributions are a key source of economic advantage and therefore significant risks are more likely to be shared (and therefore that profit split methods will apply.)
- The guidance should specifically state that only those profits, in excess of profits made from routine functions, should be subject to profit splitting. As noted above, the relative negotiating powers of the parties will drive an agreement outcome and it would be very difficult to determine protocols by which a transfer pricing analysis could determine what that negotiated agreement might look like.
- Additional detail in this area would be very useful, but the guidance must also incorporate an appropriate amount of flexibility; a formula for profit splitting which is too prescriptive is unlikely to be economically justifiable in a the broad range of circumstances to which it could apply. In its current form, the guidance in this area creates a great deal of uncertainty for taxpayers and tax authorities, as it is neither detailed enough to be easily applied nor flexible enough to be appropriately interpreted.
- Additionally, it is important not to confuse “making of unique and valuable contributions by both parties to a transaction” with making of unique and valuable contributions by both the parties at different stages of the value chain. For example, intangibles at the manufacturing and marketing stages of a supply chain are distinct and, in a scenario where different parties contributed an

intangible at each stage, there is not necessarily the same integration of risks that would indicate that the profit split methodology could be appropriate.

11. Are there situations where all the parties make unique and valuable contributions to a transaction, but they do not share the economically significant risks associated with the outcomes of that transaction? If so, what guidance on the appropriate use of profit splits in such a situation should be provided?

- The mere presence of intangibles does not indicate that the transactional profit split method is necessarily the most appropriate method as intangibles can often be addressed more reliably by other methods. Examples include the CUP method for trademarks, and the resale price method for technology where external evidence exists. The key factors in determining whether the transactional profit split method is the most appropriate method are the level of integration among the related parties, joint management of the unique and valuable contributions, and sharing of the economically significant risks.
- Certain phrases in paragraphs 6 and 10 of the Discussion Draft could also lead to the actual profit split methodology being applied too widely, meaning that these paragraphs could be seen as inconsistent with the rest of the Discussion Draft. In particular, the Discussion Draft states that “It would be contrary ... 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.” However in financial market transactions a company can trade or transfer risk – therefore one can bear the consequences of a risk but not control that risk. For example, insurance and CDS providers bear risk that they do not control. It is recommended to re-word this paragraph to account for separation of risk and control under appropriate circumstances, as would happen in third party financial transactions.
- For example, assume that manufacturer Company P in Country X sells its intangible-embedded products to subsidiary Company S that performs routine function as a distributor in Country Y. Although the tax authority of Country Y may argue that Company S owns unique and valuable marketing intangibles, Companies P and S may not share a control function with regard to economically significant risks.

C.3.3 Group synergies

12. The Final BEPS Report on Actions 8-10 noted that group synergies were to be addressed in the guidance on profit splits. The approach taken in this Discussion Draft is to make reference to the incremental or marginal system profits arising from the group synergy, which would then be shared amongst the relevant associated enterprises. The analytical framework suggested in the draft, based on an accurate delineation of the actual transaction, would not support the combining and splitting of total system profits on the basis of group synergies alone. Comments on this point are invited.

- BIAC agrees with the approach taken in the Discussion Draft that group synergies alone would not support the combining and splitting of “total system profits.” However, we are concerned

with the use of the phrase “total system profits” since that seems to be a reference to a global profit split. Applying a transactional profit split method wherever there are synergies would likely result in the transactional profit split method becoming the default method, which we believe is inconsistent with the TPG as a whole.

- Group synergies may arise without the degree of integration necessary to consider using a profit split methodology. For example, functional efficiencies of scale can be exploited via the sharing of back office functions, but does constitute an incidence where economically significant risks are jointly controlled and shared.
- An example illustrating allocation of relevant synergies would be helpful.

C.3.4 Value chain analyses

13. Does this section properly describe a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit split method is appropriate?

- BIAC believes that a value chain analysis may be a useful tool for all pricing methods and may be helpful in the identification of profit split factors. As the transactional profit split method does not rely primarily on external evidence, it is important that the method be grounded in the industry and market factors that determine financial success or failure. Typically, these success factors (value drivers) will differ by industry and market. Therefore, a value chain analysis can be effective in identifying the specific candidate factors that determine success and therefore are candidate measures to attribute profit under all pricing methods.
- Additionally, it is important to note that for many businesses the value chain is split among several parties, multiplying the complexity of the analysis. The delineation of costs and profits in the P&L of multiple entities (and conversion to the same accounting principles) would need to be accompanied by a methodology for determining the respective importance of each party and would be extremely complex. For this reason, it must be emphasised that, in most cases, if a profit split is used it should concern residual profits only and be limited to cases with a small number of parties.
- A statement could be added to the effect that the value chain analysis should focus only on those elements which are important for analysing the specific transaction under consideration as an approach which is too broad would be very burdensome and potentially misleading.

14. If commentators see a value chain analysis as serving a greater purpose in relation to profit splits, then please provide an explanation for that view together with examples.

- As noted in our response to question 9 above, the analysis should take into account **when** value is generated in relation to each economically significant function, asset, or risk. This can help to determine whether an allocation of actual or anticipated profits is most reasonable.

C.4 Guidance for application

15. What further guidance or clarification of existing guidance would be helpful in these sections? Please provide practical examples in support of the response.

- Section C.4.1.2 discusses residual analysis. It should be made explicit that the profit split method only applies to those residual profits over and above compensation for routine functions.
- Section 4.4 provides guidance on actually splitting the profits. We note that there are few changes from the guidance already in place.
- At paragraph 38 the Discussion Drafts refers to the use of “Financial accounting...in the absence of harmonised tax accounting standards” as a basis to determine the profits to be split. This should be reiterated more strongly as, in our experience, tax authorities do not always accept such data and request detailed reconciliations between local and management accounts. This is particularly complex for transactions between head office and a PE because there is no legal documentation to use as a basis and so the P&L of the PE has to be recreated. This will be further complicated if a PE is split among several different entities, as is currently the focus of the OECD’s work on the attribution of profits to PEs. An example in the guidance would help to illustrate this point.
- See also point 16 below.

C.5 Reliance on data from a taxpayer’s own operations (internal data)

16. The discussion of profit splitting factors sets a requirement that the factors must be capable of being measured in a reliable and verifiable manner. Do commentators believe that useful ways of splitting profits have been excluded? If so, please describe these factors and explain how they meet the requirement of reliable and verifiable measurement.

- Paragraph 51 implies that a method based on risk weighting should be considered, however, it is unclear whether and how this should be measured, documented and applied when determining the exact profit split methodology to a transaction. BIAC would caution against any attempt to include a prescriptive form of allocation keys with particular weightings as the appropriateness of these weightings would vary significantly across different industries and business models.

17. What further guidance would be useful in this section relating to identifying and measuring profit splitting factors? Please illustrate your response with examples.

- While paragraph 52 states that "where location savings are a significant contributor to profits, and such costs are included in the profits to be split, then the manner in which independent parties would allocate retained location savings would need to be reflected in the profit split, taking into account the guidance in section D.6 of Chapter I.", how to split location savings among parties is not clear. A numerical example would be helpful.

18. More generally, examples are requested of scenarios where a transactional profit split of actual profits or of anticipated profits are applied, together with a brief explanation as to why the method and the approach to applying the method, is considered to be the most appropriate in the circumstances of the case.

- No specific comments.

Public comment received from Cajetan Fiedler

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

Sent via email: TransferPricing@oecd.org

Singapore, 5 September 2016

RE: Comments to the OECD's Discussion Draft on the Revised Guidance on Profit Splits

Dear Sirs,

I refer to the discussion draft on the revised guidance on profit splits published on 4 July 2016 and respectfully submit my observations and comments on the draft. In paragraphs 2 to 10, the draft introduces and explains the distinction between profit splits of anticipated profits and profit splits of actual profits. In the following, I will focus on commenting on this new distinction.

Introduction of the Transactional Profit Split of Anticipated Profits

Paragraphs 2 and 4 introduce the transactional profit split of anticipated profits. Paragraph 4, sentence 1 defines that this method is applied by splitting “the anticipated profits of an enterprise resulting from its own contributions and also from those made by an associated enterprise in order to determine a price for the contributions from that associated profits.” From this and other explanations in the draft it can be concluded that under this method, a fixed remuneration for one

Paragraphs 11 to 15 elaborate on the strengths and weaknesses of the transactional profit split in general and of the transactional profit split of actual profits but does not contain guidance on the strengths and weaknesses of the transactional profit split of anticipated profits. As the profit splits of actual and of anticipated profits splits are substantially different, as the draft also acknowledges with regard to the sharing in the risks of the transaction, this seems to be a lack. The strong differences between the two approaches lead to the assumption that their strengths and weaknesses are also different. The draft implicitly acknowledges this, as it mentions specific strengths of the transactional profit split of actual profits which indicates that the transactional profit split of anticipated profits does not possess the same strengths. To give the distinction between the profit splits of anticipated profits and of actual profits actual meaning, the specific strengths and weaknesses of the transactional profit split of anticipated profits need to be developed further.

Similarly, guidance on the transactional profit split as most appropriate method in paragraphs 16 to 20 focuses mainly on split of actual profits. Paragraph 20 which finally explains on the split of anticipated profits, suggesting that it may be mainly a method for pricing transfers of intangibles, possibly in connection with valuation techniques. This seems to be a forced statement, made to connect valuation techniques with transfer pricing methods. However, this alone would not suffice to justify establishing the split of anticipated profits as a distinct transfer pricing method.

In the long run, all pricing negotiations are a bargaining about the share of profits and every enterprise that engages in a transaction will do this based on expectations about the profits realized from the transaction. In connection with the drafts statement that the “transactional profit split of anticipated profits does not require the level of integration or risk sharing required for a

transactional profit split of actual profits”, this may suggest that the split of anticipated profits in its current form is rather an umbrella terms for all one-sided method rather than a distinct transfer pricing method. For example, an application of the transactional net margin method, too, will provide one party to a controlled transaction with relatively fixed net profits and therefore remove substantial business risks from this party. The unrelated parties that provide the comparable transaction for this will have set their pricing and therefore determined their net profits based on the anticipated profitability of the relevant value chain and their respective bargaining powers (as they provide the input for determining the net profits for the tested party under the transactional net margin method, their contributions will be relatively standardized or “routine”, but this does not change that, as commercial enterprises, they will conduct their activities based on anticipated profits for themselves as well as for their transaction partners). Therefore, under the current wording of the draft, this application of the transactional net margin method, too, can be classified as a split of anticipated profits.

Description of the Transactional Profit Split of Actual Profits

Paragraph 6 states that a “high level of integration of activities” between the parties to the controlled transactions is required to apply a transactional profit split of actual profits. Paragraph 21 further elaborates that such will be more likely the case in a situation of “parallel integration”, where both parties are involved in the same stage of the value chain. Additionally, paragraph 9, sentence 5 mentions that under a transactional profit split of actual profits “[e]ach of the parties involved remains exposed to the effects of the risks associated with business activities of the other.”

These statement may be worth further development. In the long run, all enterprises will share into the effects of the risks associated with the business activities of their transaction partners. This will be reflected in periodical re-negotiations of their arrangements. If this happens over a long time, transfer pricing methods can this, for example, reflect by updated benchmarks under the transactional net margin method or another one-sided method.

The strength of the transactional profit split of actual profits lies in its ability to approximate such re-negotiations over short time periods. This will be especially relevant in transactions that are exposed to substantial risks in the short run, as under such conditions unrelated parties would be very likely to monitor the commercial situations closely and take precautions to allow for timely repricing. This may or may not be connected with highly integrated operations. Therefore, it may be helpful if the revised guidance on the transactional profit split of actual profits considers the time horizon over which substantial business risks can be expected to materialize.

Highly integrated business operations however, may not be a necessary condition for the application of this method in all conceivable scenarios. Publicly available data on royalty contracts may give an additional indication of such situations. While royalty contracts for the use of intangibles set the usage fees often based on the revenues achieved from the use of these intangibles, there are contracts in which the owner of the intangible receives a set percentage of net profits, without necessarily being involved in the same functions or stage in the value chain as the party that commercialises the intangible.

This concludes my comments.

Yours sincerely,

Cajetan M. Fiedler

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

5 September 2016

Submitted by email: TransferPricing@oecd.org

CBI RESPONSE TO THE OECD PUBLIC DISCUSSION DRAFT “BEPS ACTIONS 8-10: REVISED GUIDANCE ON PROFIT SPLITS”

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.

The CBI has supported the OECD BEPS project since its inception and recognises the need to update international tax rules to address base eroding and profit shifting activity.

We have reviewed the response prepared by BIAC in respect of the OECD discussion draft “BEPS Actions 8-10: Revised Guidance on Profit Splits” and agree with the key points and conclusions set out in the BIAC response.

**REPLY TO THE OECD’S REQUEST FOR COMMENTS ON THE
“PUBLIC DISCUSSION DRAFT ON BEPS ACTIONS 8-10
REVISED GUIDANCE ON PROFIT SPLITS”
FROM CMS**

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

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CMS Bureau Francis Lefebvre (France)
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Do you authorize the OECD to publish your contribution on the OECD website? Yes

0.1. We would like first to welcome the OECD initiative to invite companies and practitioners to issue comments in the framework of the update of its guidance on Profit Splits. We were very interested in reviewing, in light of Actions 8-10 of the Action Plan on Base Erosion and Profit Shifting, the “*Public Discussion Draft on BEPS Actions 8-10 – Revised Guidance on Profit Splits*” released on 4 July 2016 (further referred to as the “Discussion Draft”).

0.2. This reply contains an executive summary, followed by an in-depth reply.

0.3. We thank you for giving us the opportunity to share with you our comments and would be pleased to provide you with any additional details you would be interested in.

*

EXECUTIVE SUMMARY

1.1. The Discussion Draft contains many useful updated guidelines on the profit split method (“PSM”), as well as on its strengths and weaknesses. Notably, we welcome the link made by the OECD between profit split and sharing of risks, by which the sharing of risks becomes a criterion for determining in what circumstances the PSM is an appropriate transfer pricing method.

1.2. However, we believe more emphasis should be put on the fact that the PSM is in practice very rarely applied between unrelated parties. This is largely due to the fact that a *de facto* prerequisite for profit splitting is the sharing by the parties of information on their own profits, which is not a common practice between unrelated parties (all the more when it comes to sharing information about transactional profits). It is possible that unrelated parties, when they have sufficient experience and knowledge of each other’s competencies and profiles to make an accurate assessment of their respective profits, will take such assessments into account when negotiating the financial terms of a given transaction (in this respect, the capacity to make an accurate assessment of the other party’s profit could be a criterion in establishing whether or not the PSM is relevant). Nevertheless, this cannot be construed as automatically meaning these unrelated parties will proceed to share their profits. Similarly, the fact that unrelated parties make valuable, even unique, contributions is not sufficient to automatically assume these parties will share their profits. As a result, we believe more emphasis should be placed on the fact that unrelated parties, in general, will reach an agreement over the price of a transaction based solely on their expectations regarding their own profits, and that the resulting lack of observable profit splits between unrelated parties is a fundamental weakness of the PSM.

1.3. The Discussion Draft makes an interesting distinction between the splitting of actual profits and the splitting of anticipated profits. However, the Discussion Draft considers that the two kinds of split entail different levels of risk sharing. Specifically, the Discussion Draft considers that sharing actual profits is correlated with a greater sharing of risks and that, conversely, sharing anticipated profits is correlated with a lesser sharing of risks. In our view, both kinds of profit sharing should be addressed as potentially entailing a similar level of risk-sharing. Indeed, when sharing actual profits, there are risks attached to the fluctuation of outcomes, whereas when sharing anticipated profits, there are risks attached to discrepancies between the anticipated and actual outcome. In other words, the risks shared in each case are different, but cannot be said to be inherently higher in one case than in the other.

1.4. The Discussion Draft also seems to imply – without explicitly stating so – that the splitting of anticipated profits might be most appropriate in the context of the transfer of an intangible asset, possibly in the case of an intangible asset which is not yet fully developed. If this is indeed the case, we believe it should be clearly stated.

1.5. The new guidance in the Discussion Draft seems to state that it is possible to share an anticipated profit by means of valuation techniques (such as the discounted cash flows

method). Such an approach would be an entirely new advancement of the OECD guidelines and, as such, should be developed and analysed in great detail.

1.6. We believe there is a possible risk that certain parts of the Discussion Draft might be at odds with OECD Transfer Pricing Guidelines (“TPGs”). Specifically, we believe the Discussion Draft should provide further guidance on how to articulate its recommendation that hindsight is to be avoided when assessing a past profit split (correctly, in our opinion), with the recommendations stemming from the OECD TPGs (specifically, from the new Chapter VI) which state that when using valuation techniques (such as the Discounted Cash Flows Method), extreme caution is advised and price adjustment clauses may need to be used.

1.7. Similarly, certain elements of the Discussion Draft may be at odds with the OECD TPGs as regards the use of costs, or cost-related keys, as a splitting factor, while the new Chapter VIII suggests that costs are not equivalent to contributions (see for instance §§ 8.26 and 8.28 of the new Chapter VIII).

1.8. The Discussion Draft emphasises the need for splitting factors and measurements to be “*verifiable*” (paragraph 29 of the Discussion Draft). While we understand that the need for verifiability is important to tax administrations, we believe the Discussion Draft should provide more extensive guidance on the matter. The term “*verifiable*” should be precisely defined, and guidance should be provided on issues such as defining what constitutes (or does not constitute) an acceptable proof for verification.

1.9. Moreover, when combined with the concept of “*arbitrariness*” that the OECD introduces in paragraph 57 of the Discussion Draft, the concept of “*verifiable*” measurement raises significant issues which should deserve more guidance. By essence, any profit split not relying on comparables will embed an element of subjectivity, and it would be necessary that the OECD provides guidance on the distinction between inevitable subjectivity and arbitrariness. Indeed, if no clear line is drawn by the OECD between the two notions, then every single profit split and functional analysis performed by a tax payer will have the potential of being rejected by a tax administration as being “arbitrary”. As a result, there is a need for more guidance on the boundary between these two notions, in order to either lay a clear framework to better distinguish what is subjective and verifiable from what is arbitrary and unverifiable, or to clearly limit the use of the PSM to certain precise cases.

IN-DEPTH REPLY

A. General Comments

2.1. We understand that the OECD's position, regarding the profit split method, is that if parties share their profits, then they must also share – effectively, according to the new definitions included in the Revisions to Section D of Chapter I of the Transfer Pricing Guidelines – the risks involved in the transaction.

2.2. We agree with the principle according to which the sharing of profits should entail a certain level of risk sharing, but we believe the relation between risks and profits should be analysed in greater detail, with more examples.

2.3. Moreover, we believe this position does not take into account an important consideration, which should be explicitly stated: in order to split profits, entities must agree to share profit-related information beforehand – an uncommon practice for unrelated parties (see §§ 2.4. to 2.10 further below); under certain circumstances, the sharing of such information may even be illegal between unrelated parties (e.g.: in the context of antitrust and/or cartel regulations). Therefore, we would welcome more details concerning the context in which independent parties would choose to share their profits, and information thereabout, and on how they would effectively do so.

2.4. In our experience, profit splitting is indeed extremely rare between unrelated parties. This is due to various reasons, chief among which the fact that sharing information on one's profits is a *de facto* prerequisite to sharing said profit, and independent parties are usually, on the contrary, inclined to take all possible steps to avoid sharing information pertaining to their profits with any party with which they conduct transactions, both in general and especially as regards transactional profits. As a result, independent parties would not usually share such information unless it is already accessible to the other party in some form or another; indeed, in real-life examples of profit-sharing, parties generally proceed based on their best assessments rather than actually sharing strategic information (see examples below). Notable exceptions to this would be joint-ventures and other situations of co-entrepreneurship.

2.5. Moreover, we wish to draw attention to the fact that in transfer pricing terms, it is only possible to simulate the end result of a transaction between unrelated parties (i.e. its outcome from a profit splitting standpoint); it is not possible to simulate the parties' conduct in negotiating the split. As a result:

- It should be explicitly stated that, in most situations, independent parties do not normally choose to split their profits.
- More guidance should be issued on the conditions and precautions under which the result of a profit split between independent parties may be observed. Concerning this point specifically, we wish to draw attention to the fact that out of 19 pages discussing the profit split method ("PSM"), less than half a page is dedicated to the observation

of uncontrolled transactions involving a profit split. We believe this point would greatly benefit from additional analysis.

2.6. In addition, we note that the Discussion Draft provides some guidance on cases where the parties make unique or valuable contributions. We feel it is important that it be clearly stated that the fact that both parties make valuable or unique contributions does not, in and of itself, justify the selection of a PSM. The difficulty in measuring each party's contribution – especially in the case of unique contributions – might even hinder the application of a PSM.

2.7. To illustrate these comments, we wish to provide three examples. The first two examples are examples of how independent companies may decide to proceed to share their profits without actually sharing sensitive information on their own profits; the third example is an example of how, when they are unable to make a reasonable assumption of the other party's profits and with no information being shared, independent parties might shun a profit split. Please note that all examples used herein are for illustrative purposes only and are necessarily presented with limited facts. The examples do not have applicability beyond the purpose of seeking comments on the approaches they serve to illustrate and should not be used by taxpayers or tax administrations to interpret superficially similar cases.

Example 1

2.8. Consider two companies, A and B. For the purposes of this example, companies A and B are considered to have similar profiles and competencies. Company A is developing an intangible X. Before intangible X's development is completed, company A decides to transfer it to company B. In the future, company B shall then proceed to complete intangible X's development and use it. Because companies A and B have similar profiles and competencies, company A can reasonably assess the cost of completing intangible X from the moment it transferred it to company B; company A can also make a reasonable assumption of the benefits that will likely be derived from using intangible X. Company A can therefore make use of these assumptions when determining the price at which it decides to transfer intangible X, without company B ever having shared any information. Similarly, based on its own experience, company B can reasonably assess the costs incurred by A for the development of the intangible up to the point of its transfer and take this into account when deciding at which price to acquire intangible X, without company A ever having shared any information. As a result, both independent parties may take their own assessments of the other party's expected costs or revenues into account in negotiating over the price of the in-process intangible X¹ upon its transfer. It does not necessarily imply, however, that they actually implement a profit split method (be it on actual profits or anticipated profits) in the very process of striking a deal regarding this transfer, because they would not share their own information with the other party (which is a *de facto* requisite to any profit split), lest it would hurt their own bargaining position in the negotiation.

¹ In the context of these comments, an in-process intangible is to be understood as being an intangible which is still in the process of being developed, and has not yet reached its full development and full completion stages.

Example 2

2.9. Two full-fledged manufacturers decide to enter into a transaction. For the purposes of this example, the two manufacturers are considered to be in a parallel integration scheme². Because they are independent companies, they do not share any information relating to their profits (as previously mentioned, such sharing of information can be illegal in certain contexts). However, based on the fact that the two companies have similar profiles, they are able to make a reasonable assessment of what the other company's costs and revenues should be, given the context of their contemplated transaction, and take these assessments into account in their negotiations over the financial terms of their transaction. As a result, similarly to Example 1, no information has actually been shared between the two companies, who proceeded entirely on the basis of their internal assumptions. Again, as a result, both parties may take their own assessments of the other party's expected costs or revenues into account in negotiating over the financial terms of their contemplated transaction, but this does not necessarily imply, however, that they actually implement a profit split method (be it on actual profits or anticipated profits) in the very process of striking a deal regarding this specific transaction.

Example 3

2.10. Consider two companies: a full-fledged manufacturer and a retailer, both being full entrepreneurs in their respective businesses, with unique contributions (assume, for instance, a sportswear manufacturer with a very well-known brand, dealing with a sports equipment retail chain with its own very well-known retail chain brand). For the purposes of this example, the manufacturer is considered to have no in-depth experience in retail, and the retailer conversely has no in-depth experience in manufacturing. The two companies enter into negotiations to organise the distribution of the manufacturer's products by the distributor. Contrary to the two previous examples, neither party has the means to properly evaluate what the other party's profit may be, as they do not have the necessary experience. Similarly to the other examples, the parties do not share any information relating to their profits (if one party would have access to the other party's profit information, this would shift the bargaining power between them and possibly jeopardize the bargaining position of the party of which the profits is known by the other). Besides, as a result of this lack of information, neither party is likely to be willing to bear part of the other party's risks. The end result will be that the parties will have shared neither information on their profits nor their risks, and therefore will not have chosen to share their profits, irrespective of the fact that both are entrepreneurs and both made unique contributions to the transaction. Each party will reach an agreement with the other over the price in that transaction solely based on its expectations regarding its own profit.

² The notion of parallel integration used in this example is the same as the one described in paragraph 21 of the Discussion Draft which is being commented upon.

Conclusion to General Comments

2.11. To summarize our general comments: independent parties do not normally share information concerning their profits, which is in our view a strong indication that independent parties do not share profits at all on a frequent basis. When independent parties do enter into a profit splitting agreement, they usually determine the terms of the split based on their own assessments of the other party's profit.

2.12. In conclusion, we believe that an additional section offering comments and guidance on these issues would be helpful.

B. Specific Comments

2.13. We wish to comment regarding the correlation of integration to risk sharing, as described in paragraphs 6 and 9 of the Discussion Draft. The position expressed in the Discussion Draft is that a split of actual profits requires a higher degree of integration and greater sharing of risks than a split of anticipated profits. We do not fully agree with this position.

2.14. Indeed, a split of actual profits does not equate with a greater sharing of the effect of uncertainty, as the Discussion Draft claims. On the contrary: actual profits are certain, whereas anticipated profits are not. As a result, we disagree with the contrast drawn in paragraph 9 of the Discussion Draft between the risks shared in the splitting of actual vs. anticipated profits. There are shared risks in both cases:

- Profit split based on *actual* profits: the parties share in outcome, and the risks are mainly attached to the fluctuation of outcomes.
- Profit split based on *anticipated* profits: the parties share in *anticipated* outcome, and the risks are mainly attached to discrepancies between *anticipated* and *actual* outcomes.

In other words, there are shared risks in both cases, and while the risks which are shared are not the same, neither type should, in our view, be regarded as theoretically more or less significant – i.e. requiring more integration – than the other.

2.15. Still on the topic of integration and risk sharing, we would like to comment the following statement from paragraph 6 of the Discussion Draft:

“The difference between the effect of uncertain outcomes on the two approaches may be less significant in practice where a contingent price is determined under a transactional profit split of anticipated profits. For example, where the price set takes the form of a royalty rate based on actual sales, the amount of the royalty payment will adjust to reflect higher or lower sales than anticipated. However, under a transactional profit split of actual profits there is a greater sharing of the effect of uncertainty resulting from risks, since the profits or losses that

are split are the actual profits or losses, and since additional risks are likely to be shared depending on the level at which the profits are split.”

We do not agree with the above statement. Indeed, sales (or a royalty rate based on sales) do not directly correlate with profits. For instance, the party selling the goods can increase its profits by reducing costs, and such extra profit will not be shared through sales (or a royalty rate based on sales). This point can be further illustrated by the example of two parties who choose to split an anticipated profit relating to the transfer of an intangible asset by determining a royalty rate as a percentage of future sales linked to the intangible asset in question: in such a scenario, both parties end up sharing a comparable level of risks, because the revenue which is split corresponds to sales, which do not directly equate to profit. In other words, the fact that an anticipated profit is shared (instead of an actual one) does not necessarily reduce the level of risks that are shared. These risks may simply not be the same as if actual profits are shared.

2.16. The Discussion Draft, as it stands, does not explicitly give any detail on the context in which an anticipated profit split would be appropriate. The impression that is given (see for example paragraphs 6 and 20 of the Discussion Draft) is that the most relevant context for the selection of a split of anticipated profits would be the transfer of an intangible asset, i.e. when looking for the price of an intangible asset based on the assessment of future profits. Such a context would explain both references to valuation methods (in paragraph 20 of the Discussion Draft, for example) and why splits of anticipated profits are generally presented as happening in less integrated scenarios. We believe the Discussion Draft should clarify if this is indeed the context in which these comments are made.

2.17. Regarding paragraph 20 of the Discussion Draft specifically, we disagree (for the same reasons as those described in our comments § 2.14 and § 2.15 above) with the following statement:

“as discussed in paragraph 6, a transactional profit split of anticipated profits does not require the level of integration or risk sharing required for a transactional profit split of actual profits”

2.18 Moreover, we note that the following approach, described in the rest of paragraph 20 of the Discussion Draft, is a brand new approach:

“in circumstances where it is determined that a transactional profit split of anticipated profits is the most appropriate method, the value of a party's contribution for which reliable comparables cannot be found may be derived from the splitting of appropriate projected income or cash flows of the transferee based on a splitting factor that reflects the respective contributions of the transferor and transferee to those projected income or cash flows. The contribution can then be valued using valuation techniques discussed in sections D.2.6.3 and D.2.6.4 of Chapter VI. The amount so derived can then be used to set a single price or a series of recurring payments. Where the contribution takes the form of an intangible or rights

to an intangible the guidance on intangibles for which valuation is highly uncertain at the time of the transaction in Section D.3 and D.4 of Chapter VI will be relevant.”

We understand this to mean that it is possible to share an anticipated profit calculated by means of a valuation technique such as the Discounted Cash Flows Method (“DCF”). In other terms, it would now be possible, under certain circumstances, to calculate a profit split on the basis of a method such as the DCF, which is in itself an entirely new development in the OECD guidelines. We believe this deserves more in-depth developments: is this approach only applicable to the transfer of intangible assets? Is it applicable to recurring flows of goods or services? Is such an approach relevant in general, or is it only to be used under very specific conditions? Once again, this section gives the distinct impression that the approach to splitting anticipated profits was drafted with the transfer of in-process intangibles in mind; should this indeed be the case, it should be explicitly clarified.

2.19. Paragraph 7 of the Discussion Draft states that:

“Pricing negotiations by an uncontrolled party will typically take into account the profits it expects to derive from the transaction, and those it estimates the other party may be likely to obtain.”

We believe much stronger emphasis should be put on the fact that independent parties do not normally enter into profit-sharing agreements. While it is true that independent entities may take into account the assessments of the other party’s profits when entering into a negotiation (when they have the means to perform such assessments), this does not necessarily mean they intend to split their own profits; as such, application of the PSM is not necessarily justified. It would, however, be interesting to further elaborate on the fact that when the analysis of the transaction allows to establish that the two parties are able to mutually and reliably estimate the other party’s profits, there is a higher chance of their being inclined to share their risks and profits because the disclosure of specific details of one party’s profits is less likely to harm the balance of the negotiations. Thus, in order to assess how likely parties would be to decide to split their profits, the guidance’s recommendations could be to assess both a) how willing the companies are to share their risks, but also b) how capable they are of reliably assessing each other’s profits. In other words, the capacity to make an accurate estimation of the other party’s profits could make a key criterion in deciding whether or not to resort to the PSM. This criterion would be in line with the fact that in order to reliably apply a profit split, both parties should be able to verify that the assumptions they based the split on – viz. the profits of the other party – are accurate. Moreover, this would also be coherent with the notion that the sharing of risks and the capacity to control and/or influence said risks are linked.

2.20. We broadly agree with the example provided in paragraph 8 of the Discussion Draft concerning the impact (or lack thereof) of fluctuations in the prices for resources. However, we believe a precision should be added to indicate that this example ceases to be true when the specific resource is scarce.

2.21. Concerning paragraph 10 of the Discussion Draft, while we understand the difficulties a tax administration may encounter in the context of the PSM, such as understanding the basis for the allocation keys, we wish to underline that we believe that, in terms of legal security, tax administrations imposing the PSM on taxpayers who previously used other transfer pricing methods (“TPMs”) create major risks. Moreover, we note that paragraph 10 of the Discussion Draft states that:

“It would be contrary to the guidance in Section D of Chapter I 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.”

We agree with this statement; however, we wish to point out that we believe it is equally true of profit splits of anticipated profits.

Answers to questions 1 and 2

2.22. **Question 1.1.** We believe the distinction between actual and anticipated profits is too theoretical: examples would be helpful. More details on anticipated profit splits would also be welcome. The guidance, as it currently stands, seems to be mostly applicable to the transfer of an in-process intangible. More details on applicability to physical assets, licensing contracts with no later renegotiation, etc., would be useful.

2.23. **Question 1.2.** The distinction between the two types of profit splits is probably useful, but the statement that the split of actual profits entails more risk sharing than the split of anticipated profits should be reconsidered (see § 2.14 and § 2.15 above for details on why we believe both splits imply a certain level of risk sharing). Indeed, the OECD gives neither explanation nor justification as to why it considers one type of profit split to be more integrated and to translate to more risk sharing than the other type. We believe this distinction could be improved by focusing more on verifying whether independent companies in comparable circumstances:

- would share their profits according to risks (these risks to be shared would be different – but not necessarily more or less intense – depending on whether the profit is actual or anticipated, see § 2.14 and § 2.15 above);
- would have the capability to make their own assessments of the profit-related information (once again, different information depending on whether anticipated or actual profits are shared) to determine an appropriate split.

2.24. **Question 2.** We believe it is important to note that profit splitting only happens in highly integrated situations, whether through parallel or sequential integration, because sharing profits means sharing information that would only be available in a highly integrated situation (since parties would normally do their best efforts in order not to share such information).

2.25. Paragraph 11 of the Discussion Draft offers various examples on determining whether or not the PSM is the most appropriate TPM for a given transaction. However, they are examples of extremes (*“highly integrated operations in which the parties each perform similar functions, and in some instances share core assets used to produce the income stream”*, *“both parties to a transaction make unique and valuable contributions (e.g. contribute unique intangibles)”*, or on the contrary *“one party to the transaction performs only simple functions and does not make any significant unique contribution”*); as such, these examples leave a wide array of greyer areas undiscussed. More examples would be helpful, especially of such “in-between” cases, for instance transactions between two full-fledged manufacturers. Ideally, there would be examples in which the PSM is applicable, and examples where it is not.

2.26. We also note that paragraph 11 of the Discussion Draft makes the following statement:

“In such cases where the accurate delineation of the actual transaction confirms that the parties do not share in the risks associated with subsequent outcomes, a transactional profit split of actual profits would not be appropriate because it would inappropriately have the effect of assigning the impact of significant risks to a party which in fact does not exercise control over such risks.”

While we agree that the risk-sharing criterion is a key criterion, we wish to point out that:

- It should not be limited to splits of actual profits: it is equally relevant for the profit split of anticipated profits.
- There is a need for guidance in determining if a risk is shared or not: should the analysis be contractual? based on the parties’ conduct? on their capacity to control it? etc.

We note that paragraph 16 of the Discussion Draft provides greater focus on risks – which we welcome – while paragraph 17 of the Discussion Draft offers further guidance on this point. However, the provisions of paragraph 17 constitute a significant novelty compared to the 2010 OECD Transfer Pricing Guidelines (“TPGs”) and, as such, should in our opinion be developed in greater detail.

2.27. Paragraph 12 of the Discussion Draft states that (emphasis added):

“A strength of the transactional profit split method generally is that it offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises, while still constituting an arm’s length approach to the extent that it reflects what independent enterprises reasonably would have done if faced with the same circumstances.”

We believe this is not strictly true, as in real life independent parties only rarely share information relative to their profits, and all the more very rarely share their profits at all. The services industry is an excellent example of this: there are numerous cases where the service provider provides a high value-added service to a client (also a full entrepreneur of its own)

without ever entering into a profit splitting agreement with said client, nor sharing any information which would allow for such a possibility. Consider, for instance:

- The advertising industry. It is not unusual for an advertising company to be mandated to provide high value-added services such as helping design a new brand logo and/or slogan, organising an advertising campaign on a given territory, etc. Such services are usually remunerated *via* a set fee, negotiated upfront, and do not normally entail any form of profit splitting. For example, if an advertising company helps develop a new logo, it will not normally be entitled to any share in the profits if the product is very successful or obliged to share in losses if the product fails.
- The consulting industry. Companies often resort to external consultants for advanced and complex missions, such as financial or legal advisory for a merger, opinions on the development of a new product, information on new potential markets, in-depth advice on strategy, etc. Such services are generally high value-added services. However, they are often, in practice, remunerated on the basis of set fees (time-based, flat-rate, etc.), and not on the basis of a profit split.

In these various examples, in practice it is quite uncommon that either the service provider would share in the profits of its client (even in the case where it has access to that information), or that the client would share in the profits of its service provider.

2.28. Paragraph 13 of the Discussion Draft notes that one strength of the PSM is that “*it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result*”. We agree with this point; however, paragraph 13 follows up with the following example:

“This aspect can be particularly important when analysing the contributions by the parties in respect of the intangibles employed and economically significant risks assumed in the controlled transactions.”

This example is not, in our opinion, appropriate in this context. Intangibles are indeed often licensed, which means they are usually remunerated between unrelated parties through a percentage on sales, as opposed to a percentage on the profits derived from said sales.

Answers to questions 4 and 5

2.29. **Question 4.** We believe this section insufficiently summarises the strengths and weaknesses of the PSM, chiefly because the section fails to express the fact that the main weakness of the PSM is that such arrangements almost never happen in practice between unrelated parties. Moreover, we note a de-emphasis on the lack of comparables and on the avoidance of benchmarking studies, whereas it is often the case that profit splits are decided without such elements, on a consensual basis between taxpayers and tax administrations – advanced pricing agreements (“APAs”) being a prime example of this.

2.30. **Question 5.** We believe that splits of anticipated profits have an additional weakness, which is how to accurately anticipate the expected profits to be split. This additional layer of complexity constitutes a further weakness insofar as the anticipated profits must be regarded as reliable both by the taxpayer and the tax administration. On the taxpayer's side, this raises the issue of how to properly document the anticipations of the future profits to be made. On the tax administration's side, this raises the issue of which criteria should be used to verify if said anticipation was reliable and fair in the first place.

2.31. We agree with the statement made in paragraph 18 of the Discussion Draft, according to which "*A lack of comparables alone is insufficient to warrant the use of a transactional profit split of actual profits under the arm's length principle.*" Moreover, we believe this principle should be explicitly extended to anticipated profits as well. We also believe the provisions of this paragraph should not be limited to situations in which only one of the parties assumes very limited risks: these provisions should be applicable to all situations in which risks are not typically shared, regardless of how important they are for each party. The use of intangibles is a good example of this point: the licensee does not share its business (i.e. operational) risks, nor does the licensor share its developmental risks. Indeed, in practice between unrelated parties, the risks of product development are remunerated through a percentage of sales (which do not directly correlate with the licensor or licensee's profits), and sharing a percentage of sales does not lead to any sharing of risks. Therefore, even though there may be or have been major risks in play, the business situation at hand does not justify a sharing of risks, meaning the PSM will probably not be appropriate: a transactional method, even if comparables are scarce, will likely be more appropriate.

Answer to question 6

2.32. **Question 6.1.** We believe it should be clarified in which situations risks (as differentiated from functions) are shared. Specifically, it would be necessary to provide guidance on how to identify or materialize the intent of the parties (agreement? other means?): it is possible that a party has the ability to influence a risk, without in fact sharing it.

2.33. **Question 6.2.** As a whole, we find the draft useful, but we believe it could be greatly improved with the addition of more details.

2.34. Paragraph 20 of the Discussion Draft mentions the possibility of valuing certain contributions by using the "*valuation techniques discussed in sections D.2.6.3 and D.2.6.4 of Chapter VI*". This may, in our opinion, create potential inconsistencies with other chapters of the OECD TPGs unless further guidance is provided. Indeed:

- On several instances in other parts of the Discussion Draft commented here, the OECD (correctly, in our opinion) discourages the use of hindsight in determining an appropriate split of profits (emphasis ours):

- In paragraph 3: “When applying the transactional profit split method, care should be exercised to ensure that its application is performed in a context which is similar to that the associated enterprises would have experienced, i.e. 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”; and,
- In paragraph 30: “Irrespective of whether anticipated or actual profits are used, the basis for calculating the combined profits to be split and the determination of the splitting factors should be made without the use of hindsight and should generally be used consistently over the life-time of the arrangement”.
- In separate comments on the use of valuations techniques, the OECD encourages extreme caution in using valuation techniques such as the DCF. For example, in the Final Report on BEPS Actions 8-10, *Aligning Transfer Pricing Outcomes with Value Creation*, the OECD notes that even the slightest change to the assumptions the valuation is based on can³ “lead to large differences in the intangible value the model produces”, insisting that⁴ “this volatility is often compounded when changes are made simultaneously to two or more valuation assumptions or parameters”. Extreme caution is all the more necessary when applying the DCF that, according to the OECD, the DCF relies on accuracy of projected cash flows which are⁵ “contingent on developments in the marketplace that are both unknown and unknowable at the time the valuation is undertaken”. Also, because the OECD acknowledges the difficulties involved in performing accurate valuations, it recommends, in situations where⁶ “the projections behind the valuation are unreliable or speculative”, to follow the guidance provided in the sections on hard-to-value intangibles⁷ and on situations in which the valuation is highly uncertain⁸.
- Precisely, in comments on valuations which are highly uncertain at the time of the transaction, the OECD indicates that independent parties may take various steps to reduce uncertainty: they might⁹ “include price adjustment clauses in the term of the agreement” or, later on, agree to a¹⁰ “renegotiation of the pricing arrangements”. In both cases, the parties agree, after the transaction has taken place, to alter in some fashion the initially agreed-upon terms of the transaction.

³ Final Report on BEPS Actions 8-10, *Aligning Transfer Pricing Outcomes with Value Creation*, § 6.158

⁴ *Ibid.*, § 6.158

⁵ *Ibid.*, § 6.163

⁶ *Ibid.*, § 6.168

⁷ Final Report on BEPS Actions 8-10, *Aligning Transfer Pricing Outcomes with Value Creation*, Revisions to Chapter VI of the Transfer Pricing Guidelines, Section D.4. “Hard-to-value intangibles (HTVI)”

⁸ Final Report on BEPS Actions 8-10, *Aligning Transfer Pricing Outcomes with Value Creation*, Revisions to Chapter VI of the Transfer Pricing Guidelines, Section D.3. “Arm’s length pricing of transactions involving intangibles for which valuation is highly uncertain at the time of the transaction”

⁹ *Ibid.*, § 6.183

¹⁰ *Ibid.*, § 6.184

These three points do not appear to us to be consistent when taken altogether: further guidance on how to articulate them is necessary (e.g.: how does one articulate the need for caution and a price revision clause when using the DCF with the recommendation not to use hindsight?). For instance, assuming it is possible to use a profit split for anticipated profits relating to recurring flows, such as sales of goods or services, and assuming that the three aforementioned points must be understood as meaning a price revision clause must be included, then the question of how said revision clause is applied to these recurring flows is raised. In more concrete terms, the question would be how to revise, for instance, in year N+3, the recurring flows (e.g. sales of goods) related to year N. In addition to the difficulty of articulating these three seemingly inconsistent points, there is also the issue of the availability of objective and reliable information; more guidance is also needed on this point. Should the TPGs be understood to allow for a profit split based on anticipated profits or recurring flows, but similarly imply the need for price revision clauses, this could create very complex and administratively cumbersome situations for taxpayers.

Answer to question 7

2.35. **Question 7.** We believe that the transfer of an in-process intangible is a good example of a transaction which can make use of a profit split on anticipated profits. We also believe that examples of transfers of such intangibles which do not lead to a profit split (for instance a university which licenses an intangible it developed, earning a percentage on related sales) would make a welcome addition.

2.36. We agree with the statement made in paragraph 21 of the Discussion Draft, according to which “*a high degree of integration means that the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with, and cannot reliably be evaluated in isolation from, the way in which another party to the transaction performs functions, uses assets and assumes risks*”. However, we feel that more guidance would be useful to explain this point. Specifically, such guidance should help determine in which cases a function/asset/risk can be evaluated in isolation, in which cases such an evaluation is impossible, and so forth.

Answers to questions 8 to 14

2.37. **Question 8.** We find the distinction between parallel and sequential integration of business operations to be an interesting notion, but sequential integration should equally be further elaborated by the guidelines. It is also our belief that the notion of “commonality of functions” deserves further elaboration. Finally, more information on when to proceed with an analysis in isolation vs in integration would be useful.

2.38. **Question 9.** Commonality of functions is, in our opinion, an interesting criterion, but it should not be the only one; further criteria may include the sharing of functions (e.g. sharing of a team performing similar functions for several parties), the sharing of strategic assets, and so on. However, even in such cases, it should be taken into account whether the parties are

truly involved together or if they are acting separately and individually, notwithstanding their common functions/assets. In other terms, it is critical to define and materialize the will of the parties.

2.39. Questions 10 and 11. We believe it is actually possible for both parties to make valuable contributions without sharing risks. For example, consider a manufacturer specialized in sports footwear. This manufacturer owns a very well established, very valuable brand with worldwide recognition. The manufacturer enters into a distribution agreement with an independent retail distributor. The distributor has a well-known, valuable brand, attached to its retail chain. The distributor and the manufacturer have both made valuable contributions, and yet they do not share their risks. As a result, we believe the guidance should clearly reflect that the simple fact that the parties have all made valuable and unique contributions is not, in and of itself, enough to justify the selection of the PSM, and that other factors should be taken into consideration, such as the will of the parties to share risks, the effective sharing of risks, the impossibility to test the transaction through a benchmark, etc.

2.40. Question 12. We agree with the general concept expressed in this question and in paragraph 23 of the Discussion Draft, according to which the benefits derived from group synergies attributable to deliberate concerted group actions should be shared on the basis of incremental profits derived, without needing to combine the total profits of the parties. However, we believe further guidance on how to measure the increments of profit is necessary.

2.41. Question 13. We wish to note that the precisions included in paragraph 25 of the Discussion Draft about value chain analyses – specifically, that “*All business operations can be expressed through a value chain and many MNE groups operate through a global value chain. This alone does not imply that the transactional profit split should be applied.*” – are highly welcome. In addition to this, while we recognise the utility of the value chain analysis as a tool, we believe references should also be made to the concept of processes, which play a key part in value chain analyses. Indeed, processes turn inputs into outputs by using resources, which in turn create risks, the result of which may be measured through key performance indicators. It should be noted that a company, in and of itself, can be described as a process, since it is an entity which turns inputs (such as capital, for instance) into outputs (products, dividends, etc.) through various means (personnel, equipment and know-how for example), which creates risks which it manages. As such, because processes are such an important part of value chain analyses, including them in the guidance would help establish a dynamic analysis tool – as opposed to the static functional analysis – which would be useful for determining at which step of the chain each risk appears, how each risk is passed on and which actor of the value and process chains plays which part in helping to control them.

2.42. Question 14. We believe a proper value chain analysis could help evaluate the weight of each process in the chain, which, in turn, would help properly weigh each contribution to better calculate the appropriate split. Also, this would help identify situations in which risks

are effectively shared.

2.43. The statement that splitting factors should be capable of being measured in a “*verifiable manner*”, as stated in paragraph 29 of the Discussion Draft is new, compared to the 2010 TPGs. This addition raises various issues, such as defining what the term “verifiable” means precisely, or explaining what constitutes an acceptable proof of verification.

2.44. Paragraph 30 of the Discussion Draft states that “*the basis for calculating the combined profits to be split and the determination of the splitting factors should be made without the use of hindsight*”. First off, we find this statement by the OECD to be a very welcome reminder. However, we note that this paragraph, which we understand is meant to replace paragraph § 2.117 of the 2010 TPGs, no longer makes references to how independent parties may choose to renegotiate the terms of an agreement. This removal creates, among other issues, a possible consistency issue with respect to chapters IX and VI of the TPGs.

2.45. Paragraph 40 of the Discussion Draft draws a contrast between the use of gross vs net profits as a basis for calculating the profit split. This contrast is very interesting, however it raises various questions. For instance, intangibles may be subject to different accounting rules and standards in different countries, which may lead to a co-developed intangible having an effect on the gross profits of an entity in one country, and on the operating profits of the co-developing entity in the other country. Yet, the guideline explicitly includes intangibles as a factor in the computation of gross profits without taking this point into consideration. Moreover, the guidelines note that using gross profit as a basis for the split should reflect, among other things, that entities “*share not only market risk*”, but other risks as well. We wish to point out that if two (or more) entities share only market risk, then it would be extremely unlikely that they decide to share their profits because market risk does not directly impact profits, *per se*. As a result, we believe this should be reformulated to make it clearer that other risks, besides market risk, must be shared in order to consider the possibility of the PSM being appropriate.

Answer to question 15

2.46. **Question 15.** The logical conclusion to this section would be that the profit to be shared should be the profit which is influenced by the risks that are shared. Risks which are not shared should not have any more than a marginal impact on the profit that is split.

2.47. Note: the reference [2.13] at the beginning of paragraph 42 of the Discussion Draft seems to be a clerical error; we believe it should read [2.132].

2.48. The first bullet point of paragraph 42 of the Discussion Draft mentions, as an example of a possible criterion for determining a profit splitting factor, “*sales to independent parties*”. We wish to underline the fact that sales are rarely, if ever, used to split profits (otherwise every party would end up having the exact same profitability expressed as a percentage of

sales), which in general makes them a poor profit splitting factor. Purchase costs could constitute a reasonable alternative. Moreover, when taking into account costs, guidance will be useful to help treat certain costs such as subcontracting. We would also like to note, regarding the statement that profit splitting factors should be “*reasonably independent of transfer pricing policy formulation*”, that costs resulting from controlled transactions need not be excluded; provided it is established in a first step that they are at arm’s length, we believe they may be taken into account.

2.49. Paragraph 43 of the Discussion Draft makes the following statement:

“Examples of possible sources of information on uncontrolled transactions that might usefully assist the determination of criteria to split the profits, depending on the facts and circumstances of the case, include joint-venture arrangements between independent parties under which profits are shared”.

We do not agree with the above statement, and wish to stress the fact that joint ventures do not usually split their profits based on contributions, but rather on capital injections.

2.50. Paragraph 47 of the Discussion Draft offers examples of splitting factors based on assets and/or capital. However, we believe there are issues with using assets and/or capital as splitting factors, such as the issue of historical accounting vs fair market value. Indeed, historical accounting raises issues such as the issue of depreciation, whereas the fair market value raises the double issue of 1) calculating the fair market value, and 2) dealing with situations in which the profit split must be recalculated each year due to fluctuations of fair market value. Paragraph 47 also offers other splitting factor examples, namely costs, headcount or time spent. We wish to note that these splitting factors are all correlated with and all relate to costs, which may be in contradiction with the (new) Chapter VI of the OECD TPGs, which rejects costs as a basis to value an intangible¹¹. In addition to this, we note that the new Chapter VIII of the OECD TPGs distinguishes costs from contributions, which does not seem consistent with the guidance provided here on the PSM.

2.51. Paragraph 52 of the Discussion Draft lists the timing of expenditure as an example of issues to be taken into consideration when dealing with cost-based profit splitting factors. We believe further guidance should be provided with respect to the timing issues relating to asset-based profit splitting factors, since the timing of the investment is an important factor.

2.52. Paragraph 57 of the Discussion Draft mentions the importance of “*reliable objective data in order to limit arbitrariness*”, suggesting that the profit split can be calculated by

¹¹ Final Report on BEPS Actions 8-10, Aligning Transfer Pricing Outcomes with Value Creation, § 6.142: “*The use of transfer pricing methods that seek to estimate the value of intangibles based on the cost of intangible development is generally discouraged. There rarely is any correlation between the cost of developing intangibles and their value or transfer price once developed. Hence, transfer pricing methods based on the cost of intangible development should usually be avoided.*”

quantifying the functional analysis, provided the quantification is not arbitrary; this point needs to be clarified: what makes a specific unit of measurement arbitrary or non-arbitrary?

2.53. The concept of arbitrariness listed in paragraph 57 of the Discussion Draft, in tandem with the added concept of “verifiable” measurements of paragraph 29, raises an important question. As they stand, the guidelines can be understood as stating that a functional analysis performed by the taxpayer could be considered as arbitrary. But because it is not an exact science, and because it is performed by the taxpayer, a functional analysis is necessarily, at least in part, subjective; the true issue is drawing the line between subjectivity and arbitrariness, in order for the taxpayer to be able to assess whether his quantification is acceptable or may be rejected for being arbitrary. To be more precise: a functional analysis, as prepared by a taxpayer, is a series of affirmations and descriptions of their business and functioning. Thus, it inherently integrates a part of subjectivity. As a result, if no clear line is drawn, there exists a risk that a tax administration be able to reject the functional analysis in its entirety on the basis that it is arbitrary. This would create a fundamental contradiction with the recommendations issued by the 2010 OECD TPGs, as well as the 2015 BEPS revision to the TPGs, since the entire basis of the accurate delineation of a transaction can be summarised as the result of in-depth interviews with the taxpayer’s managers in order to accurately describe the value chain, the functions, the risks, the assets, etc., that are involved in the transaction at stake. If no clear line is drawn by the OECD to determine what makes this work arbitrary and unverifiable as opposed to subjective and verifiable, then this Discussion Draft creates a fundamental rift with the OECD TPGs. If there is a demarcation between unverifiable arbitrariness and verifiable subjectivity, then comments should be made to clarify how to properly verify the inherently subjective hypothesis upon which the functional analysis is performed. This is all the more important due to the fact that the PSM is very often chosen in contexts where there are no comparables available, which means that there must necessarily be a part of subjectivity in determining the split. Once again, this means that guidance which allows to draw the line between necessary, unavoidable subjectivity and arbitrariness must be provided.

C. Closing comments

2.54. Experience shows that, from the taxpayers’ standpoint, the usage of the PSM is most reliable when used on a consensual basis with the tax authorities, for instance when preparing an APA (it should be noted in this respect that many APAs are based on the PSM).

2.55. It is understandable that the tax authorities are worried that certain taxpayers may try to take advantage of the complexity of the PSM to shift profits out of their jurisdictions; however, conversely, there is a true risk for taxpayers when the tax authorities resort to the PSM especially when the taxpayer was relying on another TPM or when the tax authorities significantly change the split as originally assessed by the taxpayer.

2.56. The PSM is often the source of major controversy between taxpayers and tax authorities, mainly because it is often difficult, if not impossible, to support a profit split with comparables; the PSM is as such inherently subjective.

Indeed, in our experience, the subjectivity attached to any implementation of the PSM (that itself does not rely on comparables) cannot be fully eliminated, whatever the circumstances:

- Either the split is based on a quantitative factor (e.g. headcount, assets, or whatever other quantitative factor) but then the choice of a given factor *vs* other possible keys is never unequivocal and always implies some degree of subjectivity (to what extent is this factor the best and fullest measure of the parties' contributions?);
- Or the split is based on some sort of quantification of the functional analysis, which also will involve some degree of subjectivity.

Therefore, we believe the OECD should implement one of the two following solutions:

- Expand the current guidelines to help provide a clearer framework to limit subjectivity, which would both a) make the tax authorities' verifications easier and b) provide better protection to the taxpayer with respect to proposed changes by the tax authorities ; or
- Accept the inherently subjective nature of the PSM and issue guidance to clearly limit its use to certain precise cases.

2.57. We thank you for giving us the opportunity to share with you our comments and would be pleased to provide you with any additional detail you would be interested in.



Opinion Statement FC 12/2016

on the OECD Public Discussion Draft (BEPS Actions 8-10)

Revised Guidance on Profit Splits

Prepared by the CFE Fiscal Committee

Submitted to the OECD in September 2016

The CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 26 professional organisations from 21 European countries with more than 200,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe.

The CFE is registered in the EU Transparency Register (no. 3543183647-05).

We will be pleased to answer any questions you may have concerning CFE comments. For further information, please contact Piergiorgio Valente, Chairman of the CFE Fiscal Committee, or Rudolf Reibel, CFE Tax Policy Manager, at brusselsoffice@cfe-eutax.org.

Introduction

This Opinion Statement relates to the OECD Discussion Draft “*Revised Guidance on Profit Splits*”¹ on BEPS Actions 8-10 (“*Assure that transfer pricing outcomes are in line with value creation*”), released on 4 July 2016, and follows up on CFE’s previous Opinion Statement issued on this subject-matter². The OECD’s questions are printed in grey, while our answers are printed black.

Please note that the Opinion Statement is a preliminary version. The final version will be published on the CFE website in the course of the next days or weeks, under this link: <http://www.cfe-eutax.org/node/5543>.

1. General comments

CFE welcomes OECD efforts and initiatives aimed at improving guidance on the transactional profit split method.

Although we agree that today integrated global value chains play a key role, and that multinational entities (MNEs) quite often perform inter-related functions and activities while jointly controlling the risks associated to such functions, we also foresee some difficulties on the proper checking of the allocation key by MNEs and tax authorities.

Still, we have some concerns as to the practical and consistent implementation at worldwide level of profit splits by different tax authorities and different companies, and we fear that the latter may become a further point of dispute and debate with an increased risk of double taxation, causing mutual agreement procedure (MAP) cases to become even more difficult.

We are also concerned with the likelihood and risk that tax authorities might opt to apply the profit split method based on the analysis of the brief value chain overview reported in the country-by-country reporting document, or that they might start challenging the transactional net margin method (TNMM) in their audit activities.

2. Specific questions raised by the OECD

Section C1 (General Considerations on Transactional Profit Split Methods)

Questions:

1. Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular:

1.1. Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear?

¹ <http://www.oecd.org/tax/transfer-pricing/BEPS-discussion-draft-on-the-revised-guidance-on-profit-splits.pdf>

² CFE Opinion Statement FC 4d/2016 on Transfer Pricing and value creation (Action 8-10): final BEPS Recommendations (<http://www.cfe-eutax.org/node/5136>).

CFE welcomes the distinction between the two approaches, as well as any guidance that ensures further certainty and clarity to the current guidance. However, further guidance is definitely still needed on this subject.

While the Draft does provide some clarifications stating that the most appropriate method is to be applied on a factual basis of the specific case at issue, it would be rather useful if clear indications were set out for cases in which some “ordinary/routine” profits were to be offset in one manner, while allowing any residual profits to be subject to one or the other kind of profit split method.

CFE is concerned about any decision to include specific and rigid allocation keys and weightings to be used for new business models for the future (not taking into consideration the differences between industries and business models).

1.2. Is the distinction between the two profit split approaches described useful?

Please see our reply above.

2. Comments are also invited on the link between integration of business activities (and thus the sharing of risks) and the appropriate application of a transactional profit split of actual profits.

This entire subject-matter is rather complicated. It is our understanding that any guidelines ought to duly consider and acknowledge that there will never be an “absolute” comparable in case of related-party transactions since, in order to aptly conclude whether a profit split method is actually suitable (or not), the negotiating power between the two related parties should also be taken into due consideration (as it plays an important role). As such, in order to actually establish whether a profit split method is actually suitable (or not), the two related parties will necessarily be required to enter into a negotiating power relationship and any guidelines related to such issue should bear such significant aspect in mind

In addition, we fear that the term “integrated” could be interpreted in a broad sense, including cases in which the profit split method should not apply.

Section C2 of the Discussion Draft - Strengths and Weaknesses in a Nutshell

3. Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarised?

In our opinion, more details and further elucidation would be welcome on the practical aspects and the difficulties involved when applying the profit split method/s, since such aspects have not been addressed in sufficient detail within the Draft. Further details are essential in view of the several difficulties entailed in the identification process of profits and/or losses to be split.

We welcome the acknowledgment on paragraph 15 of the Discussion Draft on the increase of compliance burdens falling on companies, and on the difficulty of collecting, interpreting and managing data.

4. *Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses? If so, what are they?*

A weakness of transactional profit splits of anticipated profits is linked to the uncertainty involved in the fact that profits are not actual. Accordingly, such uncertainty is not foreseen in transactional profit splits of actual profits.

C.3 Most Appropriate Method

6. The discussion draft introduces the sharing of economically significant risks as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method.

6.1. Do commentators have any suggestions for clarifying the notion of risk sharing in this context?

6.2. Do commentators find the draft helps to clarify the circumstances where the transactional profit split method is the most appropriate method? Please provide explanations and/or examples supporting your views.

Preliminarily, a clarification should be provided as far as the notion of “economically significant risks” is concerned. A risk should be considered “economically significant” only if it has a relevant impact on the party to be determined according to both quantitative and qualitative criteria.

In determining such criteria, the unique and valuable contributions to a transaction should also be taken into consideration. The absence of comparables should not justify the decision for selecting the transactional profit split method.

Section C.3.1 High Integration Level of Operations

8. *Is the distinction between parallel and sequential integration of business operations a useful refinement in determining when the transactional profit split method is likely to be the most appropriate method?*

We, again, foresee some difficulties with regard to the practical implementation of the provisions. It is our understanding that taking into consideration the complexity of today’s business models, the basis for the selection of the method should consider the broad analysis of specific facts and circumstances - parallel integration should not immediately justify the application of the profit split method.

Section C.3.2 Unique and Valuable Contributions

10. *Comments are invited on the relationship between the making of unique and valuable contributions by both (all) parties to a transaction, and the sharing of economically significant risks.*

It is our understanding that further guidance will be needed on this specific subject matter (although we believe that it should not be overly prescriptive in order to allow practical implementation). As the Draft at issue clearly states – and understandably so – valuable and unique contributions represent a most fundamental (re)source that creates economic advantages and consequently means that the sharing of more and considerable risks is to be expected; as such, the applicable methods would be on a profit split basis. The above issues require, in any case, more detailed guidelines specifying that only such profits, in excess of profits arising on routine functions, qualify for the application of the profit split method/s.

Section C.3.3 Group synergies

12. The Final BEPS Report on Actions 8-10 noted that group synergies were to be addressed in the guidance on profit splits. The approach taken in this discussion draft is to make reference to the incremental or marginal system profits arising from the group synergy, which would then be shared amongst the relevant associated enterprises. The analytical framework suggested in the draft, based on an accurate delineation of the actual transaction, would not support the combining and splitting of total system profits on the basis of group synergies alone. Comments on this point are invited.

Considering that synergy is the ability of a group to outperform even its best individual member, we welcome the approach to make reference to the incremental or marginal system profits arising from the group synergy. The fact that we have Group synergies do not automatically mean that we should consider using the profit split method. Group synergies may arise without the degree of integration that would require the use of a profit split methodology.

Section C.4 Guidance for Application

15. What further guidance or clarification of existing guidance would be helpful in these sections? Please provide practical examples in support of the response.

Section C.4.1.2 discusses residual analysis. It should be made explicit that the profit split method only applies to those residual profits over and above compensation for routine functions.

Section 4.4 provides guidance on actually splitting the profits. We note that there are few changes from the guidance already in place.

16. The discussion of profit splitting factors sets a requirement that the factors must be capable of being measured in a reliable and verifiable manner. Do commentators believe that useful ways of splitting profits have been excluded? If so, please describe these factors and explain how they meet the requirement of reliable and verifiable measurement.

As previously stated, CFE fears the inclusion of a too rigid form of allocation keys.

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Confederation of Swedish Enterprise - Comments on the OECD Public Discussion Draft entitled: "BEPS Actions 8-10 Revised Guidance on Profit Splits "4 July - 5 September 2016

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 Actions 8-10 Revised Guidance on Profit Splits "4 July - 5 September 2016 (hereinafter referred to as the Draft).

As the global economy develops, so does 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 difficult if not impossible to find perfect comparables. Consequently, we welcome the wording in para 18 of the Draft stating that "a lack of comparables alone is insufficient to warrant the use of a transactional profit split of actual profits under the arm's length principle".

The Confederation of Swedish Enterprise is concerned that an increased reliance on profit split methods may gradually reduce the reliance on the arm's length standard with resulting increased uncertainty for businesses. 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 a reliable one-sided measure is not available. 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, and practical supporting guidance is not provided, we are concerned that we will see an 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 applications and the automatic application of non-arm’s length approaches in routine situations.

The challenge for governments and businesses is indeed enormous. Not only is the theory and insights into how profits arise not well understood and defined, the need for a uniform interpretation and implementation in perhaps as many as 50 countries for a truly global company, in profit and loss situations, is still utopia. The risk of disputes and double taxation in situations where the understanding of value creation in complex structures, assessing the importance of risk taking, synergies and hard to value intangibles, is considerable and it imposes large demands on guidance and rules.

There is no solid economic analysis of how profits arise in the proposal. Further, the analysis of how the proposed steps and measures are going to work is insufficient. The discussion draft presents a global profit split approach (whereby all profits or losses are divided between the relevant parties). We believe that the splitting of residual profits (or losses) represents a more appropriate framework in most cases. This latter method takes into account one-sided methods to price routine or ‘benchmarkable’ transactions before residual profit or losses are split between unique contributions. We would welcome reinforcement of this point in the final draft.

The discussion draft implies that the splitting of actual profits should be a preferred method to splitting anticipated profits in situations where both parties to the profit split are sharing the significant risks. Additional guidance would be appreciated in respect of this point as, in some cases, splitting actual profits will be too complex to be practicable.

The Confederation of Swedish Enterprise envisages a risk that the transfer price of more and more products and services will be disputed by at least one tax authority and that demands for a profit split therefore will become increasingly common. If net total profit is fully recognized and if governments are willing to accept the shares allocated to them, arm’s length prices will only represent the intermediary mechanism in allocating the profit to various tax authorities. The complexity will be very large and may entail too large economic costs to be viable. Governments must therefore act responsibly and a profit split method within a framework of arm’s length pricing should be applied with considerable restrictiveness and based on the facts and circumstances of each individual case to ensure arm’s length outcomes of the application.

Last but not least, 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.

On behalf of the Confederation of Swedish Enterprise

September 1, 2016

Krister Andersson
Head of the Tax Policy Department

5 September 2016

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

By email: TransferPricing@oecd.org

Dear Jeff,

BEPS Actions 8-10: Revised Guidance on Profit Splits

Thank you for the opportunity to comment on *BEPS Actions 8-10: Discussion Draft on Revised Guidance on Profit Splits* published on 4 July 2016 (the 'Discussion Draft'). Our comments are written from the perspective of the UK.

We welcome the additional guidance on the use of profit splits and the continued emphasis on the fact that the transactional profit split method should be used to price a transaction where it is the 'most appropriate method'. For profit split to be the most appropriate method the relationship between the parties needs to be balanced, with risks and input shared between the two parties such that profit splits become more appropriate as businesses become increasingly integrated. In selecting the most appropriate method it is essential to adhere to the arm's length principle as set out under Article 9 of the Model Tax Convention and included in bilateral tax treaties. This means considering whether a splitting of profits would be the pricing strategy selected were the parties unrelated. It is crucial that the guidance is clear not only in enabling tax payers and tax authorities to determine when the profit split method is appropriate but also when it is not appropriate.

Whilst it is not possible to cover all eventualities with appropriate examples in the guidance, detailed examples showing the outcome in a range of cases would aid businesses and tax authorities. In some cases, a revenue split will be more appropriate than a profit split and the inclusion of examples to illustrate this would also be useful. Examples will have the benefit of providing a more practical element to the guidance which will be helpful given its use in a wide range of circumstances by diverse businesses and tax authorities in different countries.

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

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.

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.

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

If you would like to discuss any of the points raised in this letter, please do not hesitate to contact either 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 on 11/12 October 2016 if it would be helpful.

Yours sincerely

A handwritten signature in blue ink that reads "Bill Jodwell".

W J I Dodwell
Deloitte LLP

APPENDIX – Responses to consultation questions

Section C.1 'In general'

1. Comments are invited on the usefulness of the explanation of and of this guidance on transactional profit splits of anticipated profits.

It is fundamental to the application of the profit split method, as to all transfer pricing, that the arm's length principle is the standard adhered to. Paragraph 1 of the Discussion Draft underlines this by stating that if the transactional profit split method is to be used, the key objective is to determine "the division of profits that independent enterprises would have been expected to realise from engaging in the transaction". The Discussion Draft would benefit from references back to the arm's length principle throughout. For example, paragraph 2.117 of the 2010 version of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ('the Guidelines') includes the qualifying phrase "...unless independent parties in comparable circumstances would have agreed otherwise...". This appropriate reminder no longer appears in paragraph 30 of the Discussion Draft, which would replace paragraph 2.117.

It would be beneficial to reorder the draft guidance to represent the order in which one would approach the selection of a transfer pricing method. This means that discussion of whether or not profit split as a whole is an appropriate method should precede considerations as to whether actual or anticipated profits should be used to implement the profit split, as follows:

- Functional analysis
- Delineation of the actual transaction
- Value chain analysis (C3.4) (this is relevant to selection of method in general, and not just profit splits)
- Introduction (C.1 – paragraph 1)
- Determine whether profit split is the most appropriate method (Sections C.3 – C3.3)
- Determine which variant of profit split is the most appropriate – actual or anticipated (C.1 – from paragraph 2 onwards).

In particular:

1.1 Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear?

1.2 Is the distinction between the two profit split approaches described useful?

The distinction between the two profit split approaches in the guidance is in general clear and in some cases will be useful. However, undue emphasis should not be placed on the distinction between the two approaches as it is not fundamental to the application of profit splits. It is more important to consider what third parties agree or would agree in comparable situations.

One useful distinction would be to illustrate the use of the profit split method to price a transaction, compared to its use to test the results of transfer pricing undertaken applied under a different method. Two examples below illustrate this:

Example i) – Using anticipated profit split to set a transfer pricing policy

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

The question then becomes whether the parties would have agreed a fixed rate for one or more years based on the anticipated profits expected at the time of entering into the contract or would have expected an adjusting mechanism to reach a split of actual profits.

It would generally not be expected that third parties would agree to remain locked-in to an inequitable contract without any capacity to exit or renegotiate, though the timeframe for this may vary between different industries and specific fact patterns.

Example ii) – Using anticipated profits to test an outcome

A group applies a transfer pricing policy (e.g. a fixed standard royalty rate) that produces a 50:50 split based on actual profits or a 60:40 split based on anticipated profits as actual profits have varied from anticipated profits.

The arm's length testing indicates that a 60:40 split is in line with the arm's length split of profits. It is then necessary to ascertain whether the risk profile of the business is such that the split of actual known profits or the level of anticipated profits (assuming that the group has contemporaneous evidence of what the anticipated profits were at the time of entering into the contract in the form of forecasts etc.) is more appropriate based on what might have occurred in a third party situation. It is noted that any parties agreeing a pricing structure must do so using anticipated profits as they are all that is available. In some cases, particularly where there is concern over the forecasts, an adjustment or renegotiation mechanism would be expected to exist.

The level of adjustment embedded into the pricing policy and/or intercompany agreement to account for variation between anticipated and actual profits would be expected to differ depending on the facts to match the level of participation in the risk/reward position with the function, asset and risk analysis relevant to the transaction (to the extent that third parties would be able or expected to also do so).

At one end of the spectrum, this could be a fixed payment or series of payments with no adjustments and at the other end of the spectrum, comprehensive true-up adjustments to achieve an agreed share of any profit/loss. It is not clear from the Discussion Draft where within this spectrum the dividing line between an anticipated and actual profit split method would fall or if it is important that there be such a dividing line into two mutually exclusive methods.

The more difficult it is to separate risks and assets between the parties, the more likely it is that an adjusting mechanism may need to be included to protect/compensate the parties, with the effect of bring the implementation closer to the a split of actual profits. Where the variation between actual and anticipated profits can be attributed to the particular performance of the parties then this may be grounds to re-assess the split to be used (for example, a third party agreement may contain minimum performance requirements/ restrictions that would allow immediate termination of the contract).

Third parties agree how profits will be split in advance of undertaking the transactions, including agreeing whether profits should be adjusted based on actual results.

2. Comments are also invited on the link between integration of business activities (and thus the sharing of risks) and the appropriate application of a transactional profit split of actual profits.

The more integrated the operations of the two parties and the sharing of risk between them, the more likely it is that a split of actual profits would be the appropriate approach to sharing the profits between them. In addition to this, which it would be helpful to state clearly in the guidance, is that there must also be a significant degree of parity between the parties. This may be linked to the sharing of risk in the overall undertaking. For example where the profits are split 90:10 between the

parties, and the sharing of risk follows that ratio, this may result in both parties carrying significant risk relative to the size of their own operations, but would be unlikely to result in significant sharing of risk by the party taking the smaller percentage, relative to the size of the combined business. The degree of parity between the parties is significant in determining whether the use of the profit split method is appropriate at all.

Where the business risks are easier to separate and the impact on profit aligns with the control of the risk there would be a greater expectation that the pricing would tend towards the use of anticipated profits, with each party bearing the impact of the risks that they control, assuming that profit split was the right method to be used in the first place.

It may be helpful to consider limitations on how much variation in anticipated profits unrelated parties might accept before seeking to renegotiate the terms to protect against some of the more extreme results (e.g. where one party is substantially loss-making and the other is substantially profit-making) that would in aggregate appear unreasonable.

3. Examples of scenarios where each approach to splitting profits would be the most appropriate (together with a brief explanation as to why) are also requested.

No further comments.

Section C.2 'Summary of strengths and weaknesses'

4. Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarised?

The summary of the strengths and weaknesses of profit split is consistent with previous guidance and captures many key points.

It would be beneficial to expand further on the comments in paragraph 14 of the Discussion Draft on the difficulties in applying the profit split method, particularly in relation to the complexities and costs related to applying this method. Updating and maintaining the information required to support the profit split method year-on-year is expensive and time-consuming for both businesses (and tax authorities auditing them). The time commitment required by senior employees to provide relevant information in interviews can be significant in terms of the time away from running the business.

5. Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses?

Splits of actual profits are more complex and take more input from senior business people as the calculations need to be revisited annually to adjust the pricing policy to take account of changes in the business and the transactions being priced, or the way in which they are performed. Conversely, anticipated profits splits are more likely to run the risk of obsolescence as supporting calculations may not accurately represent the up-to-date position in a dynamic business. The choice between the actual and anticipated methods are generally indicated by the circumstances of the transactions being priced and therefore different strengths and weaknesses are also likely to result from the different circumstances to which the method is being applied.

Section C.3 'Most appropriate method'

6. The discussion draft introduced the sharing of economically significant risks as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method.

6.1. Do commentators have any suggestions for clarifying the notion of risk sharing in this context?

There should be clarity that the parties intended to share the risks of business activities from the outset, and, in line with the G20/OECD guidance on Actions 8-10, have the capability and financial capacity to take on the risk.

6.2. Do commentators find the draft helps to clarify the circumstances where the transactional profit split method is the most appropriate method? Please provide explanations and/or examples supporting your views.

It is essential and very helpful that the guidance confirms that the profit split method should not be treated as a 'default' option. Additional comments on specific points are as follows:

- **Lack of precise comparables** – value chain analysis could be used to validate the final economic result of applying the adjusted comparable data;
- **Group synergy benefits** – Although not sufficient to indicate the use of a profit split approach in isolation, where a profit split method is deemed appropriate through the aggregation of all contributing factors, it would be reasonable to also include the synergy benefits within the profit split analysis. This is implied but not explicitly stated in the Discussion Draft.

7. The discussion draft notes that a transactional profit split of anticipated profits can be used in conjunction with certain valuation techniques. Examples showing the application of a transactional profit split of anticipated profits are sought.

The use of discounting for the time-value of money for a multi-year analysis will be particularly relevant if the pattern of profitability or remuneration of transactions is changeable and one party is being asked to defer their remuneration and/or bear initial losses in respect of the transaction.

Other than this, valuation techniques would generally seem to be most relevant to situations where there is a separable asset to which they may be applied together with considerations of exclusivity and useful economic life. The concepts that inform the application of valuation techniques (such as discounting for the time value of money discussed above) are likely to be relevant in the performance of a profit split analysis.

It is worth noting that discounted cash flow techniques may be used in the context of business restructurings under Chapter IX of the OECD Guidelines and the valuation of a legacy contribution where all continuing business risk is being transferred. Although this is not directly a transactional profit split, it does share many of the same features in terms of the use of anticipated profits and valuation techniques.

Section C.3.1 'Highly integrated operations'

8. Is the distinction between parallel and sequential integration of business operations a useful refinement in determining when the transactional profit split method is likely to be the most appropriate method?

The concept of sequential and parallel integration is useful when considering the likely level of integration and by extension the potential applicability of the actual and anticipated profits approaches. In this regard, there are some elements of integration and risk that are likely to span the supply chain (for example sales volume risk which is affected by multiple different factors and so harder to delineate between entities and/or phases of the relevant supply chain).

There is likely to be a spectrum of situations ranging from those comprising a purely sequential process and those where all parties are involved in all processes with a degree of parity of risk.

The closer the operations resemble a sequential process, the more likely it is that the use of comparable data and another pricing method is the most appropriate.

The extent of sequential and/or parallel integration may also inform the applicability of the residual or total profit split approaches with sequential integration being more likely to yield discrete functions to which an alternative (e.g. comparable uncontrolled price or transactional net margin) method may be applied to reduce the amount of residual profit.

The guidance is helpful where it suggests that a high degree of parallel integration is likely to be an indicator that profit split is an appropriate method. The scenario where one party is the co-ordinator of multiple routine functions in parallel should be excluded as comparable data may still be available for the discrete functional blocks (and may therefore give a more accurate arm's length result).

9. If so, how should the concept of parallel integration be further defined?

Examples for each of the three main categories of comparability factor (functions, assets and risks) demonstrating features of sequential and parallel integration may be helpful. These are likely to be questions of fact that will be identified through the normal process of analysing and documenting the business and the value chain. Some simple potential examples are provided in the table below:

Indicators	Sequential	Parallel
Functions	Separate teams, reporting lines and stage gates for progression through the supply chain.	Shared teams and common reporting lines.
Assets	Separable assets, from both a legal and economic perspective. Costs located in a single entity or able to be recharged to a single entity (subject to development, enhancement, maintenance, protection and exploitation considerations).	Assets shared due to contributions from different sources and/or shared development, enhancement, maintenance, protection and exploitation functions.
Risks	Economically significant risks managed and controlled by functions of a single entity that has the financial capacity to assume the risks.	Shared risks where the different components of risk (control and financial capacity to assume) are spread across multiple entities and not able to be separately priced.

Section C.3.2 'Unique and valuable contributions'

10. Comments are invited on the relationship between the making of unique and valuable contributions by both (all) parties to a transaction, and the sharing of economically significant risks.

11. Are there situations where all the parties make unique and valuable contributions to a transaction, but they do not share the economically significant risks associated with the outcomes of that transaction? If so, what guidance on the appropriate use of profit splits in such a situation should be provided?

It would be expected that in most cases, where both parties make a unique and valuable contribution, it would also imply that they share one or more economically significant risks (e.g. the product is not successful in the market).

It seems likely that in a circumstance where a party to the transaction does make a unique and valuable contribution but does not bear any risk that is economically significant, the business operations might rely on, for example, an external market which is more likely to yield external comparables or have a reliable income stream that could be tested directly using valuation techniques. In such circumstances, the use of comparable uncontrolled prices would be expected to provide an answer in line with the arm's length position. In such circumstances, profit split is unlikely to be the most appropriate method.

A further factor that should be considered is the degree of parity between the value of the contributions of each of the parties. It is more likely that the profit split method is appropriate where the value of contributions of the participants are of a similar scale. It is perhaps less likely that two parties would agree a formal profit split if the relative value of their contributions were say 10%-90%.

It is difficult to envisage a scenario where there would be a unique and valuable contribution that was both free of significant economic risk and also of unknown value such that a profit split assessment would be required in respect of it.

It may be the case that a third party could be insulated from risk, despite making a unique and valuable contribution, for example where there is an agreement which gives them a fixed up-front payment or a minimum level of guaranteed income.

Section C.3.3 'Group synergies'

12. The Final BEPS Report on Actions 8-10 noted that group synergies were to be addressed in the guidance on profit splits. The approach taken in this discussion draft is to make reference to the incremental or marginal system profits arising from the group synergy, which would then be shared amongst the relevant associated enterprises. The analytical framework suggested in the draft, based on an accurate delineation of the actual transaction, would not support the combining and splitting of total system profits on the basis of group synergies alone. Comments on this point are invited.

The key test is likely to be whether a discrete incremental economic benefit can be ascribed to the individual synergy (such as a cost saving). Where this is possible, it is reasonable to either separately allocate the cost saving or have one party receive the benefit of the cost saving but then to be charged for the shared service within the group that replaces it (which assumes that an appropriate comparable price can be established). In this scenario, a profit split is less likely to be appropriate. Conversely, if a

profit split were to be indicated by other factors, an allocation of group synergies could form part of the methodology.

There will, however, be some group synergies where it is harder to quantify the incremental economic benefit (e.g. increase in brand reputation and presence in the market) and these are more likely to form part of a profit split approach. If these separately unquantified group synergies can be shown to be sufficiently economically significant in aggregate then a profit split approach to either the whole business or just to the incremental synergy profit may be justified.

Section C.3.4 'Value chain analysis'

13. Does this section (value chain analysis) properly describe a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit split method is appropriate?

14. If commentators see a value chain analysis as serving a greater purpose in relation to profit splits, then please provide an explanation for that view together with examples.

The section on value chain analysis would be more appropriately positioned at the start of the OECD's guidance on selection of the most appropriate method (given that it is not solely related to the profit split method). At the least, it is the first part of the process to determine whether a profit split would be the most appropriate method and, if so, how a profit split would be applied to the transactions in question.

Although the value chain analysis would provide support which may be useful in determining the most appropriate method and the content of the analysis to be undertaken to support the choice of that method, it would not be directly applicable in assessing the split of profit between the parties. As such, it is a descriptive exercise, rather than a numerical one. The Discussion Draft emphasises that the value chain analysis should be a tool to assist the delineation of the actual transactions. The existence of a global value chain analysis does not imply that a profit split approach should be used.

Section C.4 'Guidance for application'

15. What further guidance or clarification or existing guidance would be helpful in these sections? Please provide practical examples.

The best guidance in these sections would be clear, practical examples. A series of examples with the same base facts which develop throughout the series would be most helpful.

Section C.5 'Reliance on data from taxpayer's own operations (internal data)

- 16. The discussion of profit splitting factors sets a requirement that the factors must be capable of being measured in a reliable and verifiable manner. Do commentators believe that useful ways of splitting profits have been excluded? If so, please describe these factors and explain how they meet the requirement of reliable and verifiable measurement.**
- 17. What further guidance would be useful in this section relating to identifying and measuring profit splitting factors?**
- 18. More generally, examples are requested of scenarios where a transactions profit split of actual profits or of anticipated profits are applied, together with a brief explanation as to why the method and the approach to applying the method, is considered to be the most appropriate in the circumstances of the case**

Whilst the use of profit splits is appropriate for integrated operations, the difficulty of obtaining and analysing data remains. Detailed numerical examples showing the outcome in a range of cases would aid businesses and tax authorities.

In some cases (depending on the facts and circumstances, often related to sales) a revenue split will be more appropriate than a split of profits. For example, this would be the case in a scenario where the parties contributing to the operations of a group each control their own cost base and activities but, nonetheless, some revenues are realised that benefit the group as a whole (e.g. where performance of the contracts may be undertaken by group entities other than the entity that generates the sales). An acknowledgement that a split of revenue can be more appropriate than a split of operating profit, and a detailed example of this, would be a beneficial addition to the guidance.

There may also be specific facts and circumstances that might point to a wide variety of potential profit or loss splitting factors. It would therefore be a helpful addition to the guidance to clearly state that the most appropriate approach in each circumstance will depend on the functional, risk, comparability and industry analyses as well as the value chain.

VIA EMAIL: TransferPricing@oecd.org

September 5, 2016

OECD Secretariat
Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organization for Economic Cooperation and Development
2, rue André Pascal
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FRANCE

Re: Comments on *Public Discussion Draft on Revised Guidance on Profit Splits (Chapter II of the Transfer Pricing Guidelines)*

Dear Secretariat:

We are pleased to submit comments on behalf of Deloitte Tax LLP ("Deloitte Tax"), a subsidiary of Deloitte LLP¹ regarding the *Public Discussion Draft on Revised Guidance on Profit Splits (Chapter II of the Transfer Pricing Guidelines)* (the "discussion draft").

As part of our submission to the OECD, Deloitte Tax is providing responses to several of the *Questions to Commentators* found throughout the 21 pages of guidance in the discussion draft. Although our answers to the questions are self-contained, additional context and more extensive reasoning are provided in our general comments that touch upon most of the questions submitted to commentators by the OECD. We therefore recommend that our answers be read in the broader context of our general comments.

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 dialogue with the OECD on this and other transfer pricing initiatives.

¹ Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

Very truly yours,

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DELOITTE TAX COMMENTS ON OECD'S DISCUSSION DRAFT ON BEPS ACTIONS 8, 9, AND 10: PUBLIC DISCUSSION DRAFT ON REVISED GUIDANCE ON PROFIT SPLITS (CHAPTER II OF THE TRANSFER PRICING GUIDELINES)

EXECUTIVE SUMMARY

Comments on Location of Guidance

Several important items of guidance introduced in the discussion draft appear to be of broader relevance to a transfer pricing analysis than just limited to an appropriate application of transactional profit splits. These items of guidance include:

- Distinction between parallel and sequential integration of a multinational enterprise (MNE) (C.3.1)
- Definition of unique and valuable contributions (C.3.2)
- Group synergies (C.3.3)
- Value chain analyses (C.3.4)

Because these items of guidance appear to be relevant in the context of a functional analysis, and in the accurate delineation of actual transactions within an MNE, we suggest moving the description of these concepts (including how these concepts relate to a functional analysis) to Chapter I, and to cross-reference their use and application in other chapters as appropriate.

Elimination and Resolution of Inconsistencies in the Guidance

Deloitte Tax recommends elimination and resolution of inconsistencies in the guidance. The guidance found in Chapter VI appears to favor using transactional profit splits to value intangible contributions. However, warnings on the appropriateness of transactional profit splits in the discussion draft at Paragraphs 3, 9, 10, 11, 14, 15, 16, 17, 18, 19, 21, 23, 25, 26, and 28 appear to achieve the exact opposite, and appear to limit the appropriateness of transactional profit splits in some intangibles transactions under Section D.2.6.2 of Chapter VI. It is unclear where that leaves taxpayers and tax administrations, other than having to rely on valuation techniques outside the scope of a transactional profit split. Recognizing that it may be difficult at this stage for Working Party 6 to adjust some of the guidance provided in Chapter VI to better align it with the guidance provided in the discussion draft, Deloitte Tax requests that specific examples illustrating the selection or non-selection of transactional profit splits as the most appropriate method in the context of intangible transactions be included in the revised Chapter II.

Comments on C.1 in General

Deloitte Tax believes that providing additional guidance on transactional profit splits of anticipated profits would be helpful. In particular, providing guidance on the circumstances in which a profit split of actual profits would be the most appropriate method in comparison with those circumstances in which the profit split of anticipated profits would be the most appropriate method would be helpful. Deloitte Tax believes that the current guidance has ambiguities with respect to this “actual versus anticipated” profit split issue that provides an opportunity for tax authorities to use such ambiguities to argue for transactional profit splits of actual profits when doing so would be inappropriate. Accordingly, Deloitte provides three example that we recommend be included in the guidance to mitigate that risk.

Deloitte Tax does not believe that the distinction between “gross margin” and “operating margin” in Paragraph 41 is particularly useful, and believes that it can actually confuse the issue. The determination of the costs to deduct from revenue in determining which profits to split should be guided entirely by the functional analysis and accurate delineation of the transaction, not accounting classifications of costs. The guidance in section C.4.2 should reflect this more clearly through the use of examples, and should make clear that profit splitting (accounting) operating margins is reliable only if the functional analysis of the transaction concluded that the parties share all economically significant exploitation risks, and exercise control over all those economically significant exploitation risks.

Comments on C.3 Most Appropriate Method

Deloitte Tax is concerned that tax administrations might disregard the level of risk sharing intended by the parties, and thus inappropriately split actual exploitation profits whenever parties share development activities. Accordingly, Deloitte Tax has provided an example that we recommend be included, whereby, despite the sharing of development activities, neither party intends to share in any of the exploitation risks of the other. Deloitte Tax requests that Paragraphs 21 and 22 be clarified to acknowledge that just because the parties are pooling and sharing the costs of development, this does not necessarily mean that they intend that the profits be pooled and shared as well (and explain the circumstances in which such profit pooling treatment would be inappropriate by a tax authority).

ORGANIZATION OF GUIDANCE

Chapter I of the Organization for Economic Cooperation and Development (OECD) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (“TPG”) provides an interpretation of the arm’s length principle, and general guidance on how to apply that principle.² Such guidance includes guidance on functional analysis that is of particular importance in the context of the accurate delineation of the actual transaction. Chapter II of the TPG discusses transfer pricing methods, including transactional profit splits.

LOCATION OF GUIDANCE

Although the discussion draft focuses on transactional profit splits (transfer pricing methods), a number of important items of guidance introduced in the discussion draft appear to be of broader relevance to general transfer pricing analyses than a specific discussion of transactional profit splits. These items of guidance include:

- Distinction between parallel and sequential integration of a multinational enterprise (MNE) (C.3.1)
- Definition of unique and valuable contributions (C.3.2)
- Group synergies (C.3.3)
- Value chain analyses (C.3.4)

Because these items of guidance appear to be relevant in the context of a functional analysis, and in the accurate delineation of actual transactions within an MNE, we suggest moving the description of these concepts (including how these concepts relate to a functional analysis) to Chapter I, and to cross-reference their use and application from Chapter I, in the context of Chapter II (transfer pricing methods), Chapter VI (intangibles), Chapter VIII (cost contribution arrangements), and Chapter IX (business restructurings) in those chapters.

Parallel and Sequential Integration of an MNE (C.3.1)

Although the distinction between parallel and sequential integration may provide a useful conceptual framework to start thinking about the sharing of risks within an MNE, Deloitte Tax suggests that from a practical standpoint the distinction between parallel and sequential integration provides much more than that conceptual starting point. The reality of most MNEs is that both parallel and sequential integrations take place continuously. While an initial technology may have been sequentially developed before maintenance, enhancement, protection, and exploitation take place, once launched, it is likely that further development of the technology, maintenance of the current generation, enhancement of the current generation, protection of the current generation, and exploitation of the current generation will occur in parallel.

² All references herein to the OECD TPG are references to the 2010 version of the TPG, as modified by the BEPS Final Reports on Actions 8-10 and Action 15, published October 5, 2015, and adopted into the TPG in May 2016.

The mere fact that these activities take place in parallel does not mean that “...*the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with, and cannot reliably be evaluated in isolation from, the way in which another party to the transaction performs functions, uses assets and assumes risks.*” [Emphasis added]. The reliability referred to in this sentence is a factual determination. Defining “high integration” of an MNE as a case in which it is unreliable to evaluate the functions performed and assets used by one party separate from the functions performed and assets used by another party is dangerous. Only contractual allocation of risks and accurate delineation of the actual transaction through a thorough functional analysis should determine whether using a transactional profit split is the most reliable transfer pricing method.

Deloitte Tax is concerned that C.3.1 undermines and weakens the guidance on accurate delineation of a transaction, unless this guidance is moved to Chapter I and properly integrated into the broader discussion of this topic within the TPG. It should be clear that in some cases transactional profit splits may be the most appropriate method for a sequentially integrated MNE because the MNE structured its affairs and its control over assets and functions that way. Similarly, it should be clear that in some cases transactional profit splits may not be the most appropriate method for a parallel integrated MNE because the MNE structured its affairs and its control over assets and functions in an alternative manner. Alternatively, if the section is not moved to Chapter I, the description should be strengthened by including the considerations discussed in this paragraph.

Unique and Valuable Contributions (C.3.2)

Paragraph 6.17 of Chapter I provides a definition of a unique and valuable intangible. Section C.3.2 of the discussion draft provides a definition of a unique and valuable contribution. Because intangibles are assets that are contributions within the meaning of Paragraph 22 in Section C.3.2, but not all contributions are intangibles within the meaning of paragraph 6.6 in Chapter VI, one would expect the language in Paragraph 6.17 (Chapter VI) and 22 (discussion draft) to be exactly the same but for the word “intangible” in paragraph 6.17 replacing the word “contributions” of paragraph 22.³ But this is not the case. We recommend that the definition in Paragraph 6.17 be conformed to the definition in Paragraph 22 to avoid ambiguity and conflicts between provisions and the ensuing controversy that may be difficult to resolve.

In addition, the critical element of the accurate delineation of transactions is the identification of the *economically significant risks* involved in the transactions. Deloitte Tax recognizes that unique and valuable contributions are often likely to involve economically significant risks, but this should be a discussion in Chapter I when illustrating what *economically significant risks* mean. In particular, transactions that do not involve unique and valuable intangibles still involve, in

³ The “all value requirement” guidance in the last sentence of Paragraph 6.2 appears to make the distinction between an “intangible” and a “contribution” even less relevant.

every single case, the presence of economically significant risks. This is a direct consequence of the definition of “risk” (the effect of uncertainty on the objectives of a business) at Paragraph 1.71 of Chapter I.

The objectives of every for-profit business center on profit maximization; therefore, even when a business does not involve any unique and valuable contributions, there are other risks that will be most significant in driving the expected or actual profitability of the business. It is thus not clear that C.3.2 should be more than an illustration of how to identify economically significant risks for a business that has unique and valuable contributions made by at least one party. It would be helpful to juxtapose C.3.2 with a counter example whereby *no* party to the transaction makes unique or valuable contributions, but where economically significant risks are shared and a transactional profit split is still the most appropriate method after accurate delineation of the transaction.

Group Synergies (C.3.3)

Deloitte Tax agrees that the mere existence of group synergies should not be determinant of which transfer pricing method is most appropriate. Only the accurate delineation of the transaction pursuant to a thorough functional analysis should guide that determination. Deloitte Tax suggests moving that guidance to Paragraph 1.162 of Chapter I addressing group synergies.

Deloitte Tax also believes that the value of group synergies may be exaggerated due to a lack of understanding of the effect of competition in the open market. If significant value can be created for shareholders of a company by further vertical integration (because such significant synergistic value to integration is possible), then further integration of companies will occur until synergistic rents disappear. This is a direct result of the objective of a for-profit business centering on profit maximization. Rents in the open market do not survive for long unless they are protected by barriers to entry. Other than possible regulatory barriers to vertical integration in some industries, companies by and large have the opportunity to vertically integrate as desired. Synergistic rents therefore should disappear as a result of the forces of competition.

Value Chain Analyses (C.3.4)

The discussion draft introduces four new paragraphs of guidance in connection with value chain analyses. The first sentence of the first paragraph cross-references Paragraph 1.34 of Chapter I and states that “*a value chain analysis ... may be useful in helping to identify when the transactional profit split method may be appropriate.*” It goes on to state: “*It should be emphasized however, that such a value chain analysis is merely a tool to assist in delineating the controlled transactions, in particular in respect of the functional analysis, and thereby determining the most appropriate transfer pricing methodology.*”

With respect to value chain analyses, Deloitte Tax suggests:

1. Specifically state that a value chain analysis is not a transfer pricing method.

2. Move the general guidance on value chain analysis outside of Chapter II (transfer pricing methods), which would help reinforce the notion that a value chain analysis is a tool to evaluate a transaction, not a transfer pricing method.
3. Explain what the difference is, if any, between a value chain analysis and a functional analysis. Should Working Party 6 (WP6) conclude that a value chain analysis is an analysis that is different and distinct from a functional analysis, Deloitte Tax would request that WP6 provide additional guidance on (i) what the differences are between the two types of analyses; and (ii) when a value chain analysis is appropriate (or required) to conduct, given that a functional analysis is required in all instances of a transfer pricing study

Question to commentators

13. Does this section properly describe a value chain analysis as a tool in helping delineate the actual transaction and in identifying features relevant in determining whether the transactional profit split method is appropriate?
14. If commentators see a value chain analysis as serving a greater purpose in relation to profit splits, then please provide an explanation for the view together with examples.

Deloitte Tax response

Summarizing some of the points articulated in this section, Deloitte Tax believes that this section is useful but should be moved to Chapter I. Moreover, WP6 should explain whether a value chain analysis is just another name for a functional analysis that is described in Chapter I, or if there are substantive differences that justify using different names. If WP6 believes the former is correct, we would suggest clarifying that *“a value chain analysis performed for transfer pricing purposes is called a functional analysis. Guidance on functional analyses is provided in Chapter I.”* Conversely, if WP6 believes the latter, then Deloitte requests additional guidance articulating what the differences are between a value chain analysis and a functional analysis.

Deloitte Tax does not see a value chain analysis as serving a greater purpose in relation to profit splits—in fact, we would suggest that because a value chain analysis is **not** a transfer pricing method, but merely a tool to accurately evaluate a transaction, it cannot logically serve any greater purpose in relation to profit splits than in relation to any other transfer pricing methods. Integrating value chain analysis with profit splits is erroneous and may be misleading.

CONSISTENCY OF GUIDANCE

Although Deloitte Tax does not believe that any of the guidance provided in the discussion draft contradicts the guidance provided in the TPG, as amended by the final report on actions 8-10 of October 5, 2015 (the “final report”), we are concerned about potential inconsistencies between the discussion of methods in Chapter VI and the discussion of the applicability of transactional profit splits

The discussion draft provides several specific warnings about the use of transactional profit splits in cases in which it would not be appropriate, either because of data issues or because the method is inconsistent with the results of the accurate delineation of the actual transaction. Such warnings are provided in Paragraphs 3 (*ex ante* rationale), 9, 10, 11, 14, 15, 16, 17, 18, 19, 21, 23, 25, 26, and 28. We further recognize that Section D.2.6.2 of Chapter VI contains in Paragraph 6.148 a direct reference to Section C of Chapter II, and incorporates that guidance by such reference. All warnings contained in Paragraphs 16 to 19 of the discussion draft are thus incorporated in Chapter VI by reference.

Notwithstanding the foregoing, Paragraph 6.57 states that: *“Because it may be difficult to find comparable transactions involving the outsourcing of such important functions, it may be necessary to utilize transfer pricing methods not directly based on comparables, including transactional profit split methods and ex-ante valuation techniques...”* [Emphasis added]. However, Paragraph 16 of the discussion draft under C.3 (Most appropriate method) states: *“The application of a transactional profit split of actual profits when not supported by the features derived from the functional analysis, for example in cases where other methods are difficult to apply because reliable comparables are scarce, is unlikely to produce an arm’s length outcome since the appropriate use of profit split is determined by the existence of a specific commercial relationship between the parties.”* [Emphasis added]. Furthermore, Paragraph 18 of the discussion draft under C.3 (Most appropriate method) states: *“A lack of comparables alone is insufficient to warrant the use of a transactional profit split of actual profits under the arm’s length principle.”* [Emphasis added].

While Paragraph 6.57 suggests that a lack of comparables may be sufficient basis to utilize a transactional profit split method, Paragraphs 16 and 18 of the discussion draft clearly suggest that this is not the case—only the results of the accurate delineation of the transaction informs whether or not a transactional profit split on actual profits should be considered.

In addition, guidance provided at Paragraphs 6.133, 6.138, and 6.141 suggests that (i) comparable uncontrolled price (CUP) methods are often unavailable or unreliable (6.138); (ii) one-sided methods are usually not reliable for directly valuing intangibles (6.141); and (iii) the transfer pricing method selected should take into account all contributions to value creation, not just automatically assign all

residual to the owner of the intangibles after providing a limited return to functional contributions (6.133).

Since only two methods are provided under Paragraph 6.145 to value intangibles -- the CUP method and the transactional profit split method -- after eliminating the CUP *per* Paragraph 6.138, only the transactional profit split method (complemented by valuation techniques) is left.⁴ The guidance found in Chapter VI therefore appears to favor using transactional profit splits to value intangible contributions. However, as pointed out above, warnings on the appropriateness of transactional profit splits in the discussion draft at Paragraphs 3, 9, 10, 11, 14, 15, 16, 17, 18, 19, 21, 23, 25, 26, and 28 appear to achieve the exact opposite, and appear to limit the appropriateness of transactional profit splits in some intangibles transactions under Section D.2.6.2 of Chapter VI.

It is unclear where that leaves taxpayers and tax administrations, other than having to rely on valuation techniques outside the scope of a transactional profit split.

Deloitte Tax agrees with the general tone of the guidance on the appropriateness of transactional profit splits in the discussion draft, as a result of the more rigorous and tighter application of the framework of Chapter I to Chapter II in the discussion draft, than to Chapter VI—specifically in connection with the functional analysis and the impact of the accurate delineation of the transaction on the selection of method. Recognizing that it may be difficult at this stage for WP6 to adjust some of the guidance provided in Chapter VI to better align it with the guidance provided in the discussion draft, Deloitte Tax requests that specific examples illustrating the selection or non-selection of transactional profit splits as the most appropriate method in the context of intangible transactions be included in the revised Chapter II.

⁴ We note that the discussion draft does not provide guidance above and beyond that provided in Chapter VI under Sections D.2.6.3 and D.2.6.4 in connection with the use of valuation techniques when performing a transactional profit split. Paragraphs 4 and 20 of the discussion draft directly refer to Chapter VI Sections D.2.6.3 and D.2.6.4 without elaborating on how a typical analysis should be performed.

C.1 IN GENERAL

A number of new paragraphs of guidance are provided in the discussion draft under Section C.1. Specifically, new Paragraph 2 of the discussion draft elaborates on the sentence in Paragraph 2.108 of the 2010 TPG that provides that “*It then splits those combined profits between the associated enterprises on an economically valid basis*” [Emphasis added]. According to Paragraph 2 of the discussion draft, splitting profit on an economically valid basis means either (i) splitting anticipated profits; or (ii) splitting actual profits. The guidance then goes on to describe the commercial relations between parties that would result in considering one type of transactional profit split versus the other, and how the accurate delineation of the transaction plays into each form of transactional profit split (see Paragraphs 4-10 of the discussion draft).

Although the additional guidance under C.1 emphasizing the way the accurate delineation of the transaction (expression of commercial or financial relationship between parties) plays into the appropriate selection of a profit split methodology is useful and necessary, Deloitte Tax suggests that providing additional guidance on transactional profit splits of anticipated profits (within the meaning of Paragraph 5 of the discussion draft) would be helpful. In particular, providing guidance on the circumstances in which a profit split of actual profits would be the most appropriate method in comparison with those circumstances in which the profit split of anticipated profits would be the most appropriate method would be helpful. Our comments below discuss these situations and provide examples when each profit split approach may be appropriate.

The additional guidance on actual transactions would be helpful because the nature of the commercial or financial relationship between parties, expressed through the accurate delineation of the transaction, will often show that each party runs a substantial portion of its business activities separate from the other parties, in which case a transactional profit split of actual profits would not apply. However, in such a case, transactional profit splits of anticipated profit may apply; therefore, additional guidance on a transactional profit split of anticipated profits would be useful. See guidance at Paragraph 7 of the discussion draft (addressing cases in which a profit split of actual profit is not called for given the actual delineation of the transaction) and stating that: “*However, both parties will generally continue to run their separate business activities ...*” [Emphasis added].

This guidance should be read along with the guidance at Paragraph 9 of the discussion draft (addressing cases where a profit split of actual profits is called for given the actual delineation of the transaction) and stating that: “*In such cases, the activities and associated risks of the parties are integrated such that they can often be considered as a single, cohesive business.*” [Emphasis added]. Many commercial, as well as intercompany, arrangements that involve joint development of intangibles, for example (and the sharing of development risks), specifically provide that each participant will have the exclusive rights to exploit the intangibles in a well-defined, non-overlapping territory, specifically to avoid being considered a single, cohesive business.

The following example illustrates this point. Note that this example is exactly the same as the example provided in the discussion draft at Paragraph 5, with only one additional piece of information, namely, that Company A and Company B exploit the product in separate, non-overlapping territories, and control all exploitation risks by themselves in their respective territory.

Example 1: Company A, in Country A, transfers rights in intangible X, which it owns, to an associated enterprise, Company B, in Country B, in circumstances in which Company B combines that intangible with its own intangible Y to commercialize product W, in Country B, using intangibles X and Y in combination. At the same time, Company B transfers rights in intangible Y, which it owns, to Company A, in circumstances in which Company A combines that intangible with its own intangible X to commercialize product W, in country A, using intangibles X and Y in combination. The functional analysis indicates that all exploitation functions (manufacturing, marketing, and distribution) of intangibles X and Y in product W, in country A, are controlled (within the meaning of Chapter I) by Company A, and all exploitation functions (manufacturing, marketing, and distribution) of intangibles X and Y in product W, in country B, are controlled (within the meaning of Chapter I) by Company B. In addition, Company A has exclusive exploitation rights for product W, in Country A, and Company B has exclusive exploitation rights for product W, in Country B. Therefore, the accurate delineation of the transactions confirms the contractual allocation of all exploitation risks and anticipated returns from product W to Company A in Country A, and to Company B in Country B.

This example expands on the examples of Paragraphs 4 and 5 in the discussion draft. It is an example whereby Company A and Company B have no intent to pool their profits from exploitation, but commercialize the same product, using the same intangibles, in separate and distinct territories.

Applying the guidance provided in the discussion draft correctly would lead to two conclusions: (i) there are two separate and distinct transactions taking place, the first is the license of intangible rights from Company A to Company B, without further interest of Company A in the exploitation business of Company B; the second is the license of intangible rights from Company B to Company A, without further interest of Company B in the exploitation business of Company A; and (ii) the guidance found in Paragraph 4 in the discussion draft applies to each of the separate transactions.

Therefore, the transactional profit split method that is a candidate for *most appropriate method* is the transactional profit split of anticipated profits of Company A (first transaction), and of anticipated profits of Company B (second transaction), respectively. Performing a single transactional profit split on actual pooled profits of Company A and Company B would be inconsistent with the accurate delineation of the transaction, because there is no common management and control of exploitation risks. In addition, it would not reflect the commercial or financial relationship between the parties expressed through the cross-licensing of their respective intangibles. Note that the fact pattern of Example 1 is consistent with

typical fact patterns found in cost contribution arrangements (CCA), where the CCA eliminates the need for cross-licenses between Company A and Company B.

Assume that the transactions of Example 1 result in profits in Country A, but losses in Country B. The tax administration in Country B would have a strong incentive to argue that the profits of Company A and Company B should be pooled and split using a transactional profit split of actual profits. The OECD could eliminate that incentive by articulating more clearly fact patterns that do not lead to the conclusion that a transactional profit split on actual profits is appropriate. This would greatly reduce the risk that taxpayers and tax administrations may default to transactional profit splits of actual profits when inappropriate.

Deloitte Tax therefore requests that Example 1 be included in Paragraph 6 as an illustration of how the accurate delineation of the transactions results in a rejection of the transactional profit split of actual profits in such a fact pattern.

Deloitte Tax further requests that the example provided in Paragraph 5 of the discussion draft specifically indicate that the reason a transactional profit split of actual profits is the most appropriate method to apply in this particular case is because Company A and Company B agreed *ex-ante* to share the exploitation risks of the product in both countries, and the functional analysis of the transaction supports the conclusion that each exercises sufficient control (within the meaning of Chapter I) on the economically significant exploitation risks. This elaboration should replace the sentence: “*Assuming that the facts of this case lead to the conclusions that a transactional profit split of actual profit is the most appropriate method to apply ...*” [Emphasis added]. Example 2 below modifies Example 1 to reach this conclusion after accurately delineating the transactions.

Example 2. Consider the same facts as in Example 1, other than Company A and Company B agree *ex ante* to jointly exploit intangibles X and Y in both countries. Specifically, Company A will perform all the manufacturing of product W utilizing intangibles X and Y in countries A and B, and Company B will perform all marketing, advertising, and selling functions for product W in countries A and B. Assume that there are economically significant risks associated with the manufacturing of product W, and that there are economically significant risks associated with the marketing, advertising, and selling functions of product W. Assume that the functional analysis of the transaction supports the conclusion that Company A exercises control of economically significant risks associated with manufacturing product W in both countries, and Company B exercises control of economically significant risks associated with marketing, advertising, and selling product W in both countries. Further assume that Company A exercises sufficient operational control over the risks associated with marketing, advertising, and selling functions to delegate to Company B management of those functions, and Company B exercises sufficient control over the risks associated with manufacturing functions to delegate to Company A management of those functions. As a result of the functional analysis and accurate delineation of the transaction, the transactional profit split of actual profits is determined to be the most appropriate transfer pricing method.

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

Returning to Example 1, one could potentially interpret the control that Company A exercises over *all* economically significant risks associated with the exploitation of intangibles X and Y in Country A, and the control that Company B exercises over *all* economically significant risks associated with the exploitation of intangibles X and Y in Country B, as meeting the “either separately or collectively” condition of Paragraph 9. This interpretation, however, is likely not the intended one, because clearly Company A does not exercise any control over any of the economically significant risks in Country B, and *vice versa*. The intent of that guidance is likely to cover cases where (1) Company A and Company B have a contractual arrangement providing that they will pool their profits, and (2) Company A controls *some* of the economically significant risks in *both* Country A and Country B, and Company B controls *some* of the economically significant risks in *both* Country A and Country B—such that they separately control economically significant risks. In other words, we suggest that the OECD clarify that the language “either separately or collectively” refers to a fact pattern like Example 2, not Example 1. Thus, a profit split of actual profit is only appropriate when risks are being shared, at some level, with respect to the profits being pooled or shared. Clarification of Paragraph 9 with Example 2 of what is meant, and with Example 1 of what is not meant by “separate control” in an accurately delineated transaction would be helpful.

Finally, a third example addressing facts such as those laid out at Paragraph 41 would also be helpful. In the example at Paragraph 41, the parties agree to share some of the economically significant exploitation risks, but not all. Deloitte Tax suggests presenting a third example in C.1, such as Example 3 below.

Example 3. Consider the same facts as in Example 2, other than Company A and Company B only agree *ex ante* to share the manufacturing risks associated with the exploitation of product W utilizing intangibles X and Y in both countries, not the marketing, advertising and selling risks. Specifically, each company solely controls in its country all marketing, advertising and selling functions. Assume that the functional analysis of the transaction supports the conclusion that Company A exercises control of economically significant risks associated with manufacturing

product W in both countries, and Company B exercises sufficient control over the risks associated with manufacturing functions to delegate to Company A management of those functions. As a result of the functional analysis and accurate delineation of the transaction, the transactional profit split of actual profits is determined to be the most appropriate transfer pricing method to the extent that profits are defined as pooled revenues or sales from countries A and B minus manufacturing costs.

The determination of the costs to deduct from revenue in determining which profits to split should be guided entirely by the functional analysis of the transaction including the evaluation of the costs attributable to the revenue being analyzed, not according to accounting classifications of costs. For example, if the parties agree to share manufacturing risks, and the accurate delineation of the transaction confirms that the parties exercise control over the manufacturing economically significant risks, then the definition of profits should be revenue minus those costs related to manufacturing economically significant risks (wherever those costs sit in the accounting statements). If the parties agree to share marketing and selling risks, and the accurate delineation of the transaction confirms that the parties exercise control over the marketing and selling economically significant risks, then the definition of profits should be revenue minus those costs related to the marketing and selling economically significant risks (wherever those costs sit in the accounting statements). The guidance in section C.4.2 should reflect this more clearly through the use of examples, and should make clear that profit splitting (accounting) operating margins is reliable only if the functional analysis of the transaction concluded that the parties share all economically significant exploitation risks, and exercise control over all those economically significant exploitation risks.

Question to commentators

The guidance in the 2010 Transfer Pricing Guidelines on the application of the transactional profit split method envisages its application to either projected or actual profits (see 2.127). This discussion draft proposes to explore these distinctions further and provide clearer guidance on the different applications of the two approaches.

1. Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular:
 - a. Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear?
 - b. Is the distinction between the two profit split approaches described useful?

Deloitte Tax response

Consider the example provided at Paragraph 4. Assume that a reliable analysis concludes that a reasonable measure of the relative intangible contributions of Company A and Company B is provided by the ratio of properly capitalized intangible development costs incurred by each contributor. Assume that ratio is 40 percent to Company A and 60 percent to Company B. Under the 2010 TPG, Company A and Company B could either (i) calculate the net present value of 40 percent of the projected intangible income and set an *ex ante* royalty expressed as a percentage of Company B's anticipated revenue; or (ii) agree to calculate each year the actual intangible income, and provide Company A with 40 percent. The latter is agreed upon *ex ante* but splits actual profits; the former splits anticipated profits, but the resulting allocation is based on actual results.

Assuming that Company A does not control any of the exploitation functions of Company B, the accurate delineation of the transaction under Chapter I prohibits (ii) above, as it gives Company A a stake in the *ex post* profit from the exploitation upsides and downsides of Company B's business, which it does not control.

Paragraph 9 of the discussion draft best summarizes the application of Chapter I to transactional profit splits of actual profits when it says: *"..., such outcome would only be consistent with the accurate delineation of the actual transaction in cases where the economically significant risks associated with the outcomes of the business activities are controlled, either separately or collectively, by the parties*

Question to commentators (continued)

The guidance in the 2010 Transfer Pricing Guidelines on the application of the transactional profit split method envisages its application to either projected or actual profits (see 2.127). This discussion draft proposes to explore these distinctions further and provide clearer guidance on the different applications of the two approaches.

2. Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular:
 - a. Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear?
 - b. Is the distinction between the two profit split approaches described useful?

Deloitte Tax response

Deloitte Tax believes that the distinction between when to apply the two transactional profit splits could be made clearer by including additional examples that clearly illustrate how the control framework of Chapter I will determine whether profits should be split on an actual or anticipated basis. Specifically, Deloitte Tax believes a split of actual profits is appropriate only if the parties together control some or all of the exploitation risks. If the parties do not control any exploitation risk, a split of anticipated profits may be appropriate, but a split of actual profits would be inconsistent with the control framework of Chapter I.

Deloitte Tax further believes that a clarification of what *“either separately or collectively”* is intended to mean would be helpful. See our comments.

Question to commentators (continued)

The guidance in the 2010 Transfer Pricing Guidelines on the application of the transactional profit split method envisages its application to either projected or actual profits (see 2.127). This discussion draft proposes to explore these distinctions further and provide clearer guidance on the different applications of the two approaches.

2. Comments are also invited on the link between integration of business activities (and thus the sharing of risks) and the appropriate application of a transactional profit split of actual profits.

Deloitte Tax response

The level of integration of exploitation functions and risks required for a profit split of actual profits is such that, in the words of Paragraph 9 of the discussion draft, “[the activities]...can often be considered as a single, cohesive business.”

Deloitte Tax believes that it is seldom the case that associated enterprises will structure their affairs in a way that would make it appropriate to pool profits from multiple tax jurisdictions and split them between parties to the transaction(s). Such an arrangement would likely result in the creation of a partnership and undesired taxable presences through permanent establishments. For example, the cost sharing regulations in the United States (i) require participants to have separate and non-overlapping, exclusive and perpetual divisional interests in the cost shared intangibles (preventing the pooling of profits), and (ii) specifically protect cost sharing participants from being deemed to be in a partnership or a U.S. trade or business (permanent establishment) merely by being a cost sharing participant.

Deloitte Tax does not believe that additional discussion of integration is warranted, but examples of an application of Paragraph 9 (“single, cohesive business”) would be useful.

In addition, Deloitte Tax wishes to reemphasize that an analysis of integration is part of a functional analysis and accurate delineation of the transaction, and guidance should be provided in Chapter I, not Chapter II (which should focus on applying the concept to the selection of transfer pricing methods).

C.2 SUMMARY OF STRENGTHS AND WEAKNESSES

Most of the changes in C.2 are conforming changes to the guidance provided in the 2010 TPG to reflect the risk control framework of the final report. These changes appear to be appropriate and helpful.

C.3 MOST APPROPRIATE METHOD

Paragraph 2.16 provides that “*The application of a transactional profit split of actual profits reflects a relationship where the parties either share the same economically significant risks associated with the business opportunity or separately assume closely related risks associated with the business opportunity and consequently should share in the resulting profits or losses.*” [Emphasis added].

This guidance appears to be related to the guidance at Paragraph 9 on which we have commented. Deloitte Tax reiterates its request to have a clarification of what is intended by the phrase “or separately assume closely related risks,” and a specific clarification that the transaction described in Example 1, where the accurate delineation of the actual transaction concludes that Company A does not exercise any control over any of the economically significant risks related to the exploitation of intangibles X and Y in Country B, and *vice versa*, does not meet the “separately assume closely related risks” condition of Paragraph 16.

Deloitte Tax agrees with the guidance at Paragraph 18, and requests that the OECD keep the language provided in that paragraph. Whether a transactional profit split of actual profits is the most appropriate method depends on the results of the functional analysis and accurate delineation of the actual transaction, and on the reliability of the data required to use the method relative to the reliability of data available to use alternative methods (*e.g.*, CUP or the transactional net margin method (TNMM)) *after* considering adjustments to increase the reliability of such alternative methods.

Deloitte Tax further agrees with the guidance in the next-to-last sentence at Paragraph 19, and requests that the OECD keep the language provided in that sentence. Whether a transactional profit split on actual profits is the most appropriate method depends on the results of the functional analysis and accurate delineation of the actual transaction, not on a mere factual determination that an intangible right was contributed.

Question to commentators

6. The discussion draft introduces the sharing of the economically significant risks as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method.

1. Do commentators have any suggestions for clarifying the notion of risk sharing in this context?
2. Do commentators find the draft helps to clarify the circumstances where the transactional profit split method is the most appropriate method? Please provide explanations and/or examples supporting your views.

Deloitte Tax response

Deloitte Tax believes the draft is helpful in clarifying the circumstances whereby the transactional profit split of actual profits may be the most appropriate method. Deloitte Tax further believes that the guidance on the appropriateness of transactional profit splits of actual profits could be improved by (1) more specifically addressing the differences between sharing development risks but not the exploitation risks of the resulting assets created by the development activities, and sharing both the development risks and the exploitation risks, and (2) providing examples of both types of risk sharing and how the functional analysis and accurate delineation of the transaction would result in different conclusions on the appropriateness of transactional profit splits of actual profits. See the continuation of our discussion of Example 1 in Section C.1 above.

More specifically, Deloitte Tax requests that the OECD include an example such as Example 1, in which the parties do not intend to share exploitation risks—each controls exploitation risks in its own territory and a transactional profit split of actual profits is not appropriate given the accurate delineation of the actual transaction. Such an example should be contrasted with a similar example in which the parties do intend to share exploitation risks and each controls certain (separate) exploitation risks in both countries and a transactional profit split of actual profits may be the most appropriate method. These examples would be particularly valuable in illustrating the role of the DEMPE functions of Chapter VI of the TPG in the selection of the most appropriate method.

Deloitte Tax suggests that the language in the second sentence of Paragraph 20 be amended as follows: *“For example, in circumstances where it is determined that a transactional profit split of actual profits is the most appropriate method, the value of a party’s contribution for which reliable comparables cannot be found, or that a more reliable arm’s length outcome cannot be reached through adjustment (under Step 8 of a typical process for performing a comparability analysis in paragraph 3.4) and interpretation (under Step 9 of a typical process for performing a comparability analysis in paragraph 3.4) of inexact comparables data, may be derived from the splitting of appropriate projected income or cash flows...”* [Underlined language added].

Question to commentators

7. The discussion draft notes that a transactional profit split of anticipated profits can be used in conjunction with certain valuation techniques. Examples showing the application of a transactional profit split of anticipated profits are sought.

Deloitte Tax response

Consider Example 1 and assume that the contributions of Company A to the development of intangible X have a present value of \$100, and the contributions of Company B to development of intangible Y have a present value of \$150. Thus, total development costs of both intangibles is \$250. Further assume that the exploitation of intangibles X and Y in Country A and in Country B respectively is expected to last for 10 years and to generate gross intangible income with present value of \$200, in each territory, after providing each company with an arm's length remuneration for their respective performance of functions that can be directly and reliably valued by reference to comparables in their respective countries. Thus, total gross intangible income associated with the \$250 of total costs is \$400. Finally, assume that the projected revenue in Country A and Country B over the next 10 years is \$600 and \$800, respectively.

Assume that the accurate delineation of the transaction confirms that Company A has no further interest in the business of Company B than the contribution of a unique and valuable intangible, and vice versa. Consistent with the accurate delineation of the transactions, a determination is made that the transactional profit split on anticipated profits described in Section C.4.1.2 (residual analysis) at paragraph 33 is the most appropriate method to measure the value of the contribution of a unique and valuable intangible by Company to Company B, and vice versa.

Following an application of the guidance in Section C.4.1.2 at Paragraphs 33 and 34, an application of the transactional profit split of anticipated profits to measure the contributions of Company B to Company A's profits concludes that Company A will pay Company B a royalty of 20 percent ($\$150/\250 times \$200 divided by \$600).

The addition of the underlined language above conforms Paragraph 2.20 with Paragraph 18 and reinforces the notion that adjustments to inexact comparables must be considered in parallel to alternative methods such as the transactional profit split of anticipated profits in determining the most appropriate method.

Deloitte Tax believes that the guidance at sections C.3.1 and C.3.2 is helpful in providing a way for taxpayers and tax administrations to think about the appropriateness of transactional profit splits. However, Deloitte Tax is concerned about the last sentence of both Paragraphs 21 and 22. The last sentence of Paragraph 21 reads: *"In cases of parallel integration, it may be the case the accurate delineation of the actual transaction determines that each party share economically significant risks, an a transactional profit split, using an approach which splits actual*

profits, may be found to be the most appropriate method.” The last sentence of Paragraph 22 reads: “In practice, neither of them may be able to control the development risk and to take on the key source of economic benefits from the other, but instead they together control the development risks and share in the combined profits resulting from their contributions.”

Deloitte Tax is concerned that tax administrations might disregard the level of risk sharing intended by the parties, and pool exploitation profits whenever parties share development activities. Example 1 illustrated a case where, despite the sharing of development activities, neither party intends to share in any of the exploitation risks of the other. In Paragraph 21, it appears that there is an intent to jointly exploit the marketing of the products, and Deloitte Tax suggests that the language of the example clarify in the last sentence that it *may* be the case that the accurate delineation of the actual transactions leads to a transactional profit split of actual profits, depending on the intent of the parties to share and control exploitation-related risks such as those resulting from marketing the products.

As for the last sentence of paragraph 22, Deloitte Tax suggests that the sentence be removed or changed to reflect that controlling together the development risks does not mean that the parties want to share in the combined profits resulting from their contributions. The sentence uses the words “...*together control the development risks and share in the combined profits....*” [Emphasis added]. Nothing in the example at that paragraph indicates that the parties intend to share in the combined profits, nor is there any factual information that would suggest that an actual delineation of that transaction would lead to such conclusion.

For our comments regarding value chain analysis at section C.3.4, see the section “Location of Guidance” at the beginning of this comment letter.

C.4 GUIDANCE FOR APPLICATION

Deloitte Tax agrees with the requirements outlined at Paragraph 29 in connection with the determination of the combined profits to be split and of the splitting factors. The determination of the combined profits to be split should be largely informed by the accurate delineation of the actual transaction, and is therefore fact- and circumstances-specific. Deloitte Tax believes the guidance at sections C.4.1, C.4.2, and C.4.3 is helpful in illustrating how the principles of Chapter I apply in determining which combined profits should be split; however, a discussion of how the “integration” guidance of section C.3.1, the unique and valuable contribution guidance of section C.3.2, and the value chain analysis guidance of section C.3.4 interact with the guidance of Chapter I in the accurate delineation of the transaction would be helpful. We noted at the outset of our comments that C.3.1, C.3.2, C.3.3, and C.3.4 are really Chapter I concepts that go to the accurate delineation of the transaction within the meaning of Chapter I. Which combined profits should be split is a difficult technical issue, especially when thinking about the risks that are shared versus those that are not. Deloitte Tax would welcome more targeted guidance in

the form of specific examples to help taxpayers and tax administrations navigate this complicated topic.

Question to commentators

11. Are there situations where all the parties make unique and valuable contributions to a transactions, but they do not share the economically significant risks associated with the outcome of that transaction? If so, what guidance on the appropriate use of profits splits in such situation should be provided?

Deloitte Tax response

Deloitte Tax raised that issue in Example 1, and our comments above about the language at paragraphs 21 and 22 specifically addressed this particular issue. Based on the control guidance in Chapter I, and given the definitions of a transactional profit split of actual and of anticipated profits, Deloitte Tax believes that in cases where parties make unique and valuable contributions to each other but do not share the economically significant risks associated with the outcome of that transaction, transactional profit split of anticipated profits may be the most appropriate method.

Assume that Companies A, B, C, and D all provide each other with a unique and valuable contribution, but each company fully controls how those contributions are jointly exploited in commercial activities within each company's territory. A transactional profit split of anticipated profits of Company A will result in an *ex ante* royalty due by Company A to Companies B, C, and D (different royalty rates potentially). For a calculation of that royalty rate, see our valuation example at Question 7 to Commentators above. Similarly, a transactional profit split of anticipated profits of Company B will result in an *ex ante* royalty due by Company B to Companies A, C, and D. Therefore, assuming that the transactional profit split (probably a residual profit split such as described in Paragraphs 33 and 24) is the most appropriate method, four different transactional profit splits

As discussed above, Deloitte Tax believes that the discussion of the profits to be split in Paragraphs 40 and 41 should be clarified. Deloitte Tax does not believe that the distinction between “gross margin” and “operating margin” is particularly useful, and believes that it can actually confuse the issue. The determination of the costs to deduct from revenue in determining which profits to split should be guided entirely by the accurate delineation of the transaction, not accounting classifications of costs. For example, if the parties agree to share manufacturing risks, and the accurate delineation of the transaction confirms that the parties exercise control over the manufacturing economically significant risks, then the definition of profits should be revenue minus those costs related to manufacturing economically significant risks (wherever those costs sit in the accounting statements).

Deloitte Tax is concerned that the guidance at Paragraph 46 suggesting that it is appropriate to weigh multiple factors when more than one profit split factor is used could be misconstrued as authorizing arbitrary or unverifiable weights to be used, in contradiction to the guidance on the factors themselves provided at Paragraph 42 in Section C.4.4. Deloitte Tax suggests an additional sentence at Paragraph 2.46 stating: *“The weights used to determine the relative contribution that each factor represents to the earning of the combined profits must satisfy the requirements of paragraphs 42, they must be reasonably independent of transfer pricing policy formulation, i.e., they should be based on objective data, be verifiable, and, be supported by comparable data, internal data, or both.”*

In addition, Deloitte Tax believes that some of the suggested profit split keys such as “headcount” or “time spent,” for example (Paragraph 47) are suggested without a rational basis grounded in the principles of Chapter I, and may be largely unverifiable by tax administrations. “Time spent” on an activity, for example, is routinely used for management charges allocation, and often results in endless controversy (including challenges on time record-keeping, verifying people’s calendars, truthfulness, and accuracy of time reporting).

The impact of profit split keys to the allocation of income, particularly intangible-related income, can be significant; therefore, we would strongly urge the OECD to limit its guidance on discussing how the risk control framework of Chapter I guides the thought process of selecting meaningful profit split keys. Arguably, keys that were meaningful under the 2010 TPG that did not have the control framework of Chapter I are no longer meaningful, now that the risk control framework is in place. Deloitte Tax therefore questions the approach of listing keys that have been often used under the 2010 TPG (see paragraph 2.47, for example), as a useful starting point for taxpayers and tax administrations.

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Comments on the BEPS Discussion Draft containing revised guidance on profit splits

Andrew Cousins, Richard Newby; Duff & Phelps.¹

We welcome the opportunity to respond to the OECD's discussion draft containing revised guidance on profit splits. Our comments are specifically focused on questions 13 and 14 of the discussion draft, with respect to value chain analyses.

13. Does this section properly describe a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit split method is appropriate?

For a term that is increasingly widely used in the field of transfer pricing, an official definition of value chain analysis in that context has been wanting. Since the emergence of concepts of value chain analysis in the 1990s, we are aware only of the discussion of value chain analysis in the UN Transfer Pricing Manual that provides some direction on the performance of such an analysis in an official context.

Value chain analysis is a term that is increasingly employed in a transfer pricing context; yet, with very little in the way of official guidance as to what exactly it should consist of and the appropriate circumstances for its use, we are concerned that it may be subject to misuse and misinterpretation. Rightly or wrongly, there is growing concern that some tax administrations regard "global value chain analysis" as an opportunity to perform a version of formulary apportionment by another name, rather than applying it as a means of challenging or corroborating transfer pricing established using the arm's length principle.

¹ The opinions and views expressed in this letter are those of the authors and not necessarily those of Duff & Phelps or its clients.

Chapter V now specifies that the master file should contain a description of “important drivers of business profit”. At the same time, the Country-by-Country report provides a global overview of profits and activities. This has led to concerns that some tax administrations may seek, based on a global value chain analysis that utilises this information, to apply some form of allocation to the global profits of multinationals.

As such, we consider this section C.3.4 as timely and helpful guidance in specifying the circumstances in which a value chain analysis should be used and in identifying what it should comprise. The wording suggested is sensible and provides a useful description of how to use value chain analysis as a tool in helping to delineate the actual transaction.

Given the comparatively imprecise nature of value chain analysis, where assigning a relative weight to a particular value contribution is most frequently a matter of professional judgement, we see value chain analysis as providing useful context in which the commercial and financial relations between members of a multinational group can be considered, and which lends itself to the identification of circumstances in which there are unique and valuable contributions by the parties.

We do not see sufficient precision in value chain analysis to be used for any more in-depth analysis. We do not believe that it should be considered as an alternative methodology or replacement for the arm’s length principle.

14. If commentators see a value chain analysis as serving a greater purpose in relation to profit splits, then please provide an explanation for that view together with examples.

While we do not see any greater purpose for a value chain analysis than that described in the draft section C.3.4, we are now seeing official reference to value chain analysis in documentation requirements from tax administrations as far removed as, for example, China and the United Kingdom, where assumption of the composition of a value chain analysis is apparently a given. While SAT has introduced a requirement for value chain analysis to the Chinese transfer pricing local file requirements, HMRC specifies that a value chain analysis is to be provided in support of a notification relating to the UK’s Diverted Profits Tax.

Are these references to value chain analysis consistent with the application of the value chain analysis espoused in this section? One hopes so. If the purpose of the value chain analysis is to provide useful context in which the commercial and financial relations between members of the multinational group can be considered, serving as a useful tool in identifying appropriate use of the transactional profit split method, all is well and good. Our fear is that value chain analysis has begun to take on, in the eyes of some tax administrations and professional advisers, a higher purpose that may be used to justify apportionment of global profits on the basis of formulae of their own determination, riding roughshod over the delicate recognition of functions, assets and, above all, risks that forms the basis of the arm’s length principle.

When HMRC state in their guidance on Diverted Profits Tax that “a value chain analysis of the complete activity undertaken by the group” is to be included in information provided with notification of potentially being within the scope of DPT, or where SAT specifies in its new transfer pricing documentation requirements that the local file is to contain a value chain analysis of related party transactions, can we assume that this analysis is to be used solely to provide context for identifying the circumstances where the transactional profit split method is the appropriate method to apply? Or does the analysis present tax administrations with an opportunity to attempt to apportion global profits on the basis of a formula? This is our fear. As such, guidance from the OECD on value chain analysis is timely and welcome. Official guidance is needed both as to the circumstances in which a value chain analysis is recommended and how it is to be conducted, and also as to circumstances when it is not to be used.

We do not believe that value chain analysis, or more specifically global value chain analysis, serves a greater purpose than that identified in this section under review. We believe that the approach outlined in this section is the correct one. We are of the opinion that there would be added benefit in spelling out what the value chain analysis does not do, i.e. we do not believe that it can be used to justify apportionment of profits to routine or limited risk activities.

However, the OECD has subsumed its section on value chain analysis to determination of the appropriate circumstances for the use of the transactional profit split method. The question is whether this section is the only place in which a description of value chain analysis serves a useful purpose in a transfer pricing context, or whether value chain analysis deserves an elevated place in the Transfer Pricing Guidelines. It seems appropriate to us that some discussion of value chain analysis belongs in Chapter I of the Guidelines, given that its role is to help in determining which is the appropriate method to use, rather than being a function of one specific method.

Lastly, and to reiterate comments already made, we would encourage the OECD to develop unequivocal guidance on those circumstances in which a value chain analysis would represent useful support for the arm’s length principle and the specific methodologies to be followed for performing such an analysis, together with illustrative examples.



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European Business Initiative on Taxation (EBIT)

**Comments on OECD Public Discussion Draft on BEPS Action 8-10:
Revised guidance on Profit Splits**

EBIT's Members at the time of writing this submission: AIRBUS, BP, CATERPILLAR, CONSTELLATION BRANDS, DEUTSCHE LUFTHANSA, DIAGEO, GSK, HUAWEI, INFORMA, INTERNATIONAL PAPER, JTI, PEPSICO, RELX, ROBECO, ROLLS-ROYCE, SAMSUNG, SCHRODERS, SHV, TUPPERWARE, UTC.

Submitted by email to: TransferPricing@oecd.org

Brussels, 5 September 2016

EBIT is grateful for this opportunity to comment on the OECD Public Discussion Draft on BEPS Action 8-10: revised guidance on Profit Splits (the “Discussion Draft”) dated 5 July 2016. EBIT has a number of general concerns with the Discussion Draft which are set out briefly below.

- Some terms in the Discussion Draft are unclear or subject to different interpretation, for example value chain analysis or (sequential or parallel) integration. Further guidance on what is meant under those terms would be welcomed.
- The Discussion Draft seems to indicate that the profit split method (PSM) can be seen as the default method when risks are shared or in case of integration. The choice of the PSM for a particular case should be based upon a comparability analysis, including the delineation of the transaction and the functional analysis, the principle of the most appropriate transfer pricing method and leading to an arm’s length result (including the use of one-sided methods). It should not allow a short-cut selection process in case of risk-sharing or integration. Such short-cut selection process may lead to more controversy between tax authorities (not agreeing on the application of the same method). At the same time disparities may arise between independent and associated enterprises as the arm’s length standard may not have been properly applied.
- The ‘risk’ factor as discussed in the Discussion Draft should be given the appropriate weight in the discussion and find its right place in the functional analysis, which involves consideration of functions, assets and risks.
- The PSM should not be interpreted as a method for allocating worldwide profits, but should keep its status as a transfer pricing methodology.

We refer you to the four practical examples of profit split solutions from our day-to-day experience in the context of the OECD’s work on BEPS Actions 8-10, which EBIT submitted to the OECD in December 2014 – see: <http://www.ebit-businessstax.com/pdf/pwc-ebit-submission-to-oecd-profit-split-dec-2014.pdf>. Some of the points implicit in those examples and the ones now included in the Discussion Draft are worthy of comment in the context of the questions raised in the Discussion Draft.

- It should not make a difference in the application of the PSM whether the transfer price is set on an ex ante basis (anticipated profits) or an ex post (actual results) basis. Transfer pricing methods and the selection thereof should be part of the correct application of the arm’s length principle. This principle should apply regardless of whether anticipated or actual profits are used. One weakness of using a PSM on anticipated profits, however, lies in its dependence on the reliability and accuracy of the

financial projections used as indicated in the section on valuation methods under the revised Chapter VI.

- It is not clear what is meant by risk sharing in the context of the integration of business activities, in particular as several companies within a MNE may be liable to the same or similar risks. It cannot be concluded from that liability to the same risks that they are sharing that risk. Also between unrelated parties, enterprises may face the same risks. Sharing of risk is one of the factors that may lead to the conclusion that a PSM may be the most appropriate method, but it should not be determinative in and of itself.
- PSM is regularly used in royalty rate setting where the residual (or part thereof) is used as the basis for the determination of the royalty.
- EBIT agrees that the absence of reliable comparables or data should not in itself be a factor that leads to the selection of the PSM as most appropriate method. Furthermore, tax authorities should respect a reasonable weighting of the relevant factors used in the PSM.
- The Discussion Draft points out that sequential integration should not be basis for use of the PSM. At the same time, it should be made clear that parallel integration is not, of itself, a reason to apply the PSM. If it is the intention to refer to a specific distinction, then this should be clarified, but it may mean more than just ‘similar and at the same time’ as indicated in the Discussion Draft. Even in circumstances where there is parallel integration, the facts of a particular case may indicate there is no reason to use the PSM.
- In the case of sequential integration, parties may make unique and valuable contributions but do not necessarily share the economically significant risks associated with the transaction. Parties may co-operate extensively and may be exposed to the same business risks, but may not have agreed on sharing the profits from the proceeds of the end product. This is also linked to the use of the term ‘unique and valuable contribution’ which should be interpreted in a narrow way. The broader the concept of unique and valuable is defined, the less likely it becomes that the guidance is appropriate. The concern is that if the concept is not interpreted or defined in a narrow way tax authorities may interpret the concept differently (i.e. broader) which may lead to the inappropriate use of PSM. Further this different interpretation will lead to more controversy.
- It is doubtful whether a discussion of “synergies” is useful in determining whether a profit split is the most appropriate transfer pricing method. The terms ‘synergy’ is not defined objectively in the new Section D.8 of Chapter I. It cannot be the intention of the Discussion Draft to indicate that the presence of a synergy would determine that the PSM is by default the most appropriate method. Further, guidance is lacking on how to value or measure “synergies,” which is an absolute necessity if the advantage or disadvantages of the synergies need to be allocated between the members of the multinational group proportionate to their contribution to the synergy. EBIT agrees with the guidance in the Discussion Draft that there is no need to use the PSM simply on account of group synergies alone. It would be useful to strengthen the guidance that existence of synergies alone should not lead to the selection of the PSM as most appropriate method.
- A value chain analysis (VCA) could be a useful tool in determining and analysing transfer pricing, but it should not be compulsory as a part of any transfer pricing analysis. There is a concern that VCA may be used to view the MNE as one entity, contrary to the arm’s length standard. Another concern is that the existence of VCA could be interpreted that

EBIT comments on OECD Public Discussion Draft on BEPS Action 8-10: revised guidance on Profit Splits

the PSM is the default method, without the proper analysis. The Discussion Draft does not define the term ‘value chain analysis’. It should be clear that a VCA is different from a functional analysis. VCA should not be construed as a transfer pricing method, but it is a tool that may give more insight in the business. It cannot replace the proper transfer pricing analysis, including the correct delineation of the transaction and functional analysis. We agree with the caution expressed in the Discussion Draft as VCA is not a precise process, varying in format and detail. It focuses on the relative contribution of different business processes, but may not always give an answer as to whether unique and valuable contributions exist, synergies are achieved or the PSM is the most appropriate method.

- Further guidance on identifying and measuring relevant splitting factors is appropriate. It would be helpful to have an indicative list of splitting factors, and at the same time recognise that not all splitting factors may be appropriate under all circumstances. A thorough functional analysis is key in identifying the split factors.

EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this important area. EBIT is committed to a constructive dialogue with the OECD and is always happy to discuss.

Yours sincerely,

European Business Initiative on Taxation – September 2016

For further information on EBIT, please contact its Secretariat via Bob van der Made, Telephone: + 31 6 130 96 296; Email: bob.van.der.made@nl.pwc.com).

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Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration
Attn. Tax Treaties, Transfer Pricing and Financial Transactions Division
By email: TransferPricing@oecd.org

SUBJECT: PUBLIC DISCUSSION DRAFT ON “REVISED GUIDANCE ON PROFIT SPLITS”

5 September 2016

Dear Sir / Madam,

By means of this letter, EY would like to share its comments on the public Discussion Draft on “BEPS Actions 8-10: Revised Guidance on Profit Splits” (the Discussion Draft) as released by the OECD on 4 July 2016. We appreciate the opportunity to provide comments and to contribute to the public consultation and discussions about this topic. This letter presents the collective view of EY’s global international tax network.

Key comments

The Discussion Draft seeks to provide further guidance in respect of the use of the profit split method (PSM) for transfer pricing purposes. In considering our views on the proposed guidance and questions raised, we have some overarching comments which we believe would be helpful to consider and some more specific comments which are provided subsequently. The overarching comments focus on two main aspects: (1) when to use the PSM; and (2) how to apply the PSM.

When to use the profit split method

We welcome additional guidance that clearly articulates when the PSM should be used to prevent indiscriminate application of the PSM in circumstances in which the method cannot be reliably applied and the associated increase in controversy and uncertainty that this would entail.¹ We also believe that any such guidance should be consistent with the well-established principle that any transfer pricing method should be assessed against alternative transfer pricing methods taking into account the facts of the situation and the availability of data in order to choose the most appropriate method. For this reason, we think the Discussion Draft needs not only to consider the circumstances in which the PSM can address the theoretical issues raised in determining an arm’s length price but also what “evidence” will be necessary in order for the PSM to be applied with reasonable reliability. It would be helpful if the OECD could provide examples of when the PSM is considered the most appropriate method.

¹ We also refer to our comments in response to the 16 December 2014 discussion draft on profit splits in which we noted our concern about a proliferation of profit splits being seen in relation to the transfer pricing arrangements of MNEs, largely predicated on the fact that MNEs are becoming increasingly integrated in the context of their global operations and also the fact that some tax authorities are increasingly seeking to tax a greater share of an MNE’s global profits.

However, we do not want to imply that the guidance should be narrowly prescriptive. The most appropriate method rule is necessarily flexible and sensitive to the particular circumstances of each case. We believe that guidance should be similarly flexible (e.g., by acknowledging that the guidance may not foresee all potential scenarios and by not being too prescriptive on when the PSM can be applied) and reaffirm that the PSM should be assessed against alternative methods taking into account the facts of the situation as well as the reliability and availability of data for each option. This would help ensure that the “most appropriate method” is selected as already envisaged by the OECD Guidelines. In addition, we recommend that specific wording be added to emphasise that the transfer pricing method selected by a taxpayer should be respected by tax authorities unless an alternative method can be demonstrated to be more appropriate. Hence, tax authorities should not be allowed to replace one of the other four methods with a PSM, just because the arrangement at issue shows some of the features described in the Discussion Draft (e.g., interrelated transactions, joint contributions to intangibles, or sharing of risks) which are peculiarly conducive to the use of PSMs.

How to apply the profit split method

We question why the Discussion Draft is primarily concerned with applying the PSM to actual profits rather than anticipated profits. In our experience the PSM is at least as likely to be applied to anticipated profits.² Further, notwithstanding the purported emphasis on actual profits, the Discussion Draft provides only limited guidance on how the PSM is to be applied to either actual or anticipated profits. We recommend the OECD develop more guidance on how to apply profit splits including some examples demonstrating the various steps in applying the PSM.

More detailed comments with respect to the Discussion Draft are presented below. If you have any comments or questions, please feel free to contact any of the following:

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Yours Sincerely,
On behalf of EY

John Hobster / Ronald van den Brekel

² In fact, in some countries, notably the US, applying the PSM to actual profits is generally avoided as it might create a deemed partnership.

Detailed comments

Our detailed comments with respect to the Discussion Draft are presented in the sections below. As requested, we respond to the questions included in the Discussion Draft, while at the same time also commenting on some, in our view, important points not specifically covered by those questions. For readability's sake we have reiterated (or paraphrased) the questions in the sections below.

Questions to commentators (page 6)

The existing guidance on the application of the transactional profit split method envisages its application to either projected or actual profits. The Discussion Draft proposes to explore these distinctions further and provide clearer guidance on the different applications of the two approaches.

1. Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular: (1) is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear; and (2) is the distinction between the two profit split approaches described useful?
2. Comments are also invited on the link between integration of business activities (and thus the sharing of risks) and the appropriate application of a transactional profit split of actual profits.
3. Examples of scenarios where each approach to splitting profits would be the most appropriate (together with a brief explanation as to why) are also requested.

Response

As previously discussed, the Discussion Draft provides only limited guidance of how the PSM is to be applied to either actual or anticipated profits. We think the discussion on how the PSM is to be applied is currently inadequate.

We do appreciate that the revised guidance as per paragraph 3 seeks to further clarify the caution that should be taken to prevent the use of hindsight in applying the PSM. While we appreciate the additional emphasis, we note that revised wording (e.g., that profits to be split and the splitting factors "must be determined ex ante on the basis of information known or reasonably foreseeable") may be read as suggesting that the profit split method cannot be used ex post to test the actual outturn results. In our view, such ex post use of the PSM for price testing purposes (also in cases where other methods were used to set prices) can be useful and appropriate, so long as care is taken only to use information that was known at the time of the transactions were entered into. We therefore suggest the phrase be rewritten as follows: "must be determined on the basis of information known or reasonably foreseeable ex ante".

Similarly, paragraph 5 suggests that the profit splitting factors must be determined *ex ante*, even for a split of actual profits. We expect that the revised wording means to suggest that the *approach* needs to be determined ex ante (e.g., how to determine the profit, define the factors to be used, etc.) but that the *actual split* needs to be based on the actual outturn factors. For example, it can be determined ex ante that headcount is used, but then the profits should be split based on actual headcount in the period under review. If our understanding is correct, we suggest clarifying this in paragraph 5.

Further, we note that some companies / tax authorities prefer to use anticipated or actual outcomes for other methods (e.g., the TNMM) and no distinction between anticipated and actual results is made in the OECD Guidelines for these methods, so we are not convinced it is necessary to make such a distinction for profit splits specifically.

The Discussion Draft puts a strong emphasis on the sharing of risks in cases where actual profits are split and emphasises the fact that one company would be exposed to the risks associated with the business activity of the other. Clearly the economic effect of risks can be shared between associated enterprises, when the prices applied between the enterprises have that effect, but the point of the guidance seems to be that the transfer pricing method chosen should not determine the allocation of risk. Therefore we suggest stating clearer that the determining factor, in deciding whether risks are economically shared between the associated enterprises, is whether each entity is individually responsible for controlling economically significant risks that impact the outcome of the overall transaction. In this regard, we note that it may not always be easy to assess whether and to which extent risks are shared.

However, more importantly, we are concerned about the fact that the Discussion Draft implies that where associated enterprises *"share economically significant risks"* they *"should split the unanticipated, actual profits arising from their combined activities"* (e.g. in paragraph 9, 10, and 16). We recommend revising this wording to clarify that the mere joint control of risks is not enough to consider the PSM to be the most appropriate method for the case at hand.

Question to commentators (page 8)

4. Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarised?
5. Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses? If so, what are they?

Response

As noted above, we do not believe that the Discussion Draft provides adequate guidance on how the PSM could be applied and this limits the extent to which we can comment on the relative strengths and weaknesses.

Question to commentators (page 9)

6. The discussion draft introduces the sharing of economically significant risks as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method.
 1. Do commentators have any suggestions for clarifying the notion of risk sharing in this context?
 2. Do commentators find the draft helps to clarify the circumstances where the transactional profit split method is the most appropriate method? Please provide explanations and/or examples supporting your views.

Response

For our main comments with respect to the notion of risk sharing, we refer to our comments on question 1, 2 and 3 above (which include the implied correlation between integration of business activities and the sharing of risks as per question 2). In addition, we would like to point out that profit split methods in our view can also be appropriate where parties are interdependent on each other for the realisation of a profitable outcome, even though risks are not necessarily shared. This may be the case in joint operations, in situations where outcomes are heavily interdependent, and in case where joint contributions of intangibles take place (which of course may well manifest itself in a sharing of risks). This is reflected in paragraph 20 as well, but paragraph 20 limits the application to anticipated profits.

An examples in which PSM is commonly applied is when confronting the problem of “asset synergy” by which we mean a circumstance in which the value of two or more assets (typically technology intangibles) together is greater than the additive value of the separate assets. As an example, consider a transaction involving two members of the same MNE group that are located in different jurisdictions. Assume Party A is located in Jurisdiction 1 and Party B is located in Jurisdiction 2. Party A has worldwide patents on Enzyme A. Party B has worldwide patents on Enzyme B. Neither Enzyme A nor Enzyme B is particularly valuable as a pharmaceutical because of marginal utility. However, combining Enzyme A and Enzyme B creates a drug that is very effective in treating certain diseases. Assume the worldwide value of Enzyme A is 30 and the worldwide value of Enzyme B is 40 but, combined, Enzymes A and B have a worldwide value of 300. In other words, combining Enzyme A and Enzyme B results in an increase in value of 230. Assume now that Party A transfers all its rights in Enzyme A to Party B. Determining the arm’s length price of such a transfer raises the issue of how much of the 230 increase in value, attributable to synergy, will be captured by Party A at arm’s length and how much of the 230 will be captured by Party B. In our experience, profit split methods are often well suited to addressing this difficult issue because the standalone value of each party’s contribution can be determined and used as a basis on which to assign returns.

Question to commentators (page 9)

7. The discussion draft notes that a transactional profit split of anticipated profits can be used in conjunction with certain valuation techniques. Examples showing the application of a transactional profit split of anticipated profits are sought.

Response

The first sentence of paragraph 20 refers to a discussion in paragraph 6. This discussion is merely a statement that in our view is incorrect. As developed further in our response to question 10, neither the ex ante nor ex post application of the profit split method requires a sharing of risks. However, the sharing of risks is a typical result of contributions by each party that are so intertwined or so valuable that they are not appropriately rewarded with a routine return for one of the parties. The remainder of the section is not helpful and is out of place in a discussion in relation to the PSM. The question of valuation of intangibles, including HTVI, is dealt with in Chapter VI and converting relative contributions into a lump-sum or series of recurring payments is not an application of a PSM.

Question to commentators (page 10)

8. Is the distinction between parallel and sequential integration of business operations a useful refinement in determining when the transactional profit split method is likely to be the most appropriate method?
9. If so, how should the concept of parallel integration be further defined?

Response

The distinction between parallel and sequential integration is in our view irrelevant. Third parties are splitting profits based on both parallel integration of functions (e.g., geographical or focused on a specific product category) and sequential integration of functions (e.g., focused on specific functional expertise within the value chain such as R&D and manufacturing or marketing). Therefore, we recommend deleting the guidance in this regards, or clarifying that the different types of integration should not be determinative of whether (and if so, how) a PSM should be applied.

Question to commentators (page 10)

10. Comments are invited on the relationship between the making of unique and valuable contributions by both (all) parties to a transaction, and the sharing of economically significant risks.
11. Are there situations where all the parties make unique and valuable contributions to a transaction, but they do not share the economically significant risks associated with the outcomes of that transaction? If so, what guidance on the appropriate use of profit splits in such a situation should be provided?

Response

We don't think there need be any relationship between the making of unique and valuable contributions by both (or all) parties to a transaction, and the sharing of economically significant risks. In many cases, the sharing of risks is the result of the contractual terms, which allocation would be respected under the guidance of Chapter I. For example assume two parties, both of whom control unique and valuable intangible assets. Further, there is "asset synergy" between the assets. Assume that one of these parties sells its unique and valuable asset to the other for a single fixed (and arm's length) payment and the buyer takes responsibility for any further development of that asset and any assets of the buyer. Under these circumstances, the buyer takes on all the risk of further development and the seller's return has become fixed (i.e., seller has no risk).

Question to commentators (page 11)

12. The Final BEPS Report on Actions 8-10 noted that group synergies were to be addressed in the guidance on profit splits. The approach taken in this discussion draft is to make reference to the incremental or marginal system profits arising from the group synergy, which would then be shared amongst the relevant associated enterprises. The analytical framework suggested in the draft, based on an accurate delineation of the actual transaction, would not support the combining and splitting of total system profits on the basis of group synergies alone. Comments on this point are invited.

Response

Paragraph 23 suggests that the incremental profits associated with synergies should be shared by members of the group in proportion to their contribution to the creation of the synergies. The paragraph refers to paragraph 1.162 of the guidelines which says that *“If important group synergies exist and can be attributed to deliberate concerted group actions, the benefits of such synergies should generally be shared by members of the group in proportion to their contribution to the creation of the synergy. For example, where members of the group take deliberate concerted actions to consolidate purchasing activities to take advantage of economies of scale resulting from high volume purchasing, the benefits of those large scale purchasing synergies, if any exist after an appropriate reward to the party co-ordinating the purchasing activities, should typically be shared by the members of the group in proportion to their purchase volumes.”* The two paragraphs combined suggest that a central ‘co-ordinating’ company would not be included in the splitting of the incremental profits, and would receive a separate “appropriate” reward. In our view, this is not necessarily aligned to some third party arrangements. As such, it would be helpful to specifically point out that any central co-ordinating party should not be automatically characterised as a routine service provider and to clarify that the methodologies for determining the “appropriate reward” for such parties are not limited to cost based approaches but could indeed include methodologies that are linked to the total incremental profits associated with the synergies. If the guidelines are interpreted to infer that the benefits of synergies should automatically accrue to the contributors of volume, with the central entity getting only a routine return, the result will be a remuneration mechanism that is not in line with reality, and therefore not arm’s length.

Question to commentators (page 12)

1. Does this section properly describe a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit split method is appropriate?
2. If commentators see a value chain analysis as serving a greater purpose in relation to profit splits, then please provide an explanation for that view together with examples.

Response

As the Discussion Draft notes, all business operations can be expressed through a value chain. Furthermore, a value chain analysis can be helpful for understanding the end-to-end processes of a business and how these create value for the MNE. However, we see this as being fully integrated with existing guidance on the functional analysis, which is undertaken to understand the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties. We therefore believe that developing an understanding of an MNE’s value chain is fully integrated with the functional analysis that is required as part of any transfer pricing study and should be considered for any transfer pricing method. As such, the discussion on value chains may be more helpful if addressed in the OECD Guidelines in relation to all methods (e.g., in the discussion on method selection) rather than being included only in the profit split guidance which might lead to erroneous conclusions that it is only relevant for profit splits. However, while understanding the value chain of a company may be important, we worry that the revised guidance would inspire tax authorities to start asking for a separate description and documentation of the value chain analysis in addition to the existing transfer pricing documentation (even when prepared in accordance with the final Action 13 recommendations). While this is appropriate in complex

situations, the guidance should clarify that this is not required and may be an inappropriate burden on taxpayers when analysing routine functions.

Question to commentators (page 16)

15. What further guidance or clarification of existing guidance would be helpful in these sections? Please provide practical examples in support of the response.

Response

In the previous Discussion Draft on Profits Splits that was issued on 16 December 2014, an example was included where the PSM was applied using a RACI responsibility matrix (i.e. Scenario 6; paragraph 38 - 46). This approach relied on a RACI matrix and value drivers, which were identified as part of a thorough functional analysis. This example illustrates the application of the PSM using information that is readily available in most organisations, and should be collected as part of a thorough functional analysis. It would be helpful if the guidelines were to clarify whether this specific approach meets the three criteria of being independent, verifiable and supportable by comparable / internal data.

Question to commentators (page 19)

16. The discussion of profit splitting factors sets a requirement that the factors must be capable of being measured in a reliable and verifiable manner. Do commentators believe that useful ways of splitting profits have been excluded? If so, please describe these factors and explain how they meet the requirement of reliable and verifiable measurement.
17. More generally, examples are requested of scenarios where a transactional profit split of actual profits or of anticipated profits are applied, together with a brief explanation as to why the method and the approach to applying the method, is considered to be the most appropriate in the circumstances of the case.

Response

Paragraph 44 mentions that *“the assumption is that independent parties would have split combined profits in proportion to the value of their respective contributions (...)”* and that *“arm’s length parties can be assumed to split combined profits on the basis of their relative contributions to the creation of those profits.”* We think this is roughly correct and consistent with the activities of partners in partnerships (to the extent relative contributions can be assessed). Nevertheless, microeconomic theory does not provide strong support for this assertion. Consequently, we think the Discussion Draft should provide more scope for taxpayers to use alternative approaches in determining the appropriate allocation of profits. For example, a bargaining analysis could also be a useful tool in assessing profit split outcomes.

We also recommend that the OECD acknowledge that application of the transactional profit split method using market comparables data aligns with the arm’s length principle, even when such market comparables data are not *exactly* comparable to the controlled transaction, but are sufficiently comparable (i.e., the use of so called “inexact comparables” may be appropriate). Additional examples of market comparables could include licensing transactions, acquisition transactions, or supply and distribution arrangements. The Discussion Draft can acknowledge that

use of these comparables is most likely to be possible when such comparables are transactions that an MNE has with unrelated parties (internal comparables) because the data necessary to use these transactions for application of the transactional profit split method are not likely available for external comparables but are more likely to be available for internal comparables.

COMMENTS FROM THE FRENCH BANKING FEDERATION RELATING TO THE ACTIONS 8-9-10 OF THE BEPS PUBLIC DISCUSSION DRAFT ON "REVISED GUIDANCE ON PROFITS SPLITS"

The FBF, as the voice of the French banking sector representing the interests of over 400 banks operating in France, encompassing large and small, wholesale and retail, local and cross-border financial institutions, welcomes the opportunity to provide the OECD with comments on certain questions of the proposed Public Discussion Draft relating to the Actions 8-10 on "revised guidance on profit splits".

It is crucial for us to have the opportunity to provide our comments as well as our input, particularly given the complexity of certain issues under discussion. We thank the OECD for the consultative process underway and call for a continued interaction with the private sector so that the voice of business is duly taken into account.

PRELIMINARY REMARKS

We would particularly like to stress the fact that although the concepts discussed in the Draft may provide some helpful details which may be of use in certain situations for companies in general, this input seems however less relevant for the banking sector. It does not provide any specific guidance which may be applicable in the banking world; it is noteworthy that many of the examples in the discussion paper are irrelevant for banks notably where risk is discussed: the very specific types of risks incurred by banks are not addressed at all.

Moreover, the profit split concept has already *de facto* been taken into account and put in practice by the banking sector when it has had to apply the very comprehensive and detailed set of guidance provided for by the report on Attribution of Profits to Permanent Establishments.

GENERAL REMARKS

It should indeed be reminded that the situation of the banking industry is a very specific situation, as illustrated by the fact that specific work has been carried out by the OECD with the Report on the Attribution of Profits to Permanent Establishments in July 2010. This report has categorized two main types of banking activities: (i) Part II ("Banks") which relates to rather "traditional" banking activities for which "traditional" Transfer Pricing methods would normally apply; and (ii) Part III ("Global Trading") which pertains to worldwide and integrated transactions on financial instruments for which transactional profit methods may be viewed as more appropriate.

This comprehensive and detailed set of rules has been applied by banks for many years and has led them to carry thorough analyses where concepts such as global value chains are already well known and have been applied with respect to various activities such as financing and trading. Banks have thus secured adequate matching between their operational activities and the attribution of profits.

Consequently, we believe there is no relevance that the banking sector be subject to the proposals of the Draft as they are less adapted and less precise than the ones already applied by banks.

In any case, this new proposal on profit split methodology should not jeopardize the long experience of banks in the implementation of the profit split methodology.

5 September 2016

Mr. Jefferson VanderWolk
Head of the Tax Treaty, Transfer Pricing & Financial Transactions Division
Centre for Tax Policy and Administration
OECD

Dear Mr. VanderWolk,

We have pleasure in detailing below our comments on the BEPS Document: *Revised Guidance on Profit Splits*.

The following comments and responses are made with reference to the questions and paragraphs in the document in order to suggest further clarifications that the OECD might consider including in the final version of the guidance.

C1 General

1. We do not consider that the guidelines make sufficient distinction between the circumstances when it would be appropriate to use anticipated profits as the basis for the profit split, in place of the most appropriate method, which Para 2 explains is the actual profits. If there is need/opportunity/circumstance for the former, it would be helpful to provide some further detailed guiding examples of such, as we are not clear as to the distinction the OECD is trying to make. It seems to us that the best use of anticipated profits is as part of the foreseeable information at the time the transactions are entered into.

As to the example for the utilization of anticipated profits, we believe that, in the circumstances given in Para 4, whilst third parties might conceivably negotiate on this basis, they are much more likely to negotiate the application of the anticipated profit split in relation to actual profits. This is to ensure that there is no disadvantage to Company A, for example, if by virtue of the combination of technologies a block buster product comes into existence earning levels of profit significantly above those that could have reasonably been anticipated at the time of the original agreement (or vice versa for Company B if lower profits arise).

We would expect third parties to take account of such possibilities in their negotiations. Thus either resulting in the utilization of actual profits for the split between them, or an element of ex-post review and adjustment being due, even if on a prospective basis. These circumstances are partly acknowledged in Paras 7, 8, 9, but again only in relation to the sharing of actual profits.

Indeed in the example given, profit split might not even be the most appropriate method if it is a licensing of technology accruing a royalty (albeit that in negotiating the royalty, third parties are likely to have cognizance of the anticipated profits) without control over the risks (a proviso noted in Para 10) of the new product development. An external or internal CUP might be more suitable. Perhaps the example might acknowledge this and then go on to distinguish it from circumstances in which a CUP should be used.

2. The utilization of the profit split is predicated on the basis of integrated activities rather than significant contributions to the joint project. Such integration may or may not exist between third parties and yet many different kinds of third joint venture arrangements exist where joint profit outcomes are shared in negotiated ratios. OECD may like to survey and take these possible comparable arrangements into account.
3. Third party examples may be sourced and surveyed from commercially available databases of publicly disclosed agreements, including joint venture arrangements.

C2 Summary

4. In general, we think the strengths and weaknesses are well summarized. However we note that it would be helpful to explicitly state at the end of Para 11 that in such cases another traditional method should be used. In Para 12 we suggest that the assertion that such unique facts etc. 'are not present' in arrangements between independent enterprises is made less definite to 'may not be'. The comments in Para 13 will not apply to the use of profit splits based on anticipated results. These seem to us to have significant potential weaknesses that are not elucidated upon in this section. The OECD might like to give further consideration to this. We consider that the OECD is introducing too many elements of doubt into the efficacy of the method by pointing to what it thinks is an over-reliance on tax payer data etc. This may result in unnecessarily strong scrutiny, or even rejection of the method, by tax authorities on these grounds, even when it is the most appropriate method
5. For the proper monitoring of any transfer pricing method a tax authority has to rely on tax payer data and tax payer co-operation. As such we struggle to see any fundamental differences here and would recommend that the OECD adds some language encouraging tax administrations to actively engage with tax payers to understand the various assumptions etc. in a spirit of co-operation. In other words, to put the cautions in a more positive light.
6. Our comments on C1 and 4. above point to some of the weaknesses of the use of anticipated profits

C3 Most appropriate method

7. We think that the draft is helpful in clarifying the circumstances in which the transactional profit split should be used (Question 6.2) and we agree risk sharing should be defined. It may be that individual risks are not shared, but one party takes on one risk, whilst the other takes on a different risk. In such a manner, the overall risks of the business are still being shared. The OECD may like to include this possibility here. We note that it seems to be included in Paras 21 and 22 below as sequential integration.

In practice some work would need to be done to evaluate the relative amounts of these risks to ensure that the division of profits properly reflected each party's relative share/contribution to the risks borne.

8. Whilst we have no specific examples to provide, please see our earlier comments on the Intangibles draft OECD guidance, where we provided an example of a DCF valuation model to your predecessor, Joe Andrus. We reiterate our comments above on the use of anticipated profits.

Highly integrated operations

9. We agree that these definitions are useful. But there may be an implication for sequential integration that other more traditional methods might be used for certain parts of the value change, capable of separate benchmarking, yet there will persist the issue as to how to divide the remaining profits between the contributing parties. This seems to us in essence to be a residual profit split approach. Perhaps the OECD might make this plainer, if that is the intention of these comments.
10. Parallel integration could be developed further with examples using such approaches as Profit Contribution Analysis based on RACI Analysis, and Risk Evaluation Approaches.

Unique and Valuable Contributions

11. We have no particular comments to make on this.
12. We consider that this situation may arise in practice between third parties. Nevertheless, as with the general transfer pricing principles, if risk taking is not at stake, then the contributor may not be entitled to as high a share of the profits as it would if it were to bear such risks. However, this may be a little simplistic and not always be the case. For example, suppose a potentially valuable piece of intellectual property had been developed by Party A for a particular application and the development costs, marketing etc. had more than been covered by the success of product A. Suppose now that a new application for the IP was developed with minimal additional costs, but the marketing etc. of Product B was carried out by a joint venture partner, Party B. Would it be correct to allocate a greater proportion of the JV profits to Party B on the grounds that Party A had not borne much by way of risk in developing Product B? We think this would not be the bargaining position of the parties if they were third parties. Party A would enter such negotiations to maximize its additional profits from Product B, further capitalizing on its previous work in developing Product A. The OECD might like to consider such an approach in making distinctions between contributions and risks.

Group synergies

13. We have no particular comments to make on this point and are in agreement with the general principle here.

Value chain analyses

14. The use of VCA in identifying the use of the transactional profit split is useful.

15. However such analyses can go further in terms of detailed analyses and can, through a series of functional and risk weighting factors, provide the basis for the actual profit split to be applied. The OECD may like to include such resulting applications in the descriptions here.

C4 Guidance for application

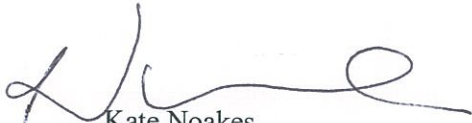
16. Under the subsection on contribution analysis, it would be helpful if the OECD could give some guidance or commentary on the common use that is made of Profit Contribution Analyses for this purpose. In the subsection on residual analyses, the OECD may like to acknowledge that a range of outcomes may be possible in stage one if it is based on comparables data and provide some further guidance on how a point in the range should be settled upon, before being able to move on to stage two. Is the intention that the median, or some other point in the range be used?
17. With regard to the expectation that material differences in accounting standards should be identified and aligned in Para 37, we wonder how this can be achieved in practice. We consider that it is more practical to use the group reporting accounting standard, say IFRS, to calculate the profit split and accept that local GAAP reporting may give rise to differences, but that these do not necessarily merit changing the basis of the profit split. Such guidance would be welcome more generally as this often creates problems for multinational groups in applying transfer pricing policies consistently.

Splitting profits

18. It may be necessary or desirable in some cases to have multiple profit splitting factors applied, or as is the case when using a PCA. The OECD may like to add these possibilities in the subsection of examples of profit splitting factors. As to the use of inflation accounting or other adjustments for higher/lower cost territories, some caution might be expressed as these adjustments might introduce elements of uncertainty rather than the sought for accuracy or parity of treatment. The OECD might like to comment on this. As previously mentioned, the OECD might like to comment on the use of PCAs to determine profit splitting factors.
19. We have no comments on this.

We trust these comments are helpful to you and, as always, we would be happy to elucidate on them and to participate in future business consultations, in particular that scheduled in October 2016.

Yours sincerely,


 Kate Noakes
Transfer Pricing Partner

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5 September 2015

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Dear Sirs

**Response from FTI Consulting to the OECD Public Discussion Draft on BEPS Actions 8-10
(‘Revised Guidance on Profit Splits’):**

We welcome this opportunity to comment on the OECD’s Revised Guidance on Profit Splits under BEPS Actions 8-10, published on 4 July 2016.

We agree to have our comments posted on the OECD website.

We would like to thank you for the opportunity to comment on the discussion draft and hope our comments are helpful.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Marvin Rust', with a stylized flourish at the end.

Marvin Rust
Enc.

Additional Contributors:

- Kirsty McMillan
- Ruth Steedman
- Joanne Hawley
- Martin Brooks

Enclosure

Introduction

The additional guidance is welcomed and helpful in determining both the selection of the transactional profit split as the most appropriate method and the application of the transactional profit split. Throughout our commentary we have identified areas where we believe the guidance could benefit from additional clarification.

Where we have raised questions or comments to the guidance, we have attempted wherever possible to support these with examples.

The two areas within the commentary in relation to which we have most observations are: (i) the introduction to the transactional profit split of anticipated profits and (ii) the language around sharing of economically significant risks. In relation to the former, we believe the transactional profit split of anticipated profits is an additional method and not a variant of the transactional profit split of actual profit. The transactional profit split of anticipated profits is a method to determine a transfer price to one party. In the example given in C.1 paragraph 4, the facts may also lead to the conclusion that the Comparable Uncontrolled Price is the most appropriate method. In both the transactional profit split of anticipated profits and the Comparable Uncontrolled Price method the focus is on setting a price to remunerate one party which has a valuable contribution but is not integrated into the overall business model and objective. On the other hand, the transactional profit split of actual profits does not determine a transfer price but determines the outcome i.e. the profit allocated, to all parties which each have valuable contributions and work together to meet a common business objective. We believe that the guidance would benefit from further separation of the two methods such that it is made clear that the transactional profit split of anticipated profits and the transactional profit split of actual profits are two separate methods which are appropriate in different circumstances. If the transactional profit split of anticipated profits were dealt with separately in its own section of the guidance, then it would indicate to tax payers and tax administrations that the two methods are mutually exclusive and not variants of the same method. We are of the view that the analysis of the circumstances of a transaction should generally lead to the conclusion that either the transactional profit split of anticipated profits or the transactional profit split of actual profits the most appropriate method.

In relation to the new commentary on the sharing of significant risks, we believe a clearer definition of 'sharing' is required such that it is not seen as interchangeable with 'controlling' significant risks. If two enterprises share a risk, then they are choosing to share in *the impact of the risk materialising*. On the other hand, control of a risk is the active management of that risk in order to *mitigate the likelihood of it materialising*. Nearly all risks will have a potential to impact on the Profit and Loss of the company(s), as such, by sharing in the risk a company chooses to share in the financial burden of the risk materialising. As mentioned in C.1 paragraph 9, 'sharing the combined actual profits of the parties contributing to the arrangement has the effect of sharing the impact of the risks...'. We agree with this definition of risk sharing, it is a function of the application of the transactional profit split method of actual profits rather than required to be present in order for the method to be appropriately applied. On the other hand, the control of significant risks, albeit not necessarily the same risks, is generally required in order for the transactional profit split method of actual profits to be appropriately applied. As such, we believe the guidance would benefit from further clarification of the difference between the control of risks and the sharing of risks. Additionally, it should be made clear that the parties do not need to control the same risks but a portion of the risks associated with the business objective in question. Overall, we would recommend that the selection of the transactional profit split of actual profits as the most appropriate method focuses on whether multiple parties are contributing towards a shared business objective and either multiple parties (i) manage significant risks of the business objective; (ii) contribute unique intangibles; or (iii) contribute key assets.

Specific Answers to Questions

1. *Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits.*

It should be made clear within the guidance that these are two separate methods, the applicability of either depends on the specific facts of the transaction. In order to make this clear, consideration should be given to treating the two methods separately in entirety rather than considering both side by side and alternating between the two. This may avoid the conclusion that first the transactional profit split method is selected as 'most appropriate' and then a decision is taken on whether to split actual or anticipated profits.

We agree that the main focus of the paper should be on the transactional profit split of actual profits as this method is applicable in transactions with highly integrated activities focused on a shared business objective. It is this integration that eliminates the potential to use other methods and the focus on a shared business objective which leads to the splitting of actual profits as the most appropriate method.

A potential concern with the application of the transactional profit split of anticipated profits is that in many situations where this could apply, the profit split method in itself may not be the most appropriate method. For example, within C.1 paragraph 4, an example is given whereby one party supplies intangible property with limited ongoing involvement. The other party then takes this intangible, develops further intangibles and commercialises the product. Here the most appropriate method may be to price the intangible using the external Comparable Uncontrolled Price method leading to a royalty arrangement which would generally give the IP owner a return based on a percentage of sales. As mentioned in the commentary, the selection of any method will ultimately impact the share of profit that the enterprise receives, but this in itself is not an indication that a split of profits is the most appropriate method. The commentary should ensure it is clear that the transactional profit split of anticipated profits should be used only when determined as the most appropriate method and not used due to a perceived lack of reliable data under another method, for which adjustments may be possible.

2. *Comments are also invited on the link between integration of business activities (and thus the sharing of risks) and the appropriate application of a transactional profit split of actual profits.*

We believe that the notion of 'risk sharing' could be misleading as it may be interpreted to mean that multiple enterprises are economically responsible for the same risk. Sharing of risks, as mentioned in C.1 paragraph 9, is the result of 'sharing the combined actual profits of the parties'. On the other hand, controlling a risk involves actively managing and mitigating that risk from materialising and hence, the potential impact on profits. It would be beneficial to clarify that whilst integrated business activities may lead to multiple parties contributing to the control of the same risk, not all risks need be

managed by every party and indeed, it would be unusual for the same risk to be managed by different parties. What is more relevant is that each party is able to contribute to the business activities through valuable contributions as well as the management of key risks. As such, it may be clearer to focus on the sharing of a common business objective rather than risks. In so doing, the parties will consider all the risks associated with meeting that business objective and will consider how to divide and manage these risks. Again, the risks that each assumes will most likely not be the same. This would more accurately reflect third party situations as third parties would not focus on risks when they partner but rather on how unique contributions will enable the achievement of a common objective. The risks each bears forms part of the contribution the enterprise makes which would be considered in totality.

3. *Examples of scenarios where each approach to splitting profits would be the most appropriate (together with a brief explanation as to why) are also requested.*

Transactional profit split of actual profits

The application of the transactional profit split of actual profits is likely most suitable for transactions whereby the two enterprises are both substantially engaged in ongoing functions which are expected to lead to the creation of the profit and are both responsible, in part, for the associated risks for that profit.

Take for example a situation whereby a group is engaged in developing and publishing stock data on a daily basis. Company A owns the trademark under which the product is sold. Additionally, Company A has developed the methodologies for how the stock data is computed at the end of each day. Company B employs the analysts responsible for computing the data. The data can only be computed through the collection of individual data from stock traders. Company B has the relationships with these stock traders and has developed the software required for collecting the data. Both companies are responsible for the marketing of the product. Company A manages online subscriptions and internet advertising and employees of Company B are responsible for attending industry events to promote the product and develop the brand. In this example, the activities of the two companies are highly integrated. As such, they it would be difficult to separate the returns for the two functions and the associated risk. Therefore, establishing the basis for the split of profits *ex ante* and then applying these to the actual profits, once the success of the combined strategies is known, is most appropriate.

Transactional profit split of anticipated profits

The application of the transactional profit split of anticipated profits is likely most suitable for transactions which are integrated but where one party has a lower level of involvement in the on-going business activities and therefore less able to influence the expected outcome.

Take for example a situation whereby Company A is owner of a trademark well known in market Y and market Z. Historically, Company A has utilised a third party to sell products in market Z and has invested heavily in marketing and brand development. Company A decides to terminate the third party agreement and to undertake this function internally via Company B, a related party. Company B will now be responsible for the sourcing, marketing and sale of products in market Z and entry into new markets W and X. Company B will bear full market risk in relation to its expenditure in promoting

and sourcing these products. In order to sell the products, Company A transfers the right to the trademark and the market access rights to Company B. Company B uses this intellectual property to create additional intellectual property and to commercialise the product. In this situation, the profits of the two enterprises are integrated as the historic work undertaken by Company A and the on-going development and support of the trademark help in the generation of profits in market Z. No profits could be generated without active marketing, sales activities and sourcing within this market. The on-going functions and risks are concentrated in Company B. Company B largely controls the success of the product in market Z, W and X through its marketing strategies and efforts as well as the quality of product sourced. Company A bears the risks related to trademark infringement and performs activities related to the defence of this trademark only. In this situation, it would likely be most appropriate for the two enterprises to *ex ante* decide on a split of anticipated profits whereby Company A would receive a share of the profit based on its contribution of the trademark and the historic market development. Company B would receive the remaining share based on its contribution of new intellectual property and marketing activities. In this situation, Company B bears the majority of the business risks and therefore, should have the majority of the profit or if its strategy is unsuccessful, the actual loss.

4. *Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarised?*

The strengths and weakness are appropriately summarised and no further comments are made.

5. *Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses?*

The key difference is that the transactional profit split of anticipated profits requires the ability to accurately predict the future cash flows generated from the combined efforts which adds an additional layer of complexity and uncertainty above the transactional profit split of actual profits. The potential weakness of the method arises from how a tax payer evidences that the split was made *ex ante* and therefore, should not be subject to challenge *post ante* in a situation whereby the actual results greatly differ from the anticipated results. Some additional clarity would be helpful on the documentation companies should keep to evidence the calculation of the anticipated profits at the point of the transaction and reemphasis how neither tax payer nor tax authorities should use hindsight in concluding whether the actual results are arm's length, provided the anticipated profits are reasonably determined.

6. *The discussion draft introduces the sharing of economically significant risks as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method. Do commentators have any suggestions for clarifying the notion of risk sharing in this context?*

Please see comments to Question 3 which are also relevant here.

Risk sharing involves the active participation of both parties in a specific project with both parties having the rights to future profit generated from the project. To be risk sharing, both parties must rely on the commercial success of the project to receive

remuneration for their contribution. It should be clarified that the two enterprises do not need to actively be managing the same risk, but both parties would be expected to be aware of what the economically significant risks are and the steps taken to mitigate these risks.

To clarify the notion further, consideration could be given to using real unrelated third party examples e.g. two unrelated companies co-developing a drug, sharing in the upfront costs and commercialisation risks. They agree in advance how to share the costs and will share the profit proportionately to the costs they have borne. The two parties manage different risks. One manages the risk of quality and product approvals, the other manages the marketing and advertising risks. As they have agreed to share the profit, they both share in the financial impact of all risks relating to the pursuit of the business objective.

- 7. *The discussion draft notes that a transactional profit split of anticipated profits can be used in conjunction with certain valuation techniques. Examples showing the application of a transactional profit split of anticipated profits are sought.***

We do not believe it is possible to give a simplified example of the application within this written response. The application would generally involve Excel modelling on the future anticipated cash flows in conjunction with a methodology for splitting the results.

- 8. *Is the distinction between parallel and sequential integration of business operations a useful refinement in determining when the transactional profit split method is likely to be the most appropriate method?***

The distinction is limited in its usefulness as in most examples, companies would have elements of both sequential and parallel integration across their value chain. For example, a company may manufacture in two locations and sell via distributors globally. This is an example of sequential integration and the two functions could likely be priced separately. However, in the same company you may have research and development, intangibles ownership and marketing in multiple locations. These functions may be more parallel and therefore suited for the transactional profit split.

Further consideration should also be given to intangibles which could be both sequential and parallel. For example, Company A may perform research, testing and diagnostics on rubber to be used in car tyres. The strength, quality and wear of the rubber is a key differentiator for the company and their advancements in this area are well known. Company B takes the rubber designed and tested by Company A and uses it to build the end product. There is substantial research and development undertaken by Company B on the performance and traction of the tyre using different measurements such as adjusting the thickness of the rubber or the size of the tyre. Both companies regularly present together at industry roadshows and events with car manufacturers to demonstrate their respective strengths in the final tyre. In this example, Company A and Company B are arguably both sequentially integrated, as Company B cannot undertake any research until Company A has completed theirs, and also have parallel integration as they perform a similar function and share in the key economic risks. In this circumstance it is not easy to define the company as either sequential or parallel and, depending on the specific facts, the transactional profit split may or may not be the most suitable method.

Therefore, when describing the two variants it may be helpful to add commentary which describes how companies are likely to have elements of both at different stages in the value chain and the key consideration here is not parallel or sequential integration but whether related parties share a common business objective and in the pursuit of achieving it, make unique and valuable contributions and bear a portion of the economically significant risks. Put another way, complex and highly integrated transactions are more likely to be appropriate candidates for the transactional profit split method.

9. *If so, how should the concept of parallel integration be further defined?*

No further comments.

10. *Comments are invited on the relationship between the making of unique and valuable contributions by both (all) parties to a transaction, and the sharing of economically significant risks.*

Please see comments to Question 3 which are also relevant here.

Whilst we agree that there is a relationship between the making of unique and valuable contributions and the control of economically significant risks, there is not the same relationship between the sharing of economic risks. The sharing of economically significant risks points to the use of the transactional profit split method as the transfer pricing method, as the risks impact the profit available to be split and as such, the parties are sharing in the financial impact of the risks. The two parties however, do not need to jointly control these risks in order for the transactional profit split to be the most appropriate method. In the same way the parties or all parties do not need to perform the same functions or contribute the same intangibles, the parties should not be required to control all of the same risks.

It is however, true that significant risks are often an indication of a complex and integrated transaction where the transactional profit split may be the most appropriate method. Therefore, evidence of both parties having control of a substantive economic risk could be expected in the same way that you would expect both parties to make an equivalent or similar contribution. In this context however, it should be noted that equivalent does not need to mean equal as this is reflected within the method used to divide the profit.

11. *Are there situations where all the parties make unique and valuable contributions to a transaction, but they do not share the economically significant risks associated with the outcomes of that transaction? If so, what guidance on the appropriate use of profit splits in such a situation should be provided?*

The sharing of economically significant risks could be seen as a function of the pricing arrangements between the entities rather than occurring practically. Take, for example, this arm's length situation where three parties contributed unique intangibles, Company A contributes the designs and is engaged in designing new products, Company B has developed patents and processes for how to make the designs and is engaged in the

manufacturing of the products, Company C owns the brand under which the product is sold and is engaged in the marketing and sales of the product. In this example, each party makes a unique contribution but the pricing would dictate whether they share in the significant risk of whether the product is a success. For example, Company A could be paid per design and be subject to very limited risks. Company C may have an agreement with Company B to buy a minimum quantity of product each year, again sheltering Company B to significant risks.

The transactional profit split may be the most appropriate method if the three parties share a common business objective and in so doing, agree to share in a portion of the business risks associated with achieving that business objective. However, if the parties agree that one party is 'key risk bearer' then this should be reflected if it is a reasonable basis for the transaction.

- 12. The final BEPS Report on Actions 8-10 noted that group synergies were to be addressed in the guidance on profit splits. The approach taken in this discussion draft is to make reference to the incremental or marginal system profits arising from the group synergy, which would then be shared amongst the relevant associated enterprises. The analytical framework suggested in the draft, based on an accurate delineation of the actual transaction, would not support the combining and splitting of total system profits on the basis of group synergies alone. Comments on this point are invited.***

Whilst we agree that group synergies alone should not always be a driver for a transactional profit split method, further clarification may be required on what constitutes a group synergy. For example, if a group has a centralised procurement function multiple members of the group may benefit from a reduction in material spend due to the volume of purchases. However, the central procurement function may additionally be driving value and cost reductions beyond just volume based savings. For example, through better supplier selection and vetting they may be improving the quality of the raw materials. Through expertise in negotiation, they may improve terms of business. As such, on the surface the synergy may appear to be cost-savings based purely on economies of scale which could be split based on an allocation key such as procurement spend, however, the benefit and synergies go beyond just the cost reduction and would be seen in other parts of the business such as product quality, operating cash flow and in the R&D function. As such, what may appear to be a group synergy could be an integrated function involving multiple parts of the business and a key value driver. To consider only the division of the cost-savings benefit would under remunerate the central entity. The question then goes back to whether the transactional profit split method is the most appropriate for the remuneration of the procurement entity given the specific facts of the transaction.

- 13. Does this section properly describe a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit split method is appropriate?***

A value chain analysis should identify the key value drivers in the business including the functions, assets and risks which are instrumental in its creation of profits and ability to compete in the market. The value chain analysis should look at the business in totality when considering these aspects. A value chain analysis does not need to identify which parties perform the functions, own the risks etc. this is an additional step which involves the layering of the functional analysis over the value chain analysis to determine which

entities in the group contribute to the value drivers identified. As such, although we agree the value chain analysis can be used as a tool to delineate transactions, it does this by providing a framework with which to consider and review the contributions of each entity. In itself, it would not provide the answer to whether the transactional profit split method is most appropriate but as rightly mentioned later in the guidance, could be instrumental in determining the profit splitting factors.

It is also noted that in paragraph 27, the paper describes a Development, Enhancement, Maintenance, Protection and Exploitation ('DEMPE') analysis. The DEMPE analysis is again a framework to structure a functional analysis of the legal entities which are involved in the Development, Enhancement, Maintenance, Protection and Exploitation of intangibles. The value chain analysis will only identify the significant intangibles and contributions to transactions within the organisation. The DEMPE analysis then considers which entities perform functions or bears risks and should therefore receive remuneration in relation to those intangibles. As such, we recommend that the section on value chain analysis be reworded such that it is clear that it is a tool to assist in the review of each entity's participation and does not in itself, require the identification of who performs the function, controls the risk or owns the asset.

14. If commentators see a value chain analysis as serving a greater purpose in relation to profit splits, then please provide an explanation for that view together with examples.

Not a greater purpose but a different purpose to how it is currently described. It is a tool to aid in the structure of the functional, asset and risk analysis and is therefore suitable to be used as a framework for considering which entities contribute to each value driver. It is equally relevant for all transfer pricing methods and useful in the delineation of the transaction. We agree that it may also be a relevant tool for the contribution analysis of the parties once the transactional profit split of actual profits has been selected as the most appropriate method.

15. Guidance for application: What further guidance or clarification of existing guidance would be helpful in these sections? Please provide practical examples in support of the response.

Further guidance would be helpful on the documentation that tax payers should retain in order to evidence that the basis for calculating the combined profits to be split was made without the use of hindsight.

16. The discussion of profit splitting factors sets a requirement that the factors must be capable of being measured in a reliable and verifiable manner. Do commentators believe that useful ways of splitting profits have been excluded? If so, please describe these factors and explain how they meet the requirements of reliable and verifiable measurement.

One further splitting factor could be the use of revenue. For example, in a situation where two parties are jointly developing and promoting a product and are equally sharing in all significant functions and economically significant risks, the party which generates the most sales should be entitled to the greater share of the profits.

17. What further guidance would be useful in this section relating to identifying and measuring profit splitting factors?

Several times within the guidance the requirement to ‘weight’ the risks or factors for splitting the profit is mentioned. It would be helpful to include guidance on how the tax payer should weight the factors and whether this methodology is required to be supported by external data or whether a reliance on internal data is sufficient. Further to this point, clarification on whether qualitative data is an acceptable means of weighting value drivers when given by the business i.e. executives weighting value contributions in a questionnaire form. With each of these considerations, there is also the consideration as to the use of averages and ranges and guidance should be considered on when and if these should be applied. It may also be beneficial to include a section on maintaining and collecting the appropriate evidence and support for any profit splitting factor.

Additionally, though the point on timing issues relating to cost-based splitting factors is true and useful, it would be helpful if the guidance went further to outline circumstances when each would be applicable. For example, salary costs would always be taken on a single-year basis but the cost of an asset would be spread over multiple years. Here it may be worth commenting on whether in the case of assets the accounting method should dictate the cost in one year i.e. the annual depreciation or whether another method may be more applicable for circumstances whereby the useful life of an asset and the depreciation life-span do not match. Additionally, further, guidance would be helpful on costs which occur in a different year to the benefit. For example, warranty costs are incurred when the product is returned as faulty but the benefit occurs in the year in which the product is sold.

18. More generally, examples are requested of scenarios where a transactional profit split of actual profits or of anticipated profits are applied, together with a brief explanation as to why the method and the approach to applying the method, is considered to be the most appropriate in the circumstances of the case.

Please see responses to question 3.

Conclusion

In conclusion, the additional guidance is both welcomed and helpful. We have identified areas where we believe the guidance would benefit from additional clarification and where applicable, provided examples.

Finally, we believe that tax payers and tax authorities would benefit from guidance on what documentation should be prepared / retained in order to demonstrate that the transfer pricing result has firstly been determined on a basis that is accepted as arm’s length, and has not been reached through the use of hindsight and secondly on a basis to support the overall selection, and application, of the transactional profit split method.



Comments on the Public Discussion Draft of BEPS Action 8-10: Revised Guidance on Profit Splits of 4 July 2016

To: Head of Transfer Pricing Unit, Centre for Tax Policy and Administration
(TransferPricing@oecd.org)

Introduction

The OECD released a public discussion draft on its revised guidance on profit splits on 4 July 2016 with comments invited by 5 September 2016. The comments provided below are prepared by the author as representative of Gazprom Marketing & Trading Ltd.

Below are some general comments on the revised guidance; further responses to the specific questions in the consultation document are set out in the table on page 5 of this document.

General overview

Overall we are generally supportive of the revised guidance in relation to the use of profit splits. We generally support the new concepts introduced by the OECD, however we note that some of these require further clarification and therefore we anticipate a further iteration of the guidance.

Our key comments in relation to the discussion draft, in particular the areas that we consider require further detail, are as follows:

- Further guidelines are required to clarify the interaction between the three criteria in determining whether a transactional profit split method ("PSM") is most appropriate. Additionally, the OECD should make clear that the PSM should not be applied in the absence of all three criteria.
- The principle of determining the basis of the profit split on an ex ante basis is good in theory, however in practice tax authorities can be more aggressive in challenging the basis following the event, particularly where one of the entities is loss making and/or losses are split. Further guidance from the OECD in dealing with such scenarios is required.
- Given the subjectivity involved in the application of the PSM, it should be made clear whether the PSM can be applied as the only justification of a transfer pricing arrangement or whether secondary tests are required to support this.
- More detailed guidance is also required on how the value chain analysis ("VCA") is applied in relation to the PSM, in particular how the results of the VCA can affect the profit allocation criteria.

- We note that throughout the OECD BEPS project, people functions are a key factor in relation to transfer pricing. However the revised guidance does not specifically refer to the role of people, for example in the context of managing economic risks and making of unique and valuable contributions; further guidance in this respect would be useful.
- The guidance on global trading arrangements in the Report on the Attribution of Profits to Permanent Establishments (“PE”) is not consistent with the new guidance on profit splits; the former should be updated to align with the revised profit splits guidance.
- The guidelines should specifically address that PSM cannot be applied by tax authorities based on the information in the CbC form, even for risk assessment purposes.
- The new concept of ‘anticipated’ profit split requires further explanation.

Key criteria for profit split

The new guidance provides further clarity on the situations where PSM is considered most appropriate. Broadly, the guidance refers to cases of (i) highly integrated operations, and (ii) unique and valuable contributions and (iii) parties sharing the economically significant risks.

We understand that these themes are considered to be the key criteria in determining whether the PSM is the most appropriate transfer pricing method, and as such the absence of all three would indicate that PSM is not appropriate; we welcome confirmation that this is in line with the OECD view in respect of the application of the general criteria.

We consider that these general themes do appropriately reflect situations where PSM should be applied and are consistent with the policy of aligning transfer pricing outcomes with value creation. In respect of the interaction between the key criteria and relative significance of each in determining whether PSM is most appropriate, we expect this to be determined by reference to the VCA and therefore determined on a case by case basis. Therefore PSM may be considered appropriate because of the presence of unique and valuable contributions despite limited sharing of economically significant risks in a certain scenario for example, and in another scenario, PSM may be deemed appropriate due to highly integrated operations, as determined by the VCA. Again, we would welcome further guidance in this area to clarify that this is in line with the OECD view.

Ex ante results

The guidance continues to comment that the basis of splitting profits should be ‘*determined ex ante on the basis of information known or reasonably foreseeable by the parties at the time the transactions were entered into*’. This is consistent with a third party commercial arrangement (e.g. non related party joint venture) whereby the relative share of profits would be determined at the outset, with any adjustments to this limited to specific (exceptional) circumstances.

There is however some concern that tax authorities may expect some true up adjustment where the profit split is determined on an ex ante basis and there are significant changes as a result of unforeseen circumstances. This appears to be inconsistent with the OECD guidance and, as noted above, inconsistent with a third party arrangement, and would also significantly increase the compliance burden on companies.

Furthermore, to the extent that the profit split factors are appropriate for the specific scenario and properly defined and documented in accordance with OECD guidance, this should limit concerns around artificial diversion of profits through inaccurate or deliberate manipulation of assumptions to arrive at the profit split. As such, we would welcome further specific clarification on the use of true up adjustments in the guidance.

Value chain analysis

The revised draft guidance clarifies that a VCA in itself does not justify the use of the PSM on the basis that it would demonstrate a very integrated MNE operating through a global value chain. The guidance notes that a VCA is merely a tool to assist in the accurate delineation of a transaction and therefore determine which method, whether a PSM or any other method, is most appropriate. To the extent that this is the main purpose of the VCA, it may be more appropriate to include this guidance in Chapter 1 on guidance on accurate delineation.

However we do consider that the role of the VCA on the context of the PSM is much wider than just the delineation of a transaction for the purpose of determining the most appropriate TP method. The VCA is also key in determining how the PSM should be applied, for example in establishing which profit (net or gross) should be split, which allocation keys should be used through analysis of the value drivers; the guidance does not sufficiently explain the role of the VCA in the wider application of the PSM.

Global trading of financial instruments

The guidance makes reference to the discussion on the appropriateness and application of profit splits to Global Trading of Financial Instruments, which is set out in the Report on the Attribution of Profits to Permanent Establishments (“PE”). This guidance focuses specifically on the application of profit splits in the context of branches of head office entities; however the discussion is more generally linked and relevant to the discussion on profit splits in this Chapter of the guidance. As such, it would be helpful if the guidance in relation to the application of profit splits in the context of global trading of financial instruments is consolidated in the transfer pricing guidelines to ensure consistency of application of the principles to businesses involved in the global trading of financial instruments.

In particular, it should be confirmed that the revised guidance on profit splits applies equally to the global trading of financial instruments and these principles apply equally to subsidiaries as well as branches. For example, the revised guidance on profit splitting factors notes that determination of allocation keys is based on the key value drivers in relation to the transaction; as such, this general principle should apply to determine the appropriate allocation key rather than limit this to remuneration only, as set out in the current guidance on the Global Trading of Financial Instruments, in the Report on the Attribution of Profits to PEs.

Country by Country reporting

As a part of Action 13, the OECD introduced an obligation of Country by Country reporting (“CbC”). The content of the form will result in the disclosure of the key economic characteristics of a business on a country by country basis. One of the biggest concerns that we have in this respect is how tax authorities will apply the information in their transfer pricing analysis.

In this context the discussion draft fails to provide assurance that the PSM cannot be used by tax authorities as a method for assessment of profit allocations between different territories and, hence, used for transfer pricing adjustment. A clear comment in the Guidelines in this respect could provide much greater clarity to both tax authorities and the business.

Responses to questions set out in the Consultation document

Question	GM&T response
<p>1. Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular:</p> <ul style="list-style-type: none"> Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear? Is the distinction between the two profit split approaches described useful? 	<p><i>The concept of transactional profit splits of anticipated profits introduced in the revised guidance is not completely clear; further guidance, including examples and a clearer definition of anticipated profits, is required to explain this concept.</i></p> <p><i>As noted above, the guidance sets out the main criteria in determining whether the PSM is relevant in a particular scenario (broadly, where there is a high degree of integration of business, unique and valuable contributions or sharing of economic risks); the interaction between these criteria and the use of profit split of anticipated profits needs further explanation. For example, the guidance suggests a lower level of integration of business and sharing of economic risks is required in the case of a profit split of anticipated profits; however the example provided also notes that a profit split of anticipated profits based on a contingent price or royalty based on actual sales may reflect a sharing of economic risks.</i></p>
<p>2. Comments are also invited on the link between integration of business activities (and thus the sharing of risks) and the appropriate application of a transactional profit split of actual profits.</p>	<p><i>We consider that the link between integration of business and application of PSM in relation to the split of actual profits is appropriate. However as noted above, it is not clear how this applies in the case of profit split of anticipated profits, primarily due to the lack of clarity in respect of this concept. We do not consider that the degree of integration of business is a decisive factor in determining whether a profit split of actual or anticipated profits is more appropriate; however this is subject to further clarity on the concept of a split of anticipated profits.</i></p>
<p>3. Examples of scenarios where each approach to splitting profits would be the most appropriate (together with a brief explanation as to why) are also requested.</p>	<p><i>N/A, as the concept itself is not clear.</i></p>
<p>4. Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarised?</p>	<p><i>The current discussion on strengths and weaknesses is generally appropriate.</i></p>
<p>5. Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses? If so, what are they?</p>	<p><i>The guidance appropriately reflects the strengths and weaknesses relating to the profit split of actual profits; we anticipate that these may be slightly different in relation to profit splits of anticipated profits although as above, further guidance on this concept is requested.</i></p>
<p>6. The discussion draft introduces the sharing of economically significant risks</p>	<p><i>The guidance is clear and helpful to the extent that it explains that the sharing of economically significant risks considers not only the</i></p>

<p>as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method.</p> <ul style="list-style-type: none"> Do commentators have any suggestions for clarifying the notion of risk sharing in this context? Do commentators find the draft helps to clarify the circumstances where the transactional profit split method is the most appropriate method? Please provide explanations and/or examples supporting your views. 	<p><i>fact bearing common risks from legal perspective, but also assumes that both parties functionally manage, and have the capacity to manage, the risks.</i></p> <p><i>However as noted above, whilst we agree that the sharing of economic risks is a relevant factor in considering whether a PSM is appropriate, we would welcome further guidance and specific examples on the interaction between the sharing of risks and other relevant criteria (integration and unique and valuable contributions). See also below response to questions 10 and 11.</i></p>
<p>7. The discussion draft notes that a transactional profit split of anticipated profits can be used in conjunction with certain valuation techniques. Examples showing the application of a transactional profit split of anticipated profits are sought.</p>	<p><i>N/A, as the concept itself is not clear.</i></p>
<p>8. Is the distinction between parallel and sequential integration of business operations a useful refinement in determining when the transactional profit split method is likely to be the most appropriate method?</p>	<p><i>The concepts of parallel and sequential integration are generally clear and helpful in determining whether a PSM is appropriate. We agree in principle that the PSM is generally more relevant in the case of parallel integration. However the assumption that functions that sequentially follow can more reliably be benchmarked is not appropriate, for instance this may also be impacted by the presence of unique and valuable contributions, which may take place sequentially (for example, where the maintenance or exploitation of intangibles takes place after development).</i></p> <p><i>The guidance should provide further guidance and examples to clarify:</i></p> <ul style="list-style-type: none"> <i>When it is considered that there is sufficient parallel integration of activities to justify use of profit split, and</i> <i>When a PSM may be most appropriate in the case of sequential integration.</i>
<p>9. If so, how should the concept of parallel integration be further defined?</p>	<p><i>See above (Q.8) in respect of suggested further guidance in respect of parallel and sequential integration.</i></p>
<p>10. Comments are invited on the relationship between the making of unique and valuable contributions by</p>	<p><i>The making of unique and valuable contributions and sharing of economic risks are not necessarily always linked. For example, in the case of highly valuable origination activity, the overall level of</i></p>

both (all) parties to a transaction, and the sharing of economically significant risks.	<i>risk arising may not be significant, or the individual parties may not share the risks, however the unique and valuable contributions are key in generating potentially significant profits for the business.</i>
11. Are there situations where all the parties make unique and valuable contributions to a transaction, but they do not share the economically significant risks associated with the outcomes of that transaction? If so, what guidance on the appropriate use of profit splits in such a situation should be provided?	<p><i>Yes - see above in respect of Q10.</i></p> <p><i>As noted above in our general comments, the key themes of integration of business activities, making of unique and valuable contributions and sharing of economic risks are all important in determining if a PSM is most appropriate. In each case, some or all of these factors may be present to varying degrees; therefore the relative significance of each in determining whether a profit split method is most appropriate should be determined on a case by case basis by reference to the VCA and functional analysis.</i></p>
12. The Final BEPS Report on Actions 8-10 noted that group synergies were to be addressed in the guidance on profit splits. The approach taken in this discussion draft is to make reference to the incremental or marginal system profits arising from the group synergy, which would then be shared amongst the relevant associated enterprises. The analytical framework suggested in the draft, based on an accurate delineation of the actual transaction, would not support the combining and splitting of total system profits on the basis of group synergies alone. Comments on this point are invited.	<p><i>The comments included in the guidance in respect of group synergies are very brief; further guidance would be helpful in particular in respect of the definition of group synergies and practical examples of these.</i></p> <p><i>Whilst the suggested approach in dealing with group synergies is logical, the methodology assumes that it is possible to separately identify the profits arising without the benefit of group synergies; in practice it may be very subjective and difficult to determine the marginal profits.</i></p>
13. Does this section properly describe a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit split method is appropriate?	<i>The content of the guidance does appropriately explain how a VCA is used to delineate the transaction and identify if a PSM is appropriate.</i>
14. If commentators see a value chain analysis as serving a greater purpose in relation to profit splits, then please provide an explanation for that view together with examples.	<p><i>As noted above, we consider that a VCA is also relevant for the purposes of determining how the PSM should be applied, in particular in establishing the level of the profit to be split defining the allocation criteria through analysis of the value drivers.</i></p> <p><i>Therefore further guidance would be welcome to explain the role of the VCA in this respect.</i></p>
15. What further guidance or clarification of existing guidance would be helpful in these sections ['Guidance for application', 'Various approaches for	<i>The guidance on 'Different measures of profit' notes that the decision on whether to split gross profits or operating profits depends on the nature of integration and sharing of risks; broadly, the splitting of gross margins involves less integration and risk</i>

splitting profits’, ‘Different measures of profits’]? Please provide practical examples in support of the response.	<p><i>sharing than profit splitting of operating margins. The guidance on the global trading of financial instruments set out in the Report on the Attribution of Profits to PEs suggest that the split of profits should be based on operating profits; based on this revised profit splits guidance, we understand that this basis can only be applied if it is determined that both parties share further risks that affect the level of operating expenses in addition to the risks affecting gross profit, which is not always the case in global book arrangements. As noted above, it would be helpful to include further guidance to clarify the impact of the revised guidance on profit splits with respect to the global trading of financial instruments.</i></p> <p><i>In general, we welcome the approach, whereby the application of the PSM will be determined on a case by case basis as determined by the VCA and based on the relevant and appropriate factors to that particular industry or business, rather than on the basis of prescriptive allocations.</i></p>
16. The discussion of profit splitting factors sets a requirement that the factors must be capable of being measured in a reliable and verifiable manner. Do commentators believe that useful ways of splitting profits have been excluded? If so, please describe these factors and explain how they meet the requirement of reliable and verifiable measurement.	<p><i>The guidance notes that the basis of splitting profits should be consistent with the key value drivers, and lists assets, capital, costs, and other factors including headcount and time spent as options, which appear reasonable.</i></p> <p><i>The guidance also notes that where multiple profit splitting factors are used, these should be weighted to determine the overall profit splitting key. However the requirement that factors must not be subjective and must be verifiable by tax administrations will likely make it very difficult to use multiple weighed factors, given that it is likely to be difficult to objectively determine the weightings.</i></p>
17. What further guidance would be useful in this section relating to identifying and measuring profit splitting factors? Please illustrate your response with examples.	N/A
18. More generally, examples are requested of scenarios where a transactional profit split of actual profits or of anticipated profits are applied, together with a brief explanation as to why the method and the approach to applying the method, is considered to be the most appropriate in the circumstances of the case.	N/A, as the concept itself is not clear

These comments have been prepared by:

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5 September 2016

Dear Mr. VanderWolk,

OECD Public Discussion Draft – BEPS Actions 8-10: Revised Guidance on Profit Splits

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 4 July 2016.

We appreciate the work that the OECD has undertaken on the wider BEPS project and would like to make the following comments on this further guidance released on transactional profit splits.

Following the discussion draft released on 16 December 2014, we appreciate the need for further clarification in the application of transactional profit splits and value the work the OECD is doing to improve the transfer pricing guidelines in this respect.

As stated in our response to the previous consultation, we feel strongly that taxpayers should take a pragmatic, rather than formulaic, approach in applying the transactional profit split method and we are pleased to see the guidance presenting considerations and examples, rather than being a series of mechanical steps that need to be followed rigidly in the application presented. However, we are disappointed not to see more illustrative numerical examples and recommend this is rectified in the next iteration of the draft guidance.

We have provided some general comments on each section in Appendix A and documented our responses to the OECD's questions included in the consultation in Appendix B.

Executive Summary

- Generally, we consider the Guidance needs to include more numerical examples to clarify the principles being explained and illustrate how they should be applied.
- In distinguishing between anticipated and actual profits, we are unclear why so much of the guidance's focus has been placed on this topic. We would like to see greater focus placed on determining when a transactional profit split should be used, in place of other methods, and if so how it should be implemented i.e. how the profits should be split between the relevant parties.
- Although we understand all references to 'profits' in the guidance are also noted to refer to 'losses', we often see tax authorities neglecting this element of the profit split and the guidance should serve

to demonstrate that the treatment should be no different in each case. We recommend that at least some, if not half, of the examples included in the guidance should demonstrate scenarios where losses are made.

- Valuations should be treated with caution when being considered in the process of determining an arm's length price. Our experience shows that valuations may be subject to a level of controversy depending on the respective parties' interest and/or prepared for different purposes (e.g. purchase price allocations). Introducing valuations as a matter of course into the transfer pricing process would add an additional level of unwelcome complexity.
- We also see limited value in emphasising the difference between sequential and parallel integration on the grounds that there are a number of exceptions to these principles that render their inclusion restricted in their application.

If you would like to discuss any of these points in more detail then please contact either myself or Wendy Nicholls, Partner, Grant Thornton UK LLP (Wendy.Nicholls@uk.gt.com; M: +44(0)7714 069862).

Yours sincerely



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APPENDIX A

General comments on Section C1

Actual vs Anticipated Profits

We agree with the statement in Paragraph 3 that ‘When applying the transactional profit split method, care should be exercised to ensure that its application is performed in a context which is similar to that the associated enterprises would have experienced, i.e. 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’ and that ‘...the basis upon which those profits are to be split between the associated enterprises, including the profit splitting factors and the way in which combined profits are calculated, must be determined *ex ante* on the basis of information known or reasonably foreseeable by the parties at the time the transactions were entered into.’

However, we believe that care is also necessary to verify that the functions performed, the assets employed and the risks undertaken by the parties are actually those foreseen *ex ante*. In controlled transactions it is possible to observe behaviours that are not aligned with those initially agreed or expected because, for example, a different organisation is more efficient for the whole Group.

Furthermore, we believe that third parties are generally more likely to use information at the time of the transaction when determining how to split the profit (i.e. use an anticipated profit split) than to split resultant profits on an *ex-post* basis. That said, there are also certain situations where the use of the transactional profit split of actual profits will be the most appropriate method. We do not believe that preference should be given to one method over another.

In addition, we would recommend that at least some, if not half, of the examples included in the guidance should demonstrate scenarios where losses are made. While we recognise that ‘profits’ should be read to include losses in the guidance, we often see tax authorities neglecting this element of the profit split and the guidance should serve to demonstrate that the treatment should be no different in each case. In our experience, tax authorities often argue that losses should be retained at ‘head office’ level, whilst being happy to accept profit split in cases of profits. Concern about such asymmetrical approaches can discourage taxpayers from using a transactional profit split of actual profits even when the factual circumstances would support its application.

Control of risks

Our impression is that the draft includes extensive discussion on the topic of risk sharing, but more guidance would be helpful about the control of risk in conjunction with the transactional profit split. Generally, the question of whether a transactional profit split of anticipated or actual profits is more appropriate will start at the functional analysis level and the determination of which parties control which risks. From this, it can then be determined which parties should bear which risks, and then what level of risk sharing is, or can be, appropriate.

While there may be a certain degree of flexibility in allocating the risks, the allocation should not contradict what third parties would agree on or create inappropriate artificial risk structures. This knowledge should then be used to help determine whether a) the transactional profit split method is the most appropriate method, and b) if so, whether the use of actual or anticipated profits would be more appropriate (or if both could be appropriate).

We consider it appropriate to include further discussion on this topic in the discussion draft.

Tax Authority Reviews

We recommend the guidance to reinforce that tax authorities should also apply the same *ex ante* principles in their analysis of the resultant profits from the profit split. In particular, with regards to the use of transactional profit splits of anticipated profits, when tax authorities examine the terms of the transactional profit split, eg the allocation keys etc, they should not use subsequent results to argue that third parties would not have agreed such terms, in particular where such results could not have been foreseen at the time the transaction was agreed. In addition, both taxpayers and tax authorities should bear in mind the risk profiles of the transaction partners. This may be critical when a group applies the transactional profit split of anticipated profits and the actual outcome of the controlled transaction is a loss.

Discounted Cash Flow Valuation

Paragraph 4 notes that 'Typically a transactional profit split of anticipated profits will be used in conjunction with a discounted cash flow valuation technique'. If this is intended to refer simply to the time value of money, we think it should be clearly stated and the words 'valuation technique' removed. If it means more, we would recommend further background and explanation be included to support this statement. Within the Grant Thornton organisation, we have many valuation professionals but their work is typically in relation to accounting (e.g. purchase price allocations) and/or capital transactions, for obvious reasons. We do not believe, as a matter of course, that valuation techniques are necessarily required in transfer pricing.

Does the OECD intend to suggest that anticipated profits should be used mainly when the parties make unique and valuable contributions (which is the case for most intangibles?). If so, please say that explicitly. If not, please explain how and when to use valuation techniques in different scenarios.

We note that the acceptance of valuation techniques for tax and transfer pricing purposes varies by jurisdiction, for example, in Germany valuations are not uncommon (in transactional profit split analysis) while in Italy valuations are quite rare.

Whilst a transactional profit split can be used in conjunction with a discounted cash flow technique, only one example is provided in the guidance and we believe it is too restrictive to make the implication that other forms of the transactional profit split of anticipated profits would be unusual. For example, it may be the case that companies set intercompany transaction prices at the beginning of the year based on reliable and verifiable profit projections.

As a further example, where a manufacturer and a distributor both make unique and valuable contributions to the supply chain, they may agree the price at which the distributor purchases the products from the manufacture in advance, based on the allocation of anticipated profits (including manufacturing costs) according to (an) appropriate allocation key(s).

General Comments on Section C3

Paragraph 18 states that 'A lack of comparables alone is insufficient to warrant the use of a transactional profit split of actual profits under the arm's length principle. In cases where the accurate delineation of the actual transaction indicates that one of the parties to the transaction assumes only limited risks, but reliable comparables data is scarce, it is likely that a more reliable arm's length outcome can be reached through the adjustment [...] and interpretation [...] of inexact comparables data rather than through the inappropriate application of the transactional profit split method.' In general, we agree with this Paragraph as the inappropriate use of complex and subjective profit split techniques should be discouraged.

However, this will depend on the facts and circumstances of the particular case, in particular with regards to what, if any, inexact comparables data is available and how well the transactional profit split model can be calibrated to capture the low-risk nature of the party.

General Comments on Section C4

In Paragraph 34, we suggest changing the phrase 'it is likely' in the first sentence of Paragraph 34 to 'it may be the case that'.

Furthermore, we would caution against references to 'value' instead of 'cost' as well as projected cash flows over an appropriate period. We understand the concern behind the paragraph is to address potential abuses in the system in respect of so called 'lo and behold' transactions, ie where an intangible asset, developed primarily by one entity bearing the risks and costs involved in the earlier stages of the development of the intangible, is transferred at minimal cost to another entity, where some further development takes place to supposedly increase the value of the intangible significantly. However, applying DCF techniques in all cases because of a concern about extreme or egregious cases would only make the method more complex to apply, more subjective, and therefore open to challenge from tax authorities, in the vast majority of cases.

Paragraph 44 states that ‘...the assumption is that independent parties would have split combined profits in proportion to the value of their respective contributions to the generation of profit in the transaction.’ We do not disagree with this per se but we caution against the repeated use of the word ‘value’. The guidance should therefore clarify that the use of the word value should not be taken to mean that valuation techniques are required to measure the contributions made by the parties or to split the profits. As noted above, we do not consider valuations to be routinely required in transfer pricing and if the implication is given that they are, we are concerned about the cost, administrative burden and complexity this would cause to our clients. Furthermore, the draft currently neglects that the split of profits between third parties also depends significantly on the market power and negotiation strength of the respective parties. The draft should address this issue and provide guidance on when this should be accounted for in applying transactional profit splits and, when appropriate, how to do so.

Paragraph 50 notes the difficulties relating to identification and ‘valuation’ (see above) when splitting profits related to intangibles. It then makes reference to the examples in the Annex to Chapter VI ‘Examples to illustrate the guidance on intangibles’. The draft should provide some specific examples for the application of transactional profit splits.

Paragraph 51 states that ‘Research and Development expenses may be suitable for manufacturers if they relate to the development of significant intangibles such as patents.’ We note that the value of intangibles, and thus the contributions by the manufacturers, normally does not correlate with the costs. Research and development costs are therefore unlikely to be a suitable allocation key for the manufacturer.

Finally, we do not agree with the amendment to section 2.139 in Paragraph 52, notably the phrase, ‘...it may be appropriate to consider whether a more reliable outcome can be achieved by adjusting the costs so that the relative share of unadjusted costs does not result in a greater or lower share of value being allocated to a location simply because of a higher or lower cost of living.’

APPENDIX B

1. Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular:

- a) Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear?**
- b) Is the distinction between the two profit split approaches described useful?**

Firstly, we question the value in placing this topic at the forefront of the guidance instead of an explanation of when the transactional profit split is the most appropriate method, which would be more useful to the reader.

Furthermore, we do not consider the guidance supplies enough explanation on why the distinction between actual and anticipated profits is made. We recommend some context be included in the guidance to explain to the reader why one might favour one method over the other.

We find that the examples used in Paragraphs 4 and 5 do not serve to clarify when a transactional profit should be performed in each circumstance. This is essential in understanding the difference between the two methods and only some brief guidance is provided later on in reference to the higher level of integrated activities apparently required for a transactional profit split of actual profits. We would therefore welcome more examples of when a split of actual or anticipated profits is likely to be the most appropriate method.

However, should it be considered useful, we would recommend that taxpayers should be free to decide whether to use anticipated or actual profits as they see fit, provided this does not contradict the levels of risk control and risk sharing, unless there are specific reasons in the case at hand that would preclude the use of one of the methods.

2. Comments are also invited on the link between integration of the business activities (and thus the sharing of risks) and the appropriate application of a transactional profit split of actual profits.

We agree with a link between the integration of business activities (and thus sharing of risk) and the appropriate application of a transactional profit split. Generally, greater risk sharing will lead to the use of profit split (of actual profits) being more appropriate, but clearly this will depend on the facts and circumstances of the case.

3. Examples of scenarios where each approach to splitting profits would be the most appropriate (together with a brief explanation as to why) are also requested.

As explained in question one, we do not consider the distinction between actual and anticipated profits to be the most important issue in the revised guidance and would therefore welcome examples of when the distinction would be required.

4. Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarised?

In our experience, a further weakness may be that transactional profit splits tend to have a higher level of complexity than other transfer pricing methods. This can make them more open to challenge in a tax audit leading to higher uncertainty for taxpayers.

In addition, the allocation key(s) used to split the profits depend(s) on the value contributions of the various parties which tends to be subjective and not objectively verifiable. We do not believe this problem is sufficiently dealt with in the draft and further guidance should be provided in this respect.

5. Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses? If so, what are they?

As transactional profit splits of actual profits may require a higher level of integration and risk-sharing between entities, there is a question of accountability and ensuring that parties only include those risks and costs in the profit split that are appropriate. This is less of a problem for transactional profit splits of anticipated profits, where assumptions are made in advance and the parties subsequently have greater accountability for their own profits and losses.

The use of anticipated profits when the transaction generates losses may increase tax litigation as it may lead to strongly unbalanced results. In other words, whilst one of the strengths of the transactional profit split of actual profits is ‘that it is less likely that either party to the controlled transaction will be left with an extreme and improbable [profit] result’ (see paragraph 13), this may be a significant weakness of the transactional profit split of anticipated profits if the implication is that only profits and not losses should be shared. Indeed, we think the word ‘profit’ should be removed from this paragraph. If profit split is the most appropriate method then, *prima facie*, so is loss split.

An example may clarify this: if a party (Company A) to a controlled transaction makes a valuable contribution but does not control the risks associated with such a transaction, in line with the principles of the Discussion Draft, then Company A should receive a share of the anticipated profits (using the transactional profit splits of anticipated profits). In such a case, the other party (Company B) will have not only to absorb all the losses generated by the controlled transaction, but will have also to compensate Company A. So, Company B will incur a significant loss, greater than the loss generated by the controlled transaction. Guidance should be given on how to handle cases of transactional profit split of anticipated profits in loss scenarios, especially when losses are recurrent.

If the application of a transactional profit split is generally difficult in its application (paragraph 14), adding a further element by applying the method to anticipated profits, may make the application of the method even more difficult and potentially more controversial. In addition to ‘full co-operation from the taxpayer’ (paragraph 15), tax authorities would need to accept that the anticipated profits were actually determined *ex ante* and agree on the reasonableness of the projections made by the taxpayers. In absence of common guidance, each tax jurisdiction may decide to impose different procedural rules to allow the use of the transactional profit split of anticipated profits, resulting in increased cross-border litigation. Guidance should be provided to minimise this situation.

6. The discussion draft introduces the sharing of economically significant risks as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method.

- a) Do commentators have any suggestions for clarifying the notion of risk sharing this context?**
- b) Do commentators find the draft helps to clarify the circumstances where the transactional profit split method is the most appropriate method? Please provide explanations and/or examples supporting your views.**

We recommend that reference is made to section D.1.2.1.1 of Chapter one of the revised transfer pricing guidelines when referring to ‘economically significant risks’ as the definition was not clear from first reading.

With respect to the sharing of economically significant risks, we recognise this is a factor that may indicate the transactional profit split method is the most appropriate method, but consider that it need not indicate a split of actual profits is more appropriate than a split of anticipated profits. Reduced risk sharing may indicate that certain forms of a transactional profit split of anticipated profits may be appropriate than a split of actual profits, and, once a certain lack of risk sharing is reached, that a transactional profit split method may not be appropriate at all.

We would also ask that consideration is given to the difference between costs incurred in mitigating or managing the risk and economically bearing the risk itself.

The draft is somewhat useful in clarifying the circumstances where the transactional profit split method is the most appropriate method and we welcome the further discussion included around the topics of highly integrated operations, unique and valuable contributions.

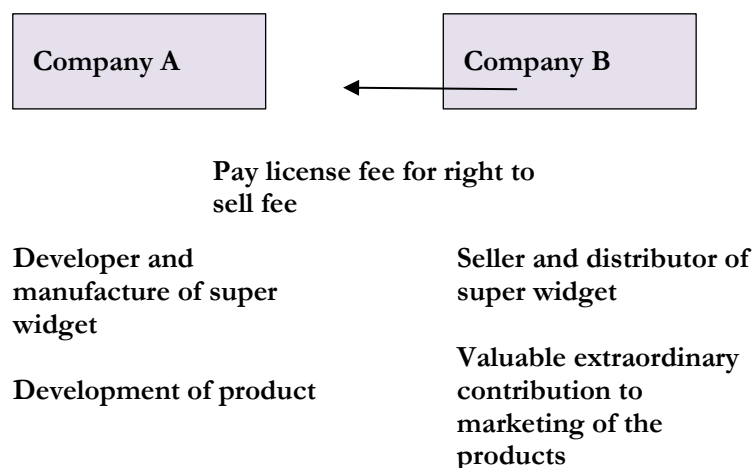
We do not necessarily agree with the statement in Paragraph 6 (& repeated in Paragraph 20) that it follows that reduced integration means anticipated profit splits are more appropriate than actual profit splits.

7. The discussion draft notes that a transactional profit split of anticipated profits can be used in conjunction with certain valuation techniques. Examples showing the application of a transactional profit split of anticipated profits are sought.

We repeat our concern about the use of certain valuation techniques to underpin the analyses to be performed for transfer pricing purposes. Valuation reports are often supplied for the purposes of purchase price allocation, not for evaluation from a transfer pricing perspective, and we could feasibly foresee this complicating discussions for our clients with tax authorities in respect of the wider BEPS initiative. Our experience shows that valuations are often surrounded with a level of controversy depending on the respective parties' interest and introducing this aspect into the transfer pricing process would add an additional level of unwelcome complexity. Moreover, should the use of valuation techniques be considered necessary, simplified procedures should be allowed for mid-sized groups so as not to create barriers to the use of transactional profit split of anticipated profits.

As requested, we provide below an example showing the application of a transactional profit split of anticipated profits:

Company A develops a new, patented super-widget. This is to be sold by Company B, which, importantly, makes unique and valuable contributions to the marketing and sale of the product. It is therefore agreed that a licence should be paid by Company B for the right to sell the super-widgets. No comparable royalty rates can be found.



The Companies agree to split the profits so that A would receive say 75% of the anticipated profits, and B 25%, ignoring the licence fee. Projections are drawn up including the anticipated revenues for Company B and costs for both Companies. The discounted sum of the resultant profits is then derived, with 75% accruing to Company A. Company B can either pay this amount immediately to Company A, or the amount can be set in relation to the sum of the discounted revenues to determine an ongoing royalty rate.

8. Is the distinction between parallel and sequential integration of business operations a useful refinement in determining when the transactional profit split method is likely to be the most appropriate method?

Firstly, we would note the similarity between the 'parallel' and 'sequential' integration terms used and the standardly accepted economic terms of 'horizontal' and 'vertical' integration. We would suggest that it may

add further complexity to the guidance in defining these new terms when terms exist already.

Our understanding of the distinction is to note the discrete nature of the supply chain and we would support that this as the focus of the section rather than the distinction purely between sequential and parallel integration.

While it is potentially more likely that transactional profit splits will be appropriate in cases of ‘parallel’ integration than in cases of ‘sequential’ integration, it is by no means the case that transactional profit splits are never appropriate in cases of sequential integration.

Paragraph 21 states that ‘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 uncontrolled transactions.’

However, this is not always the case and the analysis, as paragraph 12 suggests, needs to consider other elements. By way of example, notwithstanding the ‘discrete functions’ performed by one of the parties to the controlled transaction, there may be ‘specific, possibly unique, facts and circumstances that are not present between independent enterprises’ which may lead to the application of the transactional profit split. In particular, we highlight the example of flagship stores: a high value merchandise distributor might open a shop in a prime location incurring large expenses in full knowledge that the business will make a loss.

In our experience, it is rare to observe independent distributors making this kind of long-term investment. This is due to many reasons, most notably the level of financial investment required, the need for a long and stable relationship between the parties, and the difficulty in determining who should have control over the flagship activities and associated risks. Despite being at separate levels of the sequential supply chain (manufacturer and IP owner in business with the distributor), their interests may be aligned (e.g. increases in global and local sales and the strength of the brand) and business integrated such that the distributor would share the initial loss with a view to creating super profits in the future. In such circumstances, it seems that the transactional profit split may be the most appropriate method even if there is ‘sequential integration’ and one party does not make any (clear) unique contribution. This may be the case especially when the IP owner is unable to exercise full control over the risk management of the store’s activities, but rather this responsibility is shared with the distributor and the flagship store is expected to increase the strength of the brand, so as to create super profits.

9. If so, how should the concept of parallel integration be further defined?

Rather than providing further definition of parallel integration we would point readers to section C3.1 detailing ‘highly integrated operations’ and request the insertion of more examples.

For instance, consider the case of a specialist trader with a highly integrated supply chain. Both the purchasers and sellers may have invaluable and distinct intellectual property, in their knowledge of the product and technical requirements of the market, and neither purchase nor sale could be made without co-ordination from both ends. This may be a case where the transactional profit split method is appropriate, despite the fact that procurement and sales functions would normally be considered to be sequentially integrated.

10. Comments are invited on the relationship between the making of unique and valuable contributions by both (all) parties to a transaction, and the sharing of economically significant risks.

In general, where both parties make unique and valuable contributions to a transaction, we would expect that the economically significant risks will also be shared. As a general economic rule, higher profits (and potential losses) are associated with higher risk, while lower profits are associated with lower risk.

Hence, for both parties to make valuable contributions, it is implied that both also bear risks, otherwise it would be less likely that the contribution would be valuable. That said, there can be situations where both sides make valuable contributions, but the risks are not shared (see below), so it cannot be stated that such

situations do not exist.

11. Are there situations where all the parties make unique and valuable contributions to a transaction, but they do not share the economically significant risks associated with the outcomes of that transaction? If so, what guidance on the appropriate use of profit splits in such a situation should be provided?

No comment.

12. The Final BEPS Report on Actions 8-10 noted that group synergies were to be addressed in the guidance on profit splits. The approach taken in this discussion draft is to make reference to the incremental or marginal system profits arising from the group synergy, which would then be shared amongst the relevant associated enterprises. The analytical framework suggested in the draft, based on an accurate delineation of the actual transaction, would not support the combining and splitting of total system profits on the basis of group synergies alone. Comments on this point are invited.

We agree with the conclusions in the draft that group synergies can be accounted for by ‘...sharing [the] benefits (or negative costs) [...] through the use of appropriate allocation keys similar to the way in which allocation keys can be used to apportion costs of shared services.’

13. Does this section properly describe a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit split method is appropriate?

The document focusses on what a value chain is and how it can be used to delineate transactions. It is questionable to what extent such a description of a value chain analysis belongs in a document on the transactional profit split method. This is not specific to a transactional profit split per se, but rather belongs to the general process of identifying transactions and allocating functions, assets and risks. Paragraphs 24 through 26, for example, are probably superfluous in this context.

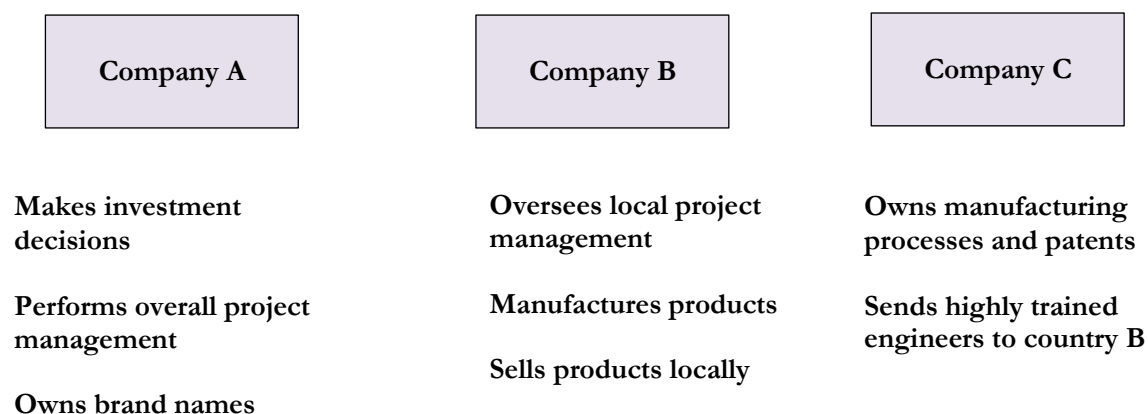
The section should instead focus on which results of a value chain analysis may indicate that a transactional profit split is the most appropriate method, and, even more importantly, how the results of a value chain analysis can be used to apply the transactional profit split. On this, the draft only states that ‘Such an analysis may also assist in determining how the method, if indeed it is the most appropriate method, should be applied, including the profits to be split and the relevant splitting factors’ in Paragraph 24 and ‘The analysis thus both contributes to the process of accurately delineating the transaction, and also determines the level of integration (which may determine the level at which profits or revenues or revenues should be split), and the economically relevant contributions (which may determine the factors to use to split the profits)’ in Paragraph 26. This should be expanded upon to make the focus on demonstrating how the value chain analysis may be used in applying the transactional profit split method.

14. If commentators see a value chain analysis as serving a greater purpose in relation to profit splits, then please provide an explanation for that view together with examples.

We do not agree with the statement that ‘such a value chain analysis is merely a tool to assist in delineating the controlled transactions, in particular in respect of the functional analysis, and thereby determining the most appropriate transfer pricing methodology’. While a value chain analysis can be useful in this respect, it can also be a useful tool in applying the transactional profit split method.

As an example, consider the case where an MNE in Country A wishes to build a new factory to launch a product in a new country, Country B. Company A in Country A is the parent company and makes the investment decisions, performs overall project management and owns the brand names to be used on the products. Company B in Country B is responsible for overseeing the local project, including locating the site, finding local subcontractors and suppliers, overseeing the construction, and will subsequently

manufacture and sell the products in Country B. Company C in Country C owns the manufacturing process and patents and sends highly-trained engineers to Country B to oversee the setting-up of the manufacturing equipment and processes.



In this example, a value chain analysis could be a useful tool in determining how to delineate the various transactions, which companies control and should bear such risks, and how valuable the individual contributions to the project are.

If the results of the analysis show that a transactional profit split is the most appropriate method, the value chain analysis will also provide insights into how to allocate the resultant profits (or losses). The draft should provide more concrete guidance on how the results of the value chain analysis can be used to apply the transactional profit split method.

It should however also be stated that a value chain analysis should not be compulsory for all taxpayers, and that taxpayers should not be required to perform such an analysis for parts of the value chain that are irrelevant to the tested transaction unless this is particularly important in understanding the context of the tested transactions.

In addition, we would be cautious in the application of such analysis that it should not extend to other, less appropriate, models, e.g. RACI analyses, with little objective validity and ability only to provide (spurious) accuracy in purportedly showing where value lies in the business.

15. What further guidance or clarification of existing guidance would be helpful in these sections? Please provide practical examples in support of the response.

The draft currently only refers to gross profits and operating profits. While these will likely be the relevant profit measures in most cases, it should be stated that taxpayers are free to use other profit measures where these are economically appropriate for the case at hand. For example, there may be cases where it is appropriate for two highly-integrated manufacturers to split the profits after subtracting only the costs of materials.

In addition, we would note the guidance is limited in its discussion of potential allocation keys and would welcome more examples of where certain keys might be used in different situations. For example, headcount may be applicable where software intellectual property is developed across multiple teams in different jurisdictions. But in some instances, where the development of intangibles is undertaken by a small number of key individuals, the cost of retaining those employees might be more applicable.

Sample calculations would also be crucial to demonstrate how a residual and contribution analysis are differentiated from a practical perspective. We find that residual analysis is helpful where it can be applied, as it reduces the pool of profits to be shared out on a subjective basis.

Finally, we would recommend the guidance notes the potential impracticalities of introducing a profit split into businesses whose accounts do not have the functional capabilities of splitting data in this fashion. Implementation is often the biggest hurdle for businesses in operating a transactional profit split.

16. The discussion of profit splitting factors sets a requirement that the factors must be capable of being measured in a reliable and verifiable manner. Do commentators believe that useful ways of splitting profits have been excluded? If so, please describe these factors and explain how they meet the requirement of reliable and verifiable measurement.

The draft mentions several possible ways of splitting profits. The list should not be exhaustive, however, and it should be stated that other ways may be used as long as they can be applied in a reliable and verifiable manner and are appropriate for the case at hand. Trying to create an exhaustive list covering every eventuality is unlikely to be fruitful.

17. What further guidance would be useful in this section relating to identifying and measuring profit splitting factors? Please illustrate your response with examples.

No comment.

18. More generally, examples are requested of scenarios where a transactional profit split of actual profits or of anticipated profits are applied, together with a brief explanation as to why the method and the approach to applying the method, is considered to be the most appropriate in the circumstances of the case.

We accept that our comments are primarily counter asking for examples from you, but we do so on the basis that our clients have expressed concern in the wider application of the transactional profit split method given the inevitable divergent and aggressive stances that will be taken by global tax authorities.

If this is the case, our clients need to understand, from the guidance, in which circumstances the OECD expect that a transactional profit split should be applied.

In our experience, the method is often applied in financial services and asset management businesses, for example we have seen transactional profit splits of actual profits applied where trade 'books' are shared between traders in different countries to ensure 24-hour coverage of world markets: one book may be shared between three traders, one based in the US, one in the UK and one in Japan. At the close of each market, the book is handed from one trader to another to maximise the exploitation of global opportunities.

We would find it helpful if the guidance were to include examples of other transactions or industries where the OECD expect that a transactional profit split should be applied.

September 5, 2016

To:

Tax Treaties, Transfer Pricing and Financial Transactions

Division, OECD/CTPA.

TransferPricing@oecd.org

Re: BEPS Actions 8-10: Revised Guidance on Profit Splits

4 July – 5 September, 2016

We respectfully present our comments on the above Discussion Draft.

We are an accountancy firm keen to see reasonable tax paid without harming bona fide international business operations.

Why is this important?

In hitech and other sectors, it can be hard to obtain data on "comparable uncontrolled prices" of similar transactions by third parties. It is often easier to take the total world profit and carve it up between different countries.

Comments:

1. The draft seems disjointed. Let's hope the final version will be more readable.
2. The OECD draft contains no guidance as to whether a profit-splitting group has a taxable permanent establishment in each country concerned – this would be a bureaucratic nightmare. Guidance on this is needed.
3. As for using inexact comparables where no exact comparables exist, the we often see "disruptive" technology which is too new for anything remotely comparable to exist. Guidance on this is needed.
4. The OECD draft apparently does not provide any guidance on how to allocate failed R&D costs. It is not uncommon to use two or more R&D teams in competition to see which can find develop something first or best. What happens to the cost of the other teams?

* * * * *

We will be happy to answer any questions arising.

Yours Truly

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Response to Draft OECD BEPS Discussion Draft on the Revised Guidance on Profit Splits

ICC welcomes the opportunity to comment on the BEPS Discussion Draft on the Revised Guidance of Profit Splits. Our comments are set forth below in response to question numbers.

ICC believes that in most cases a transactional profit split method (“TPSM”) will not be the most appropriate method and the introduction to this section of the Guidelines should so state.

1.2 The explanation is not clear. Examples will clarify the distinctions. We will be happy to provide suggestions, as appropriate.

Paragraph 4 appears prescriptive in stating that “typically a transactional profit split of anticipated profits will be used in conjunction with a discounted cash flow valuation technique”, however limited practical guidance is provided which will create significant uncertainty.

It could also be noted that a “split of actual profits” could be done either via retrospective or forward-looking adjustments.

We suggest an emphasis that a split of combined profit should be based on value drivers/allocation keys that reflect the functions, assets and risks (“FAR”), with appropriate weight for unique and valuable contribution. When a split is so based, a mere change of actual vs. anticipated profit levels should not require any change in methodology.

We also note that paragraph 6 comments on the greater sharing of risks where a transactional split of actual profits is employed because it allows for the sharing of losses. We are uncertain how this statement would apply in the context in which there is a period of losses whether or not anticipated.

2. The concept of integration is logically useful but practically difficult to utilize. In all MNC groups, there is integration at many levels that does not exist between unrelated parties and which does not necessarily impact transfer pricing relationships (such as administration, coordination, movement of personnel, and so on). If this is a concept intended to be a guiding principle, as suggested in paragraph 6, then examples will have to be developed, including updating for the post-BEPS world and CbC data. Examples would also be helpful for paragraphs 8,9,10 to distinguish circumstances in which the parties might consider sharing in the risks of the business of the other.

5. A critical weakness of the transactional profit split (“TPSM”) as formulated, with use of actual or anticipated profits, is that the demarcation between the approaches will be fuzzy in practical reality. In addition, the results are likely to vary depending on which approach is used. In practice, tax administrations may develop both methods and make proposed adjustments on the approach that provides the best answer from a base protection standpoint. Prudent MNEs may utilize both methods seeking to ascertain if they provide consistent results on a TPSM basis, as well as with the one-sided TPMs likely used for documentation purposes. Accordingly, it may be appropriate to include a paragraph suggesting that evaluation of both approaches should, if properly developed from a FAR standpoint, should produce convergent results.



It should also be emphasized that the aggregate of the profit split should not exceed the total actual profit due to utilization of a one-sided benchmarking method applied to either of the parties without considering the profit split factors for each party.

It would also be appropriate to evaluate the likelihood that TPSM determinations by tax administrations will be done after-the-fact, when hindsight may suggest that unrelated parties would have assumed risks differently.

In the comments in paragraph 18 about “a lack of comparables” it is important to note that if reliable comparables are scarce but inexact comparables exist, there should be flexibility to adopt the point in the range which closely reflects the arm’s length price point for application of TPSM (e.g., use of an inter-quartile or full range of results as appropriate). Given that TPSM involves subjectivity and frequent lack of reliable comparables, there should be flexibility in applying this method.

6.1 The sharing of risk is a critical factual question for application of the TPSM. In the present draft, it is not defined in a manner to facilitate application to specific situations. For example, when the CbC Report is prepared, it will reflect the functional elements of the related party transactions and how combined profits are allocated. The taxpayer should be applying the most appropriate method, whether that is a one-sided or TPSM based on anticipated or actual profits.

6.2 The draft could be strengthened to provide additional; descriptions and examples as described above. Again, ICC will be pleased to provide assistance in this regard.

7. Experience in handling profit split cases in APA, Competent Authority, and other contexts is that comparables can often be found in the context of public joint ventures. An example could be so framed.

8. No. The distinction of “sequential” and “parallel” seems academic in nature without reference in the practical world in which transfer pricing matters must be resolved.

11. In related party transactional structures, such as “value chains,” all parties typically make valuable contributions and do not share controllable risk. The transfer pricing question is the appropriate TPM. In such situation, the appropriate profit split answer should be as in paragraphs 18-19 of the proposed Guidelines.

12. Synergies should be treated as is passive association.

13. This “value chain” analysis seems duplicative of normal functional analysis. The discussion of value chain analysis should be moved to Chapter I because, if it is somehow different from a normal functional analysis, it still should relate to all transfer pricing methods and not just the TPSM.

14. Our ICC policy has been to limit our responsive comments to BEPS proposals to these 2 pages. We will be pleased to provide an example of value chain analysis.

15, 16, 17, and 18. Once the issues noted above have been resolved, we will be delighted to propose examples or work with a team to develop appropriate illustrations. In the absence of such update, there is too much uncertainty in the principles to be applied to invest the time to suggest examples.



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.

Mexico City, September 5, 2016

Via e-mail

TransferPricing@oecd.org

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

Dear all,

On behalf of IFA Grupo Mexicano, A.C. (Mexican Branch of the International Fiscal Association), kindly find below the comments on the Public Discussion Draft –“*BEPS ACTIONS 8-10 – Revised Guidance on Profit Splits*” (the “Draft”).

The discussion draft proposes to explore distinctions on the application of the transactional profit split method to either projected or actual profits. Detailed description of each method is included, but it is still confusing when is it proper to use one method over the other. The application of the projected profits, based on net present value concept, is commonly used to set a fixed price, based on the allocation of profits between profit generator assets and/or investments, with identifiable specific risks. It is not clear whether it can be used to allocate functions. No other use (besides very specific transactions in the financial industry), would be observable between unrelated parties. Hence, it is difficult to apply.

Under the Revised Guidance on Profit Splits, tax authorities might have an erroneous idea that regardless of contractual allocation of risks (assuming accurate delineation of the actual transaction), in presence of high level of integration of activities, including the assumptions of the associated risks, the use of an actual profit split method would always be more appropriate over other methods. The level of integration of activities should not be decisive of which method, projected or actual profits, should be applied. Rather than the level of integration, analyses of functions, assets and risks, contractual arrangements and data available should define the appropriateness of projected or actual profits applicability.

There should be detailed description of what documentation should be in place, in order to prove that the profit split method was used to set the price for a controlled transactions under an ex ante analysis. Further clarification is required to understand if the use of a profit split method would be respected for purposes of setting a price, and the validity to document its reasonability, regardless of the actual outcome of the transactions. For example, the use of anticipated profits for setting an arm's length price, versus the use of actual profits to test the arm's

length outcome. Both methods are applied under different facts and circumstances, and economically different circumstances. For example, setting a royalty as a fixed payment based on projected profits and testing the outcome based on actual profits.

In addition, under the value chain analysis, the discussion draft sets out that consideration should be put in where and how value is created, considering economically significant functions, assets and risks; and how those may create opportunities to capture profits in excess of what the market would otherwise allow. But it is important to highlight the absence of any discussion of market conditions or local market circumstances, detailed explanation of how to incorporate into the value chain analysis, market conditions or local market circumstances. Without any specific guidance, the presence of market imperfections, tax authorities could erroneously be driven to the conclusion that a profit split is appropriate. The discussion draft is confusing, and might lead to correlate value chain analysis with the application of profit splits.

In summary, the application of the transactional profit split method should be applied only when it is the most appropriate method, based on guidance under Chapter 1 of the OECD Transfer Pricing Guidelines.

* * *

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.

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

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5 September 2016

VIA E-MAIL

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Re: Comments on the 4 July 2016 Discussion Draft on Revised Guidance on Profit Splits

Dear Sir or Madam,

The International Alliance for Principled Taxation (IAPT) is a group of major multinational corporations based throughout the world, and representing business sectors as diverse as consumer products, media, telecommunications, oilfield services, computer technology, energy, health care, beverages, software, IT systems, publishing, management consulting, and electronics.¹ 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 IAPT appreciates the opportunity to provide input to the OECD with respect to the Discussion Draft on Revised Guidance on Profit Splits released by the OECD on 4 July 2016. Our comments are set forth in the Annex to this letter.

¹ The current membership of the IAPT is made up of the following companies: Accenture plc; Adobe Systems, Inc.; Anheuser-Busch InBev NV/SA; Cisco Systems, Inc.; The Coca-Cola Company; Exxon Mobil Corporation; Hewlett Packard Enterprise Company; Johnson & Johnson; Microsoft Corporation; Procter & Gamble Co.; REXL Group plc; TE Connectivity Ltd.; Thomson Reuters Corporation; Transocean Ltd.; Tupperware Brands Corporation; Vodafone Group plc; and Yum! Brands, Inc.

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5 September 2016
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INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

Sincerely yours on behalf of the IAPT,

A handwritten signature in dark ink, appearing to read 'C. Silberztein', with a stylized flourish at the end.

Caroline Silberztein
Baker & McKenzie SCP
Counsel to the IAPT

Annex

ANNEX

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

COMMENTS ON THE 4 JULY 2016 DISCUSSION DRAFT ON
REVISED GUIDANCE ON PROFIT SPLITS
5 SEPTEMBER 2016

IAPT Comments on the 4 July 2016 Discussion Draft on Revised Guidance on Profit Splits

1. Introduction

1. We are pleased to provide hereafter our comments on the 4 July 2016 Discussion Draft on Revised Guidance on Profit Splits (hereafter “the Draft”). We value the opportunity to comment on an early discussion draft, both on general questions of principle and on specific drafting points.

2. The Draft is a very important document as the new OECD guidance on profit split will ultimately crystallize the OECD view on the allocation within multinational groups of their residual profits (i.e. profits or losses that remain after the “routine” functions, assets and risks have been compensated using a CUP or one-sided method).

3. To a large extent, the new profit split guidance will be the culmination of the work on risks and intangibles performed in the context of the BEPS project. The revised Chapters I and VI, including the new guidance on the “accurate delineation of transactions”, revised guidance on the recognition of actual transactions and revised guidance on risks and intangibles provide comprehensive and powerful concepts and analytical tools that aim to address situations where the residual return would be inappropriately allocated among associated entities.

4. We think that it is essential for the new guidance on profit split to provide clearer indications as to when a profit split may or may not be the most appropriate method, and that such indications be consistent with the arm’s length principle and with the Final Actions 8-10 report of October 2015. We drafted our comments with this background in mind.

2. Executive summary

5. We support many of the statements in the Draft, including paragraphs 16-18 which in our view are of paramount importance on the appropriateness of a profit split method, paragraph 23 on group synergies and paragraph 3 on hindsight. Our comments below are focused on the areas where we believe the Draft can be improved.

6. The Draft is a very dense and complex document. We see a risk that readers may get lost in the vast amount of detailed technical discussions and lose sight of the key principles that any taxpayer or tax administration considering the selection of this method should bear in mind. We therefore suggest that the **structure of the document** be revised, to more clearly separate the discussion of the threshold question *when* to apply a profit split method, which in our view should be addressed upfront and strengthened, from the guidance on *how* to apply it, which should follow in a second part of the document. An executive summary would also be helpful.

7. We think that the Draft would benefit from being more solidly and methodically grounded in the **guidance at paragraphs 2.2 to 2.11 on the selection of the most appropriate method**.

8. We find the discussion of **strengths and weaknesses** of the profit split method to be very unbalanced and incomplete. We provide suggestions related to several important weaknesses which in our view are missed or under-estimated.

9. We think that the Draft could be re-balanced by clearly acknowledging that in the vast majority of cases, a **one-sided method** is more appropriate than a profit split method. Including additional examples of typical situations where a one-sided method would be the most appropriate would be very helpful in practice.

10. We do not find the proposed guidance on “**highly integrated operations**” and “**value chain analyses**” to be helpful, and accordingly suggest deleting paragraphs 19-20, Section C.3.1 and Section C.3.4 of the Draft.

11. We find the discussion of **unique and valuable contributions** confusing. We think that several paragraphs of the Draft may be read as suggesting that any “important” functions, assets or risks that “contribute to the creation of value” may potentially qualify as unique and valuable contributions supporting the selection of a profit split method. In our view, all entities within a multinational enterprise are expected to contribute to the creation of value, and the notion of what is “important” is far too subjective to be the threshold for the selection of the most appropriate transfer pricing method.

12. Further, we find that the discussion of **risk** could be improved by acknowledging that the significance of risk depends on the nature of the transaction. For instance, the sharing of risk by multiple parties may appropriately lead to the selection of a profit split method in some financial transactions for which risk is the key profit generator. On the other hand, the mere fact that a manufacturer or distributor assumes some risks, even significant ones, may not suffice to support the selection of a profit split method if such risks are similar to the ones of comparables and if the manufacturer or distributor does not also contribute the unique and valuable intangibles that are key to the profit making in the transaction. We also find that it would be helpful if the discussion of risk in the Draft was more clearly aligned with the one in the revised Chapter I.

13. We find that it would be helpful to include guidance that clarifies when the performance of **DEMPE** functions may or may not be regarded as a unique and valuable contribution.

14. We commented on the following specific questions posed in the Draft:

Question in the Draft	Section in this letter addressing the question	Question in the Draft	Section in this letter addressing the question
Q2	4.6	Q8, Q9	4.6
Q4	4.5	Q10	4.4
Q6	4.4.2-4.4.3	Q13, Q14	5

3. Structure of the Draft

15. The Draft is a very dense and complex document, reflecting significant work done by the OECD to address many difficult technical questions related in particular to the application of a profit split in practice. We commend the OECD for this difficult undertaking.

16. We see a risk that readers may get lost in the vast amount of detailed technical discussions and lose sight of the key principles that any taxpayer or tax administration considering the selection of this method should bear in mind. We therefore suggest that the structure of the document be revised, to more clearly separate the discussion of the threshold question *when* to apply a profit split method, which in our view should be addressed upfront and strengthened, from the guidance on *how* to apply it, which should follow in a second part of the document. In effect questions related to the appropriateness of the profit split method are currently addressed at paragraphs 14-18 and 22 of the Draft. While these paragraphs contain good guidance, we find that they do not provide a complete and sufficiently solid analysis of all the issues involved in the selection of this method. Furthermore they come after what is already a detailed and complex discussion at paragraphs 2-11 of the differences between splitting actual or anticipated profits, which we think rather belongs to the guidance on *how* to apply a profit split once the threshold question of whether such method is the most appropriate to the circumstances of the case has been passed.

17. We further suggest that the Draft could be made clearer as to how it relates to other parts of the Guidelines. In particular, in the discussion related to the selection or rejection of the profit split as the most appropriate method to the circumstances of the case, the requirement to follow the guidance in paragraphs 2.2-2.11 and the factors identified at paragraph 2.2 could be made explicit as it would strengthen the logical articulation of the discussion. Further, the relationship of the discussion of unique and valuable contributions to the new guidance in Chapter I on risk and in Chapter VI on intangibles could be made clearer.

18. Accordingly we would like to propose the following revised structure:

Proposed New Sections	Corresponding Sections in the Draft (the below-proposed reordering of paragraphs does not take into account the substantive and editorial comments made in the following sections of this letter)
C.1 - In general	Based on paragraph 1 of the Draft; adding an executive summary to highlight the key messages before the reader dives into the details of Draft
C.2 Determining whether a profit split is the most appropriate method to the circumstances of the case	Such determination is to be made in accordance with paragraph 2.2 - 2.3 and 2.6 - 2.11 of the Guidelines and in particular the factors identified at paragraph 2.2 of the Guidelines. In order to help ensure that the following discussion is grounded in a solid and clearly identified analytical framework, we recommend adding a reminder that in accordance with the guidance at paragraph 2.2 of the Guidelines, the most appropriate method should be selected

	<p>based on the following criteria :</p> <ul style="list-style-type: none"> - respective strengths and weaknesses of the OECD recognised methods; - appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; - availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods; and degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them. <p>We further recommend that each of these 3 criteria be discussed in the following sub-sections (see proposal below for new Sections C.2.1, C.2.2 and C.2.3).</p>
C.2.1 Strengths and weaknesses of the profit split method	Based on Section C.2, paragraphs 11-15 of the Draft
C.2.2 Appropriateness of the profit split method in view of the nature of the controlled transaction	Based on paragraph 22 of the Draft + discussion of relationship to the sharing of risk based on paragraphs 16-17 of the Draft
C.2.3 Availability and reliability of comparables	Based on paragraph 18 of the Draft
C.2.4 Group synergies	Based on Section C.3.3. of the Draft
C.2.4 Conclusion - when is a profit split is the most appropriate method	To be added
C.3 Guidance for application: general comments	
C.3.1 Compliance with the arm's length principle	Based on current paragraphs 28-30 of the Draft
C.3.2 Various approaches for splitting profits : contributions and residual analyses	Based on Section C.4.1 of the Draft
C.4 Guidance for application: determination of the profits to be split	
C.4.1 Determining the profits to be split: transactional focus and availability of financial	Based on Section C.4.2 of the Draft

data	
C.4.2 Splitting anticipated or actual profits	Based on paragraphs 2-10 of the Draft
C.4.3 Different measures of profits	Based on Section C.4.3 of the Draft
C.5 Splitting the profits	
C.5.1 In general	Based on Section C.4.4 of the Draft
C.5.2 Splitting factors	Based on Section C.4.5 of the Draft
C.5.3 Reliance on data from a taxpayer's operations (internal data)	Based on Section C.5 of the Draft Alternatively, this part of the discussion could be moved to C.2.3 on availability of comparables (as one factor leading to the selection of the most appropriate transfer pricing method)..

19. For the reasons detailed below, we do not find the proposed guidance on “highly integrated operations” and “value chain analyses” to be helpful, and accordingly suggest deleting paragraphs 19-20, Section C.3.1 and Section C.3.4 of the Draft.

20. Furthermore, for consistency purposes, we suggest deleting or rewording paragraphs 2.4-2.5 as the new guidance on profit splits is finalized.

21. Finally, we would appreciate it if the OECD could clarify whether the Annexes II and III to Chapter II will be retained, amended or deleted. In case of deletion, an explanation of the reasons why they are no longer found relevant would be helpful.

4. When to apply a transactional profit split method

4.1 In general

22. In our view, the primary challenge for the revised guidance is to secure a broad consensus on the circumstances in which a profit split method may be the most appropriate method. From this perspective, paragraphs 16-18 in Section C.3 of the Draft are of paramount importance. We strongly support these three paragraphs, especially the statement at paragraph 16 that:

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

23. We support the contract R&D example at paragraph 17 and the clarification at paragraph 18 that:

A lack of comparables alone is insufficient to warrant the use of a transactional profit split of actual profits under the arm's length principle.

24. We find however that the following important additional points are missing in the Draft:
- While arguably a profit split method might often be appropriate, it should only be selected if it is *the most appropriate* method to the circumstances of the case, i.e. it should not be selected where another method (e.g. a one-sided method) is more appropriate, consistently with the guidance at paragraph 2.2 of the Guidelines.
 - A profit split method being a two-sided method, by essence it may only be appropriate where multiple parties to the transaction make unique and valuable contributions that at arm's length would lead to an agreement to share profits and losses. Where one party to the transaction only contributes routine (non unique, benchmarkable) functions, assets and risks, a one-sided method is generally more appropriate and a profit split method should not be selected.

4.2 *Strengths and weaknesses*

25. The only weaknesses identified in the Draft are described at paragraph 14. We think that it is important for the OECD to acknowledge that there are other important weaknesses to a profit split such as the following:

- A profit split method is an extremely complex method for taxpayers to apply and for tax administrations to audit. This complexity and its implications in terms of costs and resources for both the taxpayer and the tax administration should not be understated. It is primarily due to the volume and nature of information needed to apply the method.

Tax administrations that want to substitute a profit split for another method applied by a taxpayer should acknowledge that this may lead them to require analytical segmented data about the combined profits of a transaction and splitting factors that is often not available in the MNE's accounting system and may be very onerous to prepare.

Furthermore, based on our experience, not all tax inspectors have the required technical background to audit such complex determinations, leaving aside the ability to make their own profit split determinations in an audit. Profit splits are far more complex to determine and audit than one-sided methods. A broad application of the profit split method can be an issue for tax administrations that have scarce resources.

Paragraph 14 of the Draft touches upon this issue but in our view largely understates it. The second sentence of paragraph 14 ("On first review, the transactional profit split method may appear readily accessible [...]") is far from the reality and should in our view be deleted. The third sentence stating that "associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates" seems to suggest that the complexity resides in a lack of transparency on the part of MNEs. The last sentence of paragraph 14 is correct, but being presented at the end of the discussion of strengths and weaknesses of the methods as just an additional point, it loses its force and relevance and also does not address the important consequences in terms of resources for taxpayers and tax administrations.

- Further, profit split determinations are typically uncertain. There is typically a significant degree of subjectivity in the analytical determination of the profit to be split because the consolidated profit earned by several entities on one transaction is generally not identified as such in the statutory accounts and an analytical segmentation has to be performed, possibly for the sole purpose of the profit split determination. When the profit to be split is the operating profit, operating expenses, depreciation and amortization need to be analytically allocated to various business transactions. Further, the selection of the allocation keys that will be used to split the profits and their determination may also be subjective.

The OECD should acknowledge this uncertainty and note that the profit split method should be reserved for cases where the contributions by the parties are both unique and valuable. If one party makes contributions that are not unique, a simpler and more reliable method based on comparables will be more appropriate.

Tax administrations that advocate a broad use of the profit split method should stand ready to eliminate in mutual agreement procedure any double taxation that may result from the selection and application of this method or submit the case to binding arbitration. The broader the use of the profit split method, the more tax administrations will need to invest resources in transfer pricing administration, both at enforcement and dispute resolution levels.

We find that the Draft does not sufficiently reflect the direct correlation between, on the one hand, a possible broadening of the use of profit split methods and, on the other hand, an inevitable increased complexity of tax audits and increased number of cross-border disputes and mutual agreement procedures. Disputes will arise about both the appropriateness of the profit split method and the determination of the profit to be split and splitting factors.

- Finally, a tax administration that requires profit split to be selected in a given category of settings should do so consistently and accept the split of losses in comparable settings. While this may seem obvious in theory, in our experience it is not uncommon that a tax administration that advocates in audits a profit split for subsidiaries of profitable MNEs does not accept the sharing of losses in loss-making years or loss-making MNEs. We have experienced this with some OECD as well as non-OECD countries.
- In our view, because of the extreme complexity of a profit split method and of the uncertainty attached to it, it is critical that the OECD ensure that it does not become a default method. Accordingly, the mere fact that functions are “integrated” (as is most often the case within any MNE group) or that synergies are derived should not suffice for a profit split method to be the most appropriate. Doing otherwise would jeopardize the basic workability of the arm’s length principle in practice. While the point on synergies is correctly addressed at paragraph 23, the Draft contains confusing comments on “integrated operations” which in our view open the door to wide-ranging interpretations and a broadening of the profit split method to cases where it is not consistent with the arm’s length principle and is not the most reliable, hence the most appropriate method.

4.3 Profit split versus one-sided methods

26. It would be helpful for the OECD to clearly state that, consistently with the existing guidance at paragraphs 2.2-2.3, in the vast majority of cases a one-sided method is more appropriate than a profit split to test the compliance with the arm's length principle of the party to the transaction that has the simplest functional analysis (such as a contract R&D entity, a distributor or a contract manufacturer), including where the latter uses intangibles belonging to a foreign associated enterprise or performs some DEMPE functions but does not contribute unique, valuable intangibles and does not share economically significant risk.

27. Including further examples of transactions where a one-sided method would be more appropriate than a profit split would be helpful. For instance, concerning contract R&D, it could be helpful to provide confirmation that when a contract R&D team evolves over time from basic testing or development activities to higher value research activities, it may assemble a valuable team of employees. Consistently with the guidance at paragraph 1.152 of the Actions 8-10 Final Report, the existence of such workforce may lead to a comparability adjustment that is a higher return for the contract R&D provider. It would not however lead to the selection of a profit split method as the most appropriate method if the contract R&D provider does not share the risk of failure of the R&D process.

28. Paragraph 7 states that:

In any transaction the price set by the parties affects the allocation of available profits or losses from that transaction.

29. This seems to ignore the residual profit split method, whereby an arm's length remuneration typically determined through the use of one-sided methods is provided for the routine contributions, and the residual profit, after remuneration of the routine contributions, is split in proportion to the unique, valuable contributions of the parties. If one party to the transaction does not make a unique, valuable contribution, it should receive an arm's length remuneration for its routine contributions aligned with the one of the comparables, and it will not be entitled to a sharing of the residual that is derived from the contributions made by other parties to the transaction.

30. Paragraph 7 further indicates that:

Pricing negotiations by an uncontrolled party will typically take into account the profits it expects to derive from the transaction, and those it estimates the other party may be likely to obtain. For example, uncontrolled parties may negotiate a price discount for additional volume of products by reference to anticipated additional profits, and will make assumptions about how the anticipated additional profits may be divided between them, and how much of those profits they might be prepared to share with the other party as a result of setting the discount at a particular level.

31. This seems to suggest that independent parties typically split their anticipated profits. We think that this is an incorrect statement, and one which is inconsistent with the arm's length principle and the revised OECD guidance on options realistically available. As noted at paragraph 1.38 of the Actions 8-10 Final Report :

Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives. In other words, independent enterprises would only enter into a transaction if it is not expected to make them worse off than their next best option. For example, one enterprise is unlikely to accept a price offered for its product by an independent commercial enterprise if it knows that other potential customers are willing to pay more under similar conditions, or are willing to pay the same under more beneficial conditions.

32. In competitive situations, where the buyer has the option to acquire goods or services from a range of providers, the price is not set by reference to the profits that the providers estimate the acquirer may be likely to obtain. Rather, the price is set by reference to the price that the providers estimate their competitors are likely to offer. This is because a buyer who has the option realistically available to acquire comparable goods or services at a lower price will do so, irrespective of the amount of profit it earns. The buyer will not volunteer to share its profits with the seller unless it has no better option available.

33. In our experience, paragraph 7 illustrates a common misunderstanding. Some tax administrations consider that as a matter of “fairness”, a share of the residual should be allocated to the entities performing routine functions in the case where the group as a whole is “very profitable”. This position is not supported by economic reality and is also not supported by the arm’s length principle. In the open market, the cases where independent parties agree to share profits and losses based on an allocation key are very specific and limited. The same should be true for controlled transactions between associated enterprises insofar as the arm’s length principle remains the standard.

34. In fact, the cases where a provider is able to obtain a greater share of profits are the ones where it has a strong bargaining power, for instance because it owns unique, valuable intangibles, so that the purchaser does not have a better option to source comparable products or services at a lower price. In this respect, we believe that the next-to-last sentence of paragraph 11 should be reinforced as follows:

*On the other hand, ~~the sharing of economically significant risks is less likely to occur~~ **a profit split will not be appropriate** where one party to the transaction performs only simple functions and does not make any significant unique contribution (e.g. contract manufacturing or contract service activities in relevant circumstances).*

35. Paragraph 13 indicates that:

A further strength of the transactional profit split of actual profits is that it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result, which does not appropriately reflect the contributions made in terms of functions, assets, and risks by each party. This is because the value contributed by both parties to the transaction is assessed, and also because the profits being divided are the actual profits arising rather than a benchmarked profit for one of the parties. This aspect can be particularly important when analysing the contributions by the parties in respect of the

intangibles employed and economically significant risks assumed in the controlled transactions.

36. The first sentence is unbalanced and should be rephrased or deleted. In effect, as much as a one-sided method may lead to incorrect result if inappropriately applied, a profit split method, if inappropriately selected or inappropriately applied, may lead to too much profits or loss being allocated to an entity that does not make the unique and valuable contributions to the transaction or makes contributions that do not warrant such allocation.

37. The second sentence may be read as suggesting that a profit split method would be superior to one-sided methods even in the case of routine activities. It may also or alternatively be read as suggesting that a profit split method would be recommended as a sanity check for one-sided methods. Either interpretation would be inconsistent with the guidance on the selection of the most appropriate transfer pricing method and use of more than one method at paragraphs 2.2-2.11 of the Guidelines. We therefore recommend that the second sentence of paragraph 13 be deleted.

4.4 *Unique and valuable contributions*

38. Paragraph 22 is of paramount importance as it provides the foundation for determining when a profit split method may be the most appropriate. As indicated above, we think that this paragraph should be moved upfront and provide the basis for a more comprehensive discussion of the appropriateness of the method.

39. This paragraph starts as follows:

Another situation in which the transactional profit split method may be the most appropriate method is where multiple parties to the transaction make unique and valuable contributions, such as unique and valuable intangibles (see paragraph 6.17). Contributions, whether in the form of functions performed, assets used, or risks assumed, 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.

40. In our view, the situation described at paragraph 22 is not just “another situation”: it is the only situation in which a transactional profit split method may be the most appropriate method. This is all the more true in that the definition of “contributions” proposed in this paragraph is very broad as it encompasses functions performed, assets used, or risks assumed. Where one party to the transaction does not make any unique and valuable contribution, it will not be entitled to share the residual profit (or loss) beyond the remuneration of its routine function, and a profit split method will not be appropriate. This is well illustrated in the example at paragraph 17 of the Draft. Including further examples of situations where a profit split method is not appropriate could be very helpful to better draw the line, for instance in relation to “routine” manufacturing and distribution activities.

41. Furthermore, we find that the discussion in the Draft in relation to the notion of *unique and valuable contributions, such as unique and valuable intangibles* is confusing. The Draft may be read as suggesting that any contribution in the form of important functions, risks or assets may lead to a

profit split being the most appropriate method. In our view this would be incorrect for the reasons outlined below.

4.4.1 Important functions, assets and risks and contributions to the creation of value do not suffice for a profit split to be the most appropriate method

42. All entities within a multinational enterprise aim at contributing to the creation of value, otherwise they would not exist. The threshold question to determine whether a profit split method is the most appropriate method is therefore not whether an entity performs functions, contributes assets or assumes risks that are “important” (as this would be a very subjective criterion) and contribute to the creation of value (as this should be the expectation for any entity), or whether they are “integrated” (as this will be the case for most operations within a multinational enterprise). The threshold question should remain whether multiple parties to the controlled transaction make contributions that (a) exceed the ones of independent comparables and cannot be taken into account through a comparability adjustments (i.e. are “unique”) and (b) are valuable. Both cumulative criteria are important, as the mere lack of comparables should not suffice to make a profit split the most appropriate method; as acknowledged at paragraph 18 of the Draft.

4.4.2 Depending on the nature of the transaction, risk taking may be only one of the contributions to value, and may or may not be among the most important ones

43. At arm’s length, risk may be contractually allocated to one party to a transaction, or shared among multiple parties. Contractual terms typically set out the scope of the risks that are assumed by each party or shared among them, and the responsibilities of the parties in relation to risk management. Where both parties to a transaction agree to share a particular risk, they typically share the consequences *of that risk*, but not necessarily the profits from the whole transaction as the latter may have much broader inputs and implications than the mere sharing of that risk.

44. In our view it follows that under the arm’s length principle, where each party to a controlled transaction assumes unique and valuable risks (i.e. economically significant risks that are not found in the comparables and cannot be adjusted through a comparability adjustment), each of them should be allocated the profit (or loss) associated with the specific risks it assumes, in accordance with the guidance at paragraphs 1.100 - 1.106 of the revised Chapter I. If multiple parties share the assumption of a given risk, they should also share the profit (or loss) associated with the assumption of such risk. On the other hand, they should not necessarily share the profit from other inputs to the transaction, such as unique and valuable intangibles they do not contribute, or other risks they do not share. This is consistent with the R&D example at paragraph 17, as it states that “Notwithstanding that the risks assumed by Company B might be economically significant, especially in relation to Company B’s business, the critical aspect in the example is that it is the entity assuming the development risk, Company A, that will bear the consequences associated with the success or failure of the intangible to be developed”.

45. Risk may be more or less significant depending on the transaction considered. The sharing of risk may lead to a profit split being the most appropriate method if and only **if the shared risk is the key generator of profit (or loss) in the transaction**. Some transactions in essence consist in the taking on of risk and the profits derived are mostly associated with the risk taking. This may be the case in particular for some financial transactions, as well as for some research and development

activities where the ability to take on and fund the risk associated with the success or failure of the R&D is the core value driver of the transaction. In such cases, if multiple parties share the financing risk, applying the new Chapter I guidance on risk allocation may lead to the sharing of the profits derived from the transaction.

46. In other cases, the key generators of profit (or loss) in the transaction may be a combination of unique, valuable intangibles and risk-taking. This would be the case for instance if one party to a transaction contributes unique, valuable technology and multiple parties to the transaction contribute funding and associated financing risk. In such a case, the profit may be shared among the parties to reflect their various contributions. [In making this comment, we acknowledge that following the revised guidance in Chapter I, determining that a party assumes risk may require that party to perform some risk management functions.]

47. However, in many cases, risk is only one element of the transaction, while contributions in the form of unique and valuable intangibles are the key generator of profit (or loss) in the transaction and the differentiating factors compared to comparables. This is typically the case for instance in 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. In such cases, even though the manufacturer or distributor assumes some risk (and should be compensated for it), it does not follow that a profit split method would be appropriate; the party contributing the unique and valuable intangibles will generally be the one entitled to the residual profit. [In making this comment, we acknowledge that following the revised guidance in Chapter VI, determining that a party contributes unique and valuable intangible may require that party to contribute more than “just” legal ownership of the intangible.]

48. Accordingly, we think that it would be incorrect to consider that the sharing of risk automatically leads to a profit split method being the most appropriate. In effect, in a profit split method, the combined profit or residual profit from the transaction is being shared. The profit to be split may derive from a range of contributions beyond the specific risk sharing, such as unique and valuable intangibles contributed by one party only, as well as other risks that may be assumed by one party only.

49. Thus, if only one party to the transaction contributes the unique and valuable intangibles while multiple parties assume risks, the former should be the only one entitled to the profit derived from the intangibles contributed, while the latter would each be allocated the profit (or loss) associated with the assumptions of the specific risks they co-assume, in accordance with the guidance in revised Chapter I.

4.4.3 Not all risks warrant returns above those of comparables

50. Despite the strong emphasis of the revised Guidelines on risk, it is important to recognize that every business assumes some important risk. At arm’s length, an independent contract-manufacturer, service provider or distributor assumes operational risks as well as the risk of losing clients and being out of business. The market - and therefore the arm’s length principle - does not compensate the assumption of such risks through a sharing of intangible related profits with principals.

51. On the other hand, cases where an associated enterprise assumes significant risks that are not assumed by independent comparable enterprises would support the allocation of profits (or losses) to the risk-bearing associated entity that go beyond the returns earned by comparable enterprises. Depending on the nature of the risk at hand, a comparability adjustment may be performed to adjust the comparables and take the additional risk into account.

52. In our view, the beginning of paragraph 11 is misleading and should be revised, in that it seems to suggest that the sharing of risk is more important than contributions of unique and valuable intangibles in determining the appropriateness of a profit split method.

4.4.4 *Contributions in the form of unique and valuable intangibles*

53. A profit split method may be the most appropriate method where multiple parties to the transaction contribute unique and valuable intangibles. This is because it is assumed that the profit from the transaction is derived from the combination of the contributed unique and valuable intangibles, and that each party will share the profit (or loss) in proportion to its contribution to the making of the profit. Furthermore, a party that contributes unique and valuable intangibles may typically assume the risk associated with the development or exploitation of such intangible (risk that the contributed intangible may lose value).

54. That being said, in determining the profit split among multiple parties contributing unique and valuable intangibles, the extent of the risk associated with the intangible contributions should also be assessed. In the case where the parties share the risks associated with the development or exploitation of intangibles, a profit split that shares the *actual* profits derived from those activities may be the most appropriate method. On the other hand, as noted in paragraph 4 of the Draft, a split of *anticipated* profits (such as in a discounted cash flow approach) may be most appropriate in a situation where the parties do not share or co-control the risk that the actual profits be greater or lower than anticipated.

4.4.5 *Conclusion on unique and valuable contributions*

55. Each party should be remunerated for its contributions. Depending on the nature of the transaction, risks and intangibles may be more or less significant. A financial transaction may consist in the assumption of risk while the core of a manufacturing or distribution transaction would typically lie in intangibles.

56. Furthermore, all businesses bear some risk and the assumption of risk may give rise to routine returns only, depending on the nature of the risk at hand. Thus, if a contract manufacturer, service provider or distributor assumes operational risk as well as the risk of losing clients and going out of business, and based on the assumption that such risks are comparable to the risks of independent contract manufacturers, service providers or distributors, then it would not be entitled to profits above those of the comparables.

57. There may also be cases where the risks assumed by a party are not assumed by independent comparable parties, thus leading to the allocation of profits (or losses) beyond those of the comparables. Such determination should be made in accordance with the guidance in revised Chapter I. Because the standard is to apply the *most* appropriate transfer pricing method, a profit split method should not be applied where a method based on comparables can be applied more reliably, subject to comparability adjustment for risk where appropriate.

58. In other cases, such as some financial transactions and some research and development activities, risk may be the key profit-making driver and the sharing of risk may lead to a sharing of the profit (or loss) from the transaction.

59. We therefore suggest that the beginning of paragraph 22 be amended as follows:

*~~Another situation in which~~ **The transactional profit split method may be the most appropriate method is where multiple parties to the transaction make contribute unique and valuable contributions, such as unique and valuable intangibles (see paragraph 6.17). Furthermore, where multiple parties to a transaction assume significant risks, the guidance at paragraphs 1.100 to 1.106 should be followed.***

60. Further, we suggest that the revised language be moved up to the start of the discussion of the appropriateness of the profit split method and that the rest of Section C.3 of the Draft be restructured to clearly address the types of unique and valuable contributions that may or may not lead to a profit split being the most appropriate method, as discussed below, as well as the relationship with the guidance in Chapters I and VI of the Guidelines.

4.5 *More guidance needed with respect to intangibles and DEMPE functions*

61. A clear statement on the importance of assessing the contributions of unique, valuable intangibles in determining whether a profit split method is appropriate would be welcome.

62. Furthermore, following the Actions 8-10 Final Report, additional comments illustrating the relevance (or non relevance) of the performance of functions related to intangibles would be helpful. In effect, the Actions 8-10 Final Report puts a strong emphasis on the performance of Development, Enhancement, Maintenance, Protection and Exploitation (“DEMPE”) functions to allocate returns from intangibles. Questions relating to the appropriateness of a profit split method will arise in the case where an entity that is not the owner of the intangible performs some of the DEMPE functions.

63. We think that a profit split method is not appropriate just because an entity participates in the development of an intangible through contract R&D or marketing services, or enhances the intangible by providing feedback on possible improvements to a manufacturing process or brand positioning.

64. In our view, the greatest difficulties will arise with the notion of “exploitation”, as this notion is not defined in the Actions 8-10 Final Report, leaving the guidance open to wide-ranging interpretations.

65. As an example, assume that a brand owner funds, develops, enhances, maintains and protects a trademark. It enters into a distribution agreement with an affiliated company to distribute products under the trademark it owns. Some tax administrations have argued that in such a case, the affiliated distributor “exploits” the trademark and should therefore be entitled to a share of the intangible return. We believe that this would be an incorrect outcome, inconsistent with the arm’s length principle because independent distributors would not be entitled to a share in the residual profit in comparable circumstances. In such a case, the brand owner exploits the trademark by putting in place distribution contracts.

66. The same issue arises for contract manufacturers who use technology put at their disposal by a foreign associated enterprise: should a contract manufacturer be regarded as “exploiting” the intangibles put at its disposal by the principal? We think that a profit split is not appropriate in the case of a contract manufacturer.

67. Differing interpretations of the meaning of the word “exploitation” in the context of the revised Chapter VI will likely lead to disputes about the circumstances where a profit split method is appropriate.

68. We believe that it is essential to the sustainability of the arm’s length principle and Guidelines that the profit split method should not become a default method. We therefore urge the OECD to clarify that a profit split method is not appropriate just because a party contributes to the development, enhancement, maintenance, protection of intangibles, in cases where these functions can more appropriately be compensated using a one-sided method.

69. Furthermore, we recommend that the OECD clarify that the mere fact that an entity uses or exploits the intangibles of an associated enterprise does not entitle such entity to share in the combined or residual profit from the intangibles. In particular, a profit split method is generally not the most appropriate method for a distributor, service provider or manufacturer who performs routine functions that are similar to those of comparable independent distributors, service providers or manufacturers.

70. As an additional point, we note that the next-to-last sentence of paragraph 19 reads as follows:

However, the contribution alone of an intangible or rights in an intangible by one of the parties is not sufficient to justify the splitting of combined actual profits of the parties to the transaction under a transactional profit split of actual profits.

71. This sentence is unclear to us. Is it intended to mean that the entity that contributes intangibles or rights in an intangible “alone” may not be entitled to share in the profits of the transaction? If so, it raises serious questions in relation to cases where the contribution of an intangible, although being “alone”, is effective and recognized. If the intention is to refer to cases where an entity contributes an intangible or rights in an intangible without performing the DEMPE functions or control over risk functions required for it to be entitled to intangible return under the Actions 8-10 Final Report, this should be clarified. The sentence may alternatively be read as intended to mean that in the case of contribution of intangibles without the sharing of risk, a split of anticipated profits would be more appropriate than a split of actual profits. We suggest that this sentence be either clarified or deleted.

4.6 *Highly integrated operations*

72. Paragraph 19 states that:

[...] Highly integrated business operations may involve the sharing of functions, where the outcome of the transaction is dependent on two or more parties making contributions which are interlinked and thus cannot reliably be evaluated in isolation. In such a case, a transactional profit split of actual profits may be appropriate.

73. Paragraph 21 indicates that:

The accurate delineation of the actual transaction may determine that multiple parties share significant risks in relation to a transaction in cases in which the transaction is part of highly integrated business operations of the parties. Although most business operations undertaken by an MNE group are integrated to some degree, a high degree of integration means that the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with, and cannot reliably be evaluated in isolation from, the way in which another party to the transaction performs functions, uses assets and assumes risks.

74. We find these paragraphs confusing. In our view, the key point to determine whether a transactional profit split method is appropriate is whether or not multiple parties to the transaction make unique, valuable contributions (see Section 4.4 of this letter for our comments on the notion of “unique, valuable contributions”) . In a case where the high degree of integration concerns the contribution of intangibles and/or the assumption of economically significant risk, it may lead to the sharing of the profits (or losses) associated with the intangibles or risk-taking. However, in the case where functions that are highly integrated do not pertain to the assumption of unique and valuable intangibles and/or the sharing of economically significant risk then the high degree of integration does not make a sharing of the profits (or losses) associated with such intangibles or risks appropriate.

75. The proposed draft may however be read as suggesting that integration of functions may lead to the selection of a profit split method, irrespective of the actual contributions of unique and valuable intangibles and of the actual sharing of risk. This would be inconsistent with the arm’s length principle.

76. We further note that entities performing highly integrated functions may not be responsible for or in control of the integration. Typically, an entity (e.g. the principal) is in charge of integrating the activities performed by a series of providers that perform non-unique functions. The circumstance that one party integrates the functions performed by others does not seem to support the application of a profit split among them all.

77. We therefore find that the draft guidance on highly integrated operations is not helpful and should be deleted. We note that there are several references to integration / integrated operations throughout the Draft which we recommend should also be deleted.

78. We agree with the statement at paragraph 21 that:

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 uncontrolled arrangements.

79. We suggest some amendments to the sentence that reads as follows:

In cases of parallel integration, it may be the case that the accurate delineation of the actual transaction determines that each party contributes unique and valuable intangibles and/or shares economically significant risks, and a transactional profit split, using an approach

which splits actual profits, may be found to be the most appropriate method depending on the nature of the transaction and of the parties' respective contributions.

80. Thus, sequential integration will generally not lead to a profit split method being appropriate, while in the case of parallel integration, a profit split method may or may not be appropriate. In our view, it follows that the guidance on parallel integration and sequential integration is not helpful and the key factor remains whether or not the parties makes unique and valuable contributions as discussed above in section 4 of this letter.

4.7 Group synergies

81. We strongly support the statement at paragraph 23 that

There is no need to combine the total profits of the parties and use the transactional profit split method simply on account of group synergies alone.

5. Role of Value Chain Analyses

82. We do not support the proposed inclusion of Section C.3.4 on value chain analyses ("VCA") for the following reasons.

5.1 A new and unrealistic increased compliance standard

83. First, a requirement for taxpayers to undertake VCA (or for tax authorities to review VCA) would create a new and significant documentation requirement, and a new analytical standard in addition to the already complex and burdensome requirements involved in the accurate delineation of the transaction and functional analysis.

84. It is not fully clear from Section C.3.4 of the Draft whether the OECD intends to make VCAs compulsory. We note that paragraph 26 includes statements such as "A VCA should consider", "the analysis should also consider", "The analysis thus both contributes to the process of accurately delineating the transaction, and also determines the level of integration [...] and the economically relevant contributions". We believe that if Section C.3.4 of the Draft is incorporated in the Guidelines, tax authorities will start requiring VCA to be performed. If the intention is for VCAs not to be required, then the OECD should not include them in the Guidelines.

85. The revised Chapters I, VI, VII and VIII do not require a VCA to be performed as part of the transfer pricing analysis and the Action 13 Final report does not require a VCA to be performed as part of the transfer pricing documentation. The Guidelines are not a repository for all possibly attractive ideas and analytical concepts. They ought to provide consensus guidance, compliance with which and enforcement of which should be workable for taxpayers and tax administrations alike. We do not believe that the proposed addition of VCAs meets the administrability standard.

86. The 2010 Guidelines significantly increased the compliance burden compared to the 1995 Guidelines through the inclusion of more detailed comparability requirements in Chapter III, more detailed guidance on the transactional net margin method in Chapter II, and the addition of the new

Chapter IX on business restructuring. The 2015 Actions 8-10 Final Report significantly further increases the compliance burden and analytical complexity through the revision of Chapters I, VI and IX and the introduction of new notions such as the “accurate delineation of the transaction”, “risk management and control” and “DEMPE functions”. The Action 13 report further increases the documentation requirement through the development of the Master File and Local File concepts and country-by-country reporting. We urge the OECD not to again further increase the difficulty and costs of compliance by introducing VCAs in the Guidelines.

5.2 *A lack of clear purpose and an overlap with already existing concepts*

87. Beyond significant concerns related to the compliance burden, we note that the Draft is unclear as to what the purpose of performing a VCA would be. Paragraph 24 alone proposes three different purposes for a VCA:

*A value chain analysis, undertaken as part of the broad-based analysis of the taxpayer’s circumstances (see 1.34), may be useful in **helping to identify when the transactional profit split method may be appropriate**. Such an analysis may also assist in **determining how the method**, if indeed it is the most appropriate method, **should be applied, including the profits to be split and the relevant splitting factors**. It should be emphasised however, that such a value chain analysis is **merely a tool to assist in delineating the controlled transactions**, in particular in respect of the functional analysis, and thereby determining the most appropriate transfer pricing methodology. [emphasis added]*

88. Paragraph 25 notes that:

*[...] the purpose of the value chain analysis is to **identify the features of the commercial or financial relations between the parties** described in the paragraphs below which are indicators that the transactional profit split method may be the most appropriate method for a particular case under the guidance in paragraph 2.2.*

89. Paragraph 26 continues as follows:

*A value chain analysis should consider where and how value is created in the business operations, including in particular: (i) **consideration of the economically significant functions, assets and risks, which party or parties perform the functions, contribute the assets and assume the risks, as well as whether and how the functions, assets, and risks of the parties may be interdependent or otherwise interlinked [...]** and (ii) how the economic circumstances may create opportunities to capture profits in excess of what the market would otherwise allow, such as those associated with unique intangibles, first mover advantages, or other unique contributions.*

90. The above-identified purposes are precisely the ones of the **comparability analysis and functional analysis** as described in the revised Chapter I. This raises the question why a new analytical tool would be required in the context of the guidance on profit splits to achieve the same objectives as the ones assigned to existing concepts in Chapter I for the generality of transactions. We do not see the need or purpose of revising again the general comparability and functional analysis standard and the documentation requirements that were approved by the CFA in October 2015 and by

the Council in May 2016. If VCAs are introduced in the Guidelines, it would be helpful to clarify how they complement or replace the existing Chapter I concepts. We find that a blanket statement that VCAs may be helpful in achieving all the objectives listed at paragraphs 24-27 would not be sufficient given the potentially very onerous consequences.

91. Paragraph 24 of the Draft suggests that VCAs may need to be performed in the process of **selecting the most appropriate method** (as they are described as potentially helpful to identify when the transactional profit split method may be appropriate). We suggest that the OECD should clarify whether the guidance at paragraphs 2.2 - 2.12 of the Guidelines on the selection of the most appropriate method is under revision (our understanding was that this is not the case).

92. Paragraph 24 suggests that VCAs can assist in determining the profits to be split and the relevant splitting factors. We do not understand how VCAs can assist in determining the profit to be split. If the intention is to say that VCAs may assist in determining the relevant measure of profits (actual or anticipated, gross or net), our view is that such determination should be made based on an analysis of which party(ies) assume(s) the risk of the transaction, following the guidance in Chapter I.

93. Paragraph 26 of the Draft further states:

*In considering where and how value is created, the analysis should also consider **whether such value-creation is sustainable**, for instance, whether market advantages are protected due to barriers to entry to potential competitors or the impact of valuable intangibles. The analysis thus **both contributes to the process of accurately delineating the transaction, and also determines the level of integration** (which may determine the level at which profits or revenues should be split), **and the economically relevant contributions** (which may determine the factors to use to split the profits).*

94. Thus, paragraphs 24-26 seem to suggest that VCAs are a *panacea*, a multi-purpose tool that would resolve functional analysis, comparability analysis, accurate delineation of the transaction, determination whether a profit split is appropriate, of the profits to be split and of the splitting factors. We respectfully disagree, as our experience with VCAs is that while they may shed light on the relative significance of various contributions to the making of profits, they generally do not accomplish all the above-listed purposes.

95. Section C.3.4 is somewhat balanced by the following sentences at the end of paragraph 26:

It is important to note, however, that the value chain analysis is simply a tool to assist in accurately delineating the transaction. Moreover, it does not, of itself, indicate that the transactional profit split is the most appropriate method, even where the value chain analysis shows that there are factors which contribute to the creation of value in multiple places, since all parties to a transaction can be expected to make some contributions to value creation.

96. We strongly support these sentences. We are however concerned that they are largely insufficient to counterbalance the general tone of the section, and the high expectations set at paragraphs 24-27. We are also concerned that the inclusion of these sentences in a section that generally goes in the opposite direction may reflect a lack of consensus.

97. We further note that the positioning of the discussion of VCAs in the draft new guidance on profit splits is not neutral. The OECD did not include a discussion of VCAs in the revised Chapters I

and VI released on October 2015. It follows that a strong connection between the concept of VCAs and the appropriateness of a profit split method is *de facto* established.

98. We are also concerned with the proposed inclusion of the words “first mover advantages, or other unique contributions” and “whether such creation of value is sustainable, for instance whether market advantages are protected due to barriers to entry to potential competitors”. First, we do not see any reason for first mover advantages and barriers to entry to be singled out here. Second, the analysis of significant intangibles should be made in accordance with the guidance in Chapter VI. Intangibles within the definition of paragraph 6.6 of the Actions 8-10 Final Report is something which can be “owned or controlled” and whose “use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances”. Market features are carefully analysed at paragraphs 1.144 to 1.151 of the revised Chapter I. It would be unfortunate if the new guidance on profit split led to characterizing them as intangibles without properly considering the more careful analysis of these concepts contained in the Actions 8-10 Final Report. Finally, there is no reason to assume that first mover advantages are valuable. Even where they are intangibles within the meaning of paragraph 6.6, they are not necessarily unique and valuable and do not necessarily affect the determination of the appropriateness of a profit split method.

5.3 Lack of guidance on what a VCA is, how it should be performed and how it should be interpreted

99. If the OECD were to give a role to VCA, it should provide clear guidance as to what a VCA should cover, how it should be performed and how it should be interpreted. There is not a single definition and there are no harmonized practices in this respects. Lacking such guidance, if, based on Section C.3.4 of the Draft, tax authorities start requiring VCAs, they will likely find that the contents of VCAs presented to them, the analytical tools used and processes followed to perform VCAs as well as the conclusions that may be derived from them vary greatly from one transfer pricing documentation report to another.

5.4 Conclusion on VCAs

100. For the reasons explained above, we are concerned that the proposed guidance on VCAs would add another complex, costly and subjective exercise to the already burdensome transfer pricing documentation requirements, for ill-defined purposes which arguably are already achieved through the rest of the Guidelines and in particular the revised guidance in Chapter I. Further, we are concerned that it may open the door to unprincipled selections of the profit split method based on vague concepts that would defeat the efforts put by the OECD in the revision of Chapters I and VI in particular. Accordingly, our strong preference would be for the discussion of VCAs in Section C.3.4 as well as other references to VCAs throughout the Draft (e.g. at paragraphs 21, 40, 42, 48) to be deleted.

101. If however a section on VCAs is retained, we respectfully recommend that the role of VCAs be rebalanced. We suggest the following:

- Section C.3.4 should be moved to Chapter I of the Guidelines so as to make it neutral as to the resulting selection of the most appropriate transfer pricing method.
- The discussion of VCAs should be rebalanced, starting with the end of paragraph 26 and moderating the over-stated expectations that are currently set in respect to what VCAs can achieve.
- The performance of VCAs should not be a compulsory documentation requirement and tax administrations should refrain from requiring them in audits if they are not available.
- Where a VCA has been performed by a taxpayer, it should be viewed as an additional, optional tool that may shed light and bring further context to the transfer pricing analysis performed. However, the standard for performing transfer pricing analyses should be the one in Chapter I of the Guidelines.
- Where a VCA has been performed by a taxpayer, it may provide further context to the contributions of the parties. However, the standard for selecting the most appropriate transfer pricing method should remain the one in paragraphs 2.2 - 2.11 of the Guidelines.

6. Determination of the profits to be split

6.1 Combined or residual profits from the transaction

102. Both the contribution and the residual analyses are recognized in the Draft. Paragraph 33 dealing with residual analyses differentiates between the combined profits (before remuneration of the routine contributions) and the residual profit (after remuneration of the routine contributions, i.e. the profit to be split).

103. However, the Draft systematically refers to “combined profits” as being the profits to be split. Our reading is that the phrase “combined profits” in the Draft is to mean the profit to be split both in a contribution analysis and in a residual analysis. If this is correct, the various references to “combined profits” should be replaced with “profits to be split”.

104. Alternatively, if the OECD intentionally restricted the draft guidance to profits to be split under a contribution analysis, additional guidance on residual approaches would be needed.

6.2 Transactional approach

105. If two associated enterprises carry on two controlled transactions together, one for which a profit split is the most appropriate method and one for which it is not, only the profits from the first transaction should be split. We therefore suggest amending the first sentence of paragraph 36 as follows:

The combined or residual profits to be split [...] are the profits of the associated enterprises from the controlled transactions for which a profit split was determined to be the most appropriate method.

106. Similarly, the next to last sentence of paragraph 33 should be amended as follows :

In the second stage, any residual profit (or loss) remaining would be allocated among the parties that made unique and valuable contributions.

6.3 Actual versus anticipated profits

107. Paragraph 4 indicates that a transactional profit split of anticipated profits will typically be used in conjunction with a discounted cash flow valuation technique. We agree that in the example where the transferor does not share the risk subsequent to the transfer, the profits to be split should in effect be the anticipated profits.

108. Paragraph 5 indicates that in a transactional profit split of actual profits, although the basis for the split of combined profits is established *ex ante*, it is applied to actual, combined profits resulting from the transaction. At the end of paragraph 5 it is noted that:

Assuming that the facts of this case lead to the conclusions that a transactional profit split of actual profits is the most appropriate method to apply, the respective contributions made by each company are determined ex ante and used to split the combined actual profits of both Company A and Company B from commercialising the product in each taxable period covered by the arrangement.

109. We believe that the factors determining the respective contributions should be determined *ex ante*, but that in relevant circumstances it should be possible to split the actual profits based on the actual contributions, rather than contributions determined *ex ante* -- that is, determine in advance the splitting factor(s) (e.g. respective R&D or marketing expenses) and split based on the actual numbers. We suggest paragraph 5 be amended to reflect this.

6.4 Consistency with the revised guidance on the assumption of risk

110. In our view, a core issue relates to the consistency of the guidance on actual versus anticipated profit split with the revised guidance on risk. Splitting actual profits implies splitting the risk that the actual profits may be greater or lower than anticipated. As recognized at paragraph 10 of the Draft,

It would be contrary to the guidance in Section D of Chapter I 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.

111. We think that it follows from the revised Chapter I guidance that splitting actual profits should be reserved for cases where the parties co-control the risk that the actual profits may be lower or higher than anticipated *and* all have the financial capacity to assume the risk allocated to them through the profit split.

112. Paragraph 22 indicates that “it may be the case that the risks associated with the respective unique and valuable contribution of each of the parties cannot be controlled by the other party or parties” and provides an illustration thereof. We agree with this statement which in our view illustrates why the revised Chapter I guidance on control over risk should not prevail over the arm’s

length principle, i.e. where data from a comparable uncontrolled transaction evidence that an independent party assumes risk that it does not control, such risk allocation should be respected between associated enterprises, consistently with paragraph 1.97 of the Actions 8-10 Final Report. That being said, the end of paragraph 22 is potentially inconsistent with the revised Chapter I guidance and with other sections of the Draft (for instance at paragraphs 40-41). We therefore suggest that it should be either expanded and clarified or deleted.

6.5 *No hindsight*

113. We strongly support the draft paragraph 3 which states that:

When applying the transactional profit split method, care should be exercised to ensure that its application is performed in a context which is similar to that the associated enterprises would have experienced, i.e. on the basis of information known or reasonably foreseeable by the associated enterprises at the time the transactions were entered into, in order to avoid the use of hindsight. See paragraphs 2.11 and 3.74. That is, irrespective of whether a transactional profit split of anticipated or actual profits is used, the basis upon which those profits are to be split between the associated enterprises, including the profit splitting factors and the way in which combined profits are calculated, must be determined ex ante on the basis of information known or reasonably foreseeable by the parties at the time the transactions were entered into.

7. **Other comments**

114. Paragraph 1 states that

The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12) by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions.

115. This statement is not new as it was already in the 1995 Guidelines. We think that it would warrant an update. We suggest the following:

*The transactional profit split method seeks to ~~eliminate the effect on profits of special conditions made or imposed in~~ **determine the remuneration of each party to** a controlled transaction (or in controlled transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12) by **estimating** ~~determining~~ the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions.*

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1 September 2016

Dear Sir or Madam,

BEPS ACTIONS 8-10: REVISED GUIDANCE ON PROFIT SPLITS

IHG welcomes the opportunity to submit comments on the above paper setting out proposed revised guidance on profit splits ('The Discussion Draft').

About IHG

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

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Our Summary Comments on The Discussion Draft

Our comments are primarily focussed on aspects relating to whether or when a profit split is the most appropriate method, and related issues, rather than sections of the Guidance concerning the application of profit split methods. We find The Discussion Draft very clear and helpful in this respect –subject to the points made below concerning anticipated profit split methods-and we support the approach it takes to explaining and applying the principles which govern when a profit split approach would typically be used in arms-length circumstances, or where it may provide the most appropriate means of approximating to such an arms-length approach.

The paradigm type of circumstance in which a full profit split approach based on actual profits would be used between third parties is a circumstance where a particular enterprise is conducted in partnership, so that there is full integration of functions which drive the revenues and costs of that enterprise, as well as integrated oversight, management and decision making processes. We see that as perhaps capable of being viewed as one end of a spectrum of relative integration, to be contrasted with a value or supply chain comprising discrete, independently managed, sequential processes. In this latter case the only role an understanding of the combined value chain- and split of overall profits between component processes- is likely to have in an arms-length circumstance, is as information or assumptions which may help to inform the negotiating position of parties sitting within the value chain when negotiating prices with other parties in that value chain.

Our understanding is that the nature of the pricing arrangements which will typically be entered into between third parties, and the extent to which they reflect forms or mechanisms for sharing revenues or costs, or both (i.e. a full profit share in the latter case), will normally reflect where on this integration spectrum the arrangements sit –with respect to revenue management, cost management, or both. We believe the draft Guidance is consistent with that interpretation. We wonder however whether this or some alternate type of overview comment might be helpful as a means of drawing together different strands of comment within this and other parts of the Transfer Pricing Guidance (e.g. re various aspects of pricing or cost sharing for intangibles; as well as re dealing with risk and control) as a coherent whole.

As touched on above we do believe that there is a slight lack of clarity at the moment concerning what a transactional profit split based on anticipated profits means. Our understanding of this concept is that it refers to a joint project or continuing supply where forecasts of the anticipated profits from the project of both parties are used as a means of determining a non-actual profit based compensation for one party on a basis and at a level which (based on the anticipated profits) is expected to provide both parties with an acceptable project return. An example would be where this methodology is used to arrive at a royalty rate or an agreed schedule of fees for future services. The reason we say the compensation cannot be based on actual profits is because, if it was, then you would arrive at a profit split based on actual profits.

Our detailed comments concerning The Discussion Draft Questions

With respect to the detailed questions raised in The Discussion Draft:

- (1) *Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular:***
 - 1. Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear?***
 - 2. Is the distinction between the two profit split approaches useful?***

As set out in our summary comments we believe that greater clarity is needed concerning the meaning of a transactional profit split based on anticipated profits. As indicated we understand this to mean a circumstance where the anticipated profits of both parties to a project or continuing supply are used as a means of arriving at a method of compensation for one party –such as a revenue based service fee or royalty- which is not based on actual profits, with the other then retaining the residual profits.

(2) *Comments are also invited on the link between the integration of business activities (and thus the sharing of risks) and the appropriate application of a transactional split of actual profits*

As indicated in our summary comments, and in paragraphs 6 and 9 of The Discussion Draft, a transactional split of actual profits is most likely to be the appropriate method in circumstances where the degree of integration with respect to a particular business (forming, or within, the value chain) is at such a level that that business effectively constitutes a form of joint enterprise.

(3) *Examples of scenarios where each approach to splitting profits would be the most appropriate (together with a brief explanation as to why) are also requested.*

The generic example is given above of a profit split based on actual profits being most appropriate where there is effectively a continuing joint enterprise – by which we imply that that joint enterprise includes continuing shared risk and control aspects with respect to both revenues and costs. We would see a profit split based on anticipated profits as more likely to be applicable in circumstances where there is a joint project, but one in which the contribution of the parties to the project are either sequentially or otherwise separable –in particular, with respect to cost aspects. The nature of the arrangement thus gives one party compensation determined ex ante based on anticipated profit assumptions, and the other a residue based on actual profits and a deduction for this expense. For example, if the compensation is in the form of a royalty, then this results in risks of errors in revenue projections being shared between the parties but each party bearing its own risk of errors in its cost assumptions. This form of agreement might for example arise where there is a staged development and exploitation of an intangible as set out in paragraph 4 of The Discussion Draft.

At a simpler level the nature of a franchise agreement might be viewed as a modified form of an anticipated profit split (i.e. for a particular franchise project the franchisor receives a revenue based franchise fee and bears its own costs/risks with respect to the business format and broader brand franchised, while the franchisee retains the remaining revenues and bears its own costs/risks of the business operating under franchise). The reason we refer to this as a modified form of anticipated profit split is because, in direct terms, only the anticipated profits of the franchisee are considered –and it is thus strictly a one-sided method-but the required rate of franchise fee will reflect both marginal cost assumptions and required rates of contribution to profit.

(4) *Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarised?*

We believe that the strengths and weakness of the transactional profit split method of actual profits are appropriately captured and summarised. We do however have some hesitation concerning the more general comments made in paragraphs 12 and 14 concerning

transactional profit splits generally (i.e. including transactional profit splits of anticipated profits). That is because, in our view, the category of transactional profit splits of anticipated profits is a broad category which, to a greater or lesser degree, underpins or contributes to other methods and analysis (both third party and related party analysis- which we understand to be the logic of the value chain analysis considered in paragraphs 24 to 27). It will therefore encompass or underlie pricing methodologies where third party comparables are available and used (either directly as a CUP reference in the franchise example above or indirectly where a comparable is available for use in a transactional net margin method).

In these circumstances the comments made in paragraphs 12 and 14 are therefore perhaps too broad when applied to transactional profit splits based on anticipated profits. We can see that they have some justification where that is the primary method adopted, but even there we suspect that, for the reasons given above, there will generally be some form of independent reference point. This may perhaps enhance some of the perceived strengths, or alternatively mitigate some of the perceived weaknesses, of a profit split based on anticipated profits.

(5) *Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses? If so, what are they?*

We refer to our comments in response to question 4. A more general comment however is that their relative strengths and weaknesses will depend on the context in which they are being considered. We do believe that, as a general matter, the two approaches will be alternative approaches to a given set of circumstances which may be more or less appropriate depending on the specific facts. Thus, depending of the level of integration, one approach will generally be more appropriate than the other. Equally, as indicated, we view the anticipated profit method as providing a much broader analytical role in support of other methods, rather than just acting as the primary method in a given case.

(6) *The discussion draft introduces the sharing of economically significant risks as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method.*

- 1. *Do commentators have any suggestions for clarifying the role of risk sharing in this context?***
- 2. *Do commentators find the draft helps to clarify the circumstances where the transactional profit split is the most appropriate method? Please provide explanations and/or examples supporting your views.***

We find the concepts and draft guidance in relation to risk sharing relatively clear in the draft. As indicated in our summary comments there might perhaps be benefits from giving an overview – in terms of the integration spectrum we referred to- to help explain where a transactional profit split based on actual profits is appropriate, and where alternative methods, including those using, or underpinned, by consideration of anticipated profits are more appropriate.

(7) *The discussion draft notes that a transactional profit split of anticipated profits can be used in conjunction with certain valuation techniques. Examples showing the application of a transactional profit split of anticipated profits are sought.*

We see this type of approach as appropriate in circumstances where an existing business format or brand is to serve as the platform for modification or further development to meet

the needs of a new market, or to help fill a gap in that market. Anticipated profits of the developer can be used in conjunction with valuations of the platform IP arrived at using Chapter VI methods, to determine a suitable development royalty or alternative compensation to be paid by the developer to the owner of the platform IP.

- (8) *Is the distinction between parallel and sequential integration of business operations a useful refinement in determining when the transactional profit split method is likely to be the most appropriate method.***

We do find this distinction a useful explanatory tool –although more as a form of hallmark than as a determining criteria. As set out in our summary comments we understand the key determining criteria to relate to the degree of integration –with a transactional profit split based on actual profits only being appropriate where there are very high degrees of integration. That level of integration (as a generality) is more likely to be seen in respect of parallel processes rather than sequential processes.

- (9) *If so, how should the concept of parallel integration be further defined?***

We see limited need for further definition. The only significant addition would perhaps be to modify the paragraph 21 sentence to say ‘In contrast, where parallel integration occurs, multiple parties to the transaction may be involved in the same stage of the value chain in such a way as to effectively conduct that stage as a joint enterprise’.

- (10) *Comments are invited on the relationship between the making of unique and valuable contributions by both (all) parties to a transaction, and the sharing of economically significant risks.***

We see the making of unique and valuable contributions as a hallmark which will often be present where there is a joint enterprise of a form which may make a transactional profit split based on actual profits the most appropriate method. By virtue of making such contributions each party will in some fashion be putting its contribution at risk and will need to protect it. That may however be achieved either by jointly participating in the combination and exploitation of those intangibles (i.e. so that there is a two way sharing of risks) or by one party playing the active role in the combination and exploitation of those intangibles while giving appropriate protection to the other with respect to the intangible which it has contributed. In the latter case there is not a full sharing of economically significant risks.

- (11) *Are there situations where all the parties make unique and valuable contributions to a transaction, but they do not share the economically significant risks associated with the outcomes of that transaction? If so, what guidance on the appropriate use of profit splits in such a situation should be provided?***

We refer to our comments in relation to question 10 which include a type of circumstance in which there is not full sharing of the economically significant risks associated with the outcomes of that transaction. In our view the use of a profit split based on actual profits would generally not be appropriate in this circumstance; the use of a method based on a profit split using anticipated profits (defined in accordance with our comments above) is likely to be a more appropriate method

- (12) *The Final BEPS Report on Actions 8-10 noted that group synergies were to be addressed in the guidance on profit splits. The approach taken in this discussion draft is to make***

reference to the incremental or marginal system profits arising from the group synergy, which would then be shared amongst the relevant associated enterprises. The analytical framework suggested in the draft, based on accurate delineation of the actual transaction, would not support the combining and splitting of total system profits on the basis of group synergies alone. Comments on this point are invited.

Whereas some of the concepts of contribution and joint exploitation relevant to transactional profit splits may be applicable to group synergies, that seems to us to be a distinct topic. Transactional profit splits will generally need to be considered in relation to a narrow joint project or enterprise which forms a component part of a multinational group's business or value chain. Whereas the degree of integration necessary to consider a transactional profit split may be present where a small number of parties are involved, it would be quite extraordinary for it to be present on a wider scale. In contrast group synergies arise as a result of a much lower level of co-operation or co-ordination across a much broader range of parties with respect to complementary aspects of distinct projects and businesses. This will for example arise in relation to matters such as procurement or as a result of matters such as functional efficiencies of scale which can be exploited via things such as shared back-office functions. These involve a co-ordination of activities but typically involve a form of delegation or sub-contract rather than joint control.

- (13) *Does this section properly describe a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit split method is appropriate.***

We believe that the section does achieve that purpose. It seems to us to be most relevant however to the identification of where and how a transactional profit split method based on anticipated profits may play a role in analysing or sense checking the methodologies actually used at each stage in the value chain. For the reasons discussed in relation to question 12 it seems highly unlikely that a transactional profit split method involving multiple parties across either a full value chain, or an extended part of it, would be an appropriate primary method.

- (14) *If commentators see a value chain analysis as serving a greater purpose in relation to profit splits, then please provide an explanation of that view together with examples.***

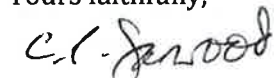
We refer to our comments in relation to question 13, which set out our view as to the primary role of a value chain analysis.

- (15) – (18)**

We have no comments to make in respect of these questions.

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

Yours faithfully,



C.P. Garwood
Head of Tax



**Irish Tax
Institute**

Leaders in Tax

Irish Tax Institute

Response to OECD Discussion Draft: Revised Guidance on Profit Splits

5 September 2016

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 Revised Guidance on Profit Splits, released for commentary on 4 July 2016. We prepared this submission with consideration and input from a number of our members.

Introduction

The relevant Discussion Draft on profit splits builds upon the consultation paper on profit splits issued during the BEPS project. The current draft contemplates modifications to Chapter II of the OECD Guidelines, which set the circumstances where the profit split method can be applied. The release of a follow-on paper on the profit split method in relatively short order is a notable achievement. Recognising that consensus has yet to be reached on the revisions to Chapter II, we strongly encourage continued progress and debate.

On this latest draft, the OECD has asked for input on 18 questions linked to the technical application of the profit split method under appropriate circumstances. We provide general comments on the matter of profit splits as well as comments and suggestions on targeted sections of the Draft. Together, our submission will cover what our members feel are the most critical questions that the Discussion Draft has sought input on.

A. General comments

Profit Split (PS) method as one of last resort in most cases

The revisions already made to the OECD Guidelines under BEPS Action 8-10, and those sought by this Draft, place focus predominantly on the PS method. None of the other four methods have received such attention in this process (*albeit some attention on the CUP method vis-à-vis commodity pricing*). In an environment where Country by Country Reporting will illustrate the global distribution of profit, it is a real expectation by taxpayers that certain tax authorities will seek to use new guidance on the PS method to apply it under examination in inappropriate circumstances. As such, these revisions to Chapter II, following the prior consultation draft, may lead to the unintended consequence by the OECD of the incorrect application of the PS method. It is critically important to clarify in the Guidelines, yet also work closely with WP6 delegates, that the proposed revisions shall in practice apply in rare circumstances and the new narrative should not bias toward the PS method.

The PS method is only applicable if, through a proper functional analysis under Chapter I, the actual transaction exhibits the minimum standard attributes specified by the Discussion Draft (e.g. unique and valuable contributions by more than one party). It would be helpful for the final guidance to contain at least one detailed example per attribute, to more specifically refine those circumstances that could qualify for the application of the PS method.

Acknowledgement of role of contracts and control over risk to set prices

Chapter I acknowledges that contractual arrangements serve the purpose to define the role performed by an entity and whether such entity assumes a specified risk, in connection with a transaction. Chapter I recognises that the contract is the designated starting point for a thorough functional analysis, whereby the contract (and its allocation of risk) is respected so long as the functional analysis supporting the contract is a representation of the conduct of the parties. The Discussion Draft focuses exclusively on the role of actual functions, risks and assets (in absence of control functions, financial capacity to assume risk and contracts), except for the small consideration in pgh 10.

The references to Section D of Chapter I, in this context, needs greater explanation with specific reliance on the role of contracts, financial capacity as well as the important control functions that lead to the appropriate allocation of key risks amongst the parties. In addition to the narrative in Chapter I, the guidance on the PS method should contain customised rules to identify the limited circumstances where the contract may be overridden by the parties' actual conduct, with respect to their sharing of risk.

Recognition of purpose to either set or test a transfer price

Transfer pricing analyses and methods are frequently used for either setting “*ex-ante*” pricing of a transaction or testing “*ex-post*” pricing or financial results of the set price. Either use of a transfer pricing method is appropriate. The Draft lacks due recognition on the distinction, and the principle of how arm's length parties would arrange and monitor their transactions. It is conceivable that *ex-ante* prices are based on a split of anticipated profits whereby *ex-post* results are tested on actual results. Both can in theory be valid applications of the profit split method, despite the same facts and circumstances.

The Guidelines should contain guidance on the application of PS in to both contexts. In particular, we would expect that it is not necessary for the same method to be used for setting and testing the same transaction.

Relevance of actual or anticipated profits (or a variant therein)

The OECD Guidelines should consistently advocate that the related party arrangements reflect how arm's length parties would be agreed. That principle should more clearly extend to this issue. The underlying business and transaction at issue are frequent indicators of how arm's length parties will agree on pricing.

The scene setting (particularly in pgh 2) suggest that the anticipated PS has limited application. We believe this is an inappropriate interpretation, as the splitting of anticipated profits would be more readily observed amongst arm's length parties as the basis to establish the price of certain transactions (e.g. sale of an asset or a fixed royalty percentage). Based on input from our members, it is rare for arm's length parties to retroactively re-price a transaction based on actual outcomes. At most, the actual profits would lead them to re-negotiate prices for future transactions. A PS of actual profits will nearly always require a 'true-up' on the price of a transaction at year end, as actual results rarely equal forecast with specificity. In practice, the split of actual profits should be permitted to fall within a range reasonable outcomes, thus not requiring 'true-ups' by default.

The work undertaken with respect to Hard to Value Intangibles demonstrates that pricing of complex transactions or arrangements may not fit squarely as wholly fixed or wholly contingent. Consideration can, in theory, be provided to whether transactions are priced based on anticipated profits (or losses), with appropriate provisions to address unexpected outcomes. For instance, a fixed royalty rate may have been set based on forecast profits. However, if the licensee earns no profit or even a loss (prior to the payment of the royalty) it may be the case that the arrangement should include a provision allowing for the re-pricing of the royalty rate. Franchise arrangements sometimes contain such allowances enabling the licensee as a going concern. Such complex arrangements require foundation in the market, and should apply if the upfront contractual arrangement allocates risk in such a way, and is consistent with Chapter I.

B. Technical comments

C.3 - Selection of most appropriate method

As noted earlier, the revisions focus largely on the splitting of actual profits rather than the method itself. Ideally, the section should contain two sequential parts: (1) determination of whether PS is or is not appropriate, and (2) determination of whether actual or anticipated profits should be split between the parties. To achieve (1), section C.3 should be expanded up front with a more thorough evaluation on the circumstances when the PS is more reliable than the other prescribed methods. This guidance should contain the analytical approach (without examples) to demonstrate where the PS should not be the selected method. The non-contingent remuneration concept in pgh 17 could be expanded upon.

As well, revisions in the introduction C.1 provide useful examples that may better suit in C.3 when choosing which profit split version is most suitable to a set of facts.

- *C.3.1 – Highly integrated operations* - The new guidance appears to define high degree of integration mainly in the context of risks shared, potentially leading to the conclusion that the type and level of integration are key determinants to requiring the PS method. This section requires greater elaboration and deference to the factual control over the core or strategic risks in the value chain, rather than the performance of functions that are highly integrated.
- An assembly line is a highly integrated operation, however, it would be unreasonable to assume an individual on the line controls the risks related to his/her role. A broader perspective of the entire line, and its risks, should be evaluated against those responsible for the control of key decisions and operational risks.
- *C.3.2 – Unique and valuable contributions* are defined in pgh 22 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. Greater clarification is warranted on this section given disputes on concepts such as marketing intangibles. This paragraph should be clearer on what is and is not unique AND valuable. For instance, when a similar contribution is made by someone else (whether controlled or uncontrolled), then the contribution ceases to be unique. Reference should also be made to Chapter VI, in that the intangible of relevance must be capable of being owned and controlled, which is normally not the case for marketing intangibles.
- *C.3.4 – Value chain analysis* considers the role of the VCA in delineating the transaction in the context of PS. However, delineating the transaction is required for all methodologies. It seems most appropriate to relocate the observations on the VCA either to supplement Chapter I. Chapter II could then refer to this wider guidance on how the VCA might impact the selection of the method.

C.4 – Guidance for application

- *C.4.3 – different measures of profit* makes clear that the choice of which profits to be split shall consider the nature of the transaction, with regard to the degree of integration of activities and risks shared. As the nature of integration and risk sharing can vary, we suggest the terms of gross or operating profit oversimplifies this exercise. For instance, the parties may only be integrated with regard to half of their operating departments. This might suggest profits should be split somewhere between gross and operating profit. Hence, it may be advisable the analyses places greatest effort in identifying the costs and expenses associated with the nature of integration and risk-sharing, and it is the profit after deducting those costs and expenses which is most reasonable to split between the parties.
- *C.4.5 – profit splitting factors* - Pgh 52 provides examples on whether adjustments may be required in order to factor “external” costs (or benefits) into the PS factors, i.e. higher compensation costs in one country vs. another. In order to appropriately align with the Chapter I analysis, however, the factors should measure costs in which are under the control of the relevant parties and not simply reflect a cost paid for by the parties.
- Furthermore, relative value can be most reliable when the same commercial drivers are employed by the relevant parties to the PS (e.g. a global trading function). The reliability weakens when one must relatively weigh two distinct commercial drivers in a business e.g. R&D vs. procurement.

- Reference to location advantages as a driver of profit can be misleading. We strongly suggest this example is clarified and that the location advantages must be controlled by the relevant party and unique to the organisation.
- *C.4.1.2 - Residual profit split method* – When the residual PS method is applied, the routine contribution of the analysis typically relies on other methods (TNMM, Cost Plus Method or Resale Price Method). Pgh 34 addresses this approach solely in context of a split of anticipated profits. If multiple parties exhibit the characteristics necessary for the PS method to apply, then the split of actual residual profits may be necessary as well.

C.2 – Strengths and weaknesses

Section C.2 remained completely unchanged, although some commentary on the issue is discussed in Section C.1 particularly on anticipated vs actual profits. Given the revisions place a great emphasis both concepts, it would be advisable to expand C.2 for each of them.

The Tax Treaties, Transfer Pricing and Financial transactions Division
Organisation for Economic Cooperation and Development

Accounting & Tax Committee
Japan Foreign Trade Council, Inc.

**Comments on Discussion Draft on BEPS Actions 8-10
(Additional Guidance on the Revised Guidance on Profit Splits)
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 ACTIONS 8-10: Public Discussion Draft on Revised Guidance on Profit Splits” released on July 4th, 2016.

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 (hereinafter referred to as “PS”) method is useful when business operations are highly integrated and reliable comparables are not identified. We therefore basically support the OECD’s efforts to stipulate the detailed guidance with regard to application of the PS method.

Especially, we appreciate that the OECD issued a specific guidance on application of the PS method such that splitting actual profits is not an appropriate transfer pricing method when one of associated enterprises performs only simple functions, only the fact that reliable comparables are not identified does not necessarily form a solid basis for applying the PS method, etc.

However, the draft guidance is still unclear in many points. It is essential that these be

clarified further to ensure consistent application of the PS method.

In addition, as the OECD also indicated the difficulty in application of the PS method in the discussion draft as weakness of the PS method, it is difficult to reach consensus on its application between a taxpayer and a tax administration, or between (among) tax administrations of two (or more) countries. We are concerned that taxpayers might be forced additional burdens, which may unduly harm the competitiveness of taxpayers. We are also concerned that the difficulty in applying the PS method leads to inefficiency of tax enforcement.

Therefore, the PS method should be applied in cases where each party to the controlled transaction possesses unique, valuable, and significant intangible assets and consequently it becomes impossible to find reliable comparables. The PS method should not be easily applied solely because it is difficult to identify reliable comparables with complexity of value chain or business integration.

It is also necessary to clarify that the burden of proof should be imposed on the tax administrations if the opinion of tax administrations differs from that of taxpayers.

Specific Comments

Actual profits and anticipated profits (Q. 1 and 2)

- The situation where the PS of anticipated profits should be applied is unclear. In order to prevent tax administrations from abusing the PS of anticipated profits against taxpayers' intention, the guidelines should set out clearly the cases where the PS of anticipated profits is the most appropriate/not appropriate. For instance, it should be made clear that the PS of anticipated profits should not be applied in cases where only one party has significant intangibles.
- We understand that the PS of actual profits provides solution in cases where business operations of two or more associated enterprises are highly integrated and they share economically significant risks. However, the definitions of "highly integrated business operations" and "sharing of economically significant risks" are not clearly stated, which could unduly expand tax administrations' discretion with regard to application of the PS of actual profits and reduce predictability for taxpayers. Therefore, in order to ensure predictability for taxpayers, the applicability of the PS of actual profits should be clearly indicated such that applying it only when each party to the transaction has significant intangibles and value is created by mutual use of those intangibles. In other words, it should be made clear that the PS of actual profits should not be applied in cases where only one party has significant intangibles

Strengths and weaknesses of the PS method (Q. 4)

We understand that strengths and weaknesses of the PS method are appropriately recognized and summarized. The practical difficulty of applying the PS method is a particularly major weakness, as noted in the discussion draft. That is, (1) deciding the scope of revenue and cost information to be gathered in application of the PS method, (2) how to gather the revenue and cost information (it is doubtful whether the information can be gathered adequately), and (3) taxpayer's administrative and cost burden is expected to increase by the analysis of such information even when the information can be gathered and the PS method is susceptible to many estimates. Moreover, as the discussion draft notes, "in most cases tax administration will not be able to perform the analysis or verify the information without full co-operation from the taxpayer", and we are concerned that a considerable administrative burden will be imposed on enterprises in cooperating with attempts by tax administrations to verify transfer pricing based on the PS method. If the PS method is widely applied, this burden may unduly harm the competitiveness of enterprises in practice. In light of these factors, the PS method should be applied carefully.

Most appropriate method

(Q. 6)

The definition of "risk sharing" should be made clear, otherwise the discretion of tax administrations regarding application of the PS method may be unduly expanded. As noted above, a typical example of "risk sharing" could be defined as each associated enterprise to the transaction possesses significant intangibles and value is created by mutual use of those intangibles; and application of the PS method should be limited to the situation where some significant intangibles are involved.

(Q. 7)

Our understanding is that the PS of anticipated profits requires less "highly integrated business operations" and "sharing of economically significant risks" than the PS of actual profits. However, it is inappropriate to easily conclude that the PS method based on the splitting of anticipated profits should be automatically applied in case where there are no "highly integrated business operations" and "sharing of economically significant risks" between (among) parties to the transaction even if there are no comparables. In other words, if there are no comparables, the most appropriate method should be selected from among transfer pricing methods including other than the PS method.

Value chain analysis (Q. 13)

We acknowledge that a value chain analysis can be useful to understand the actual transactions in some cases. However, there are situations where transactions can be accurately delineated without such an analysis. In such situations, legal obligation for taxpayers to conduct a value chain analysis would put an unnecessary cost burden on them. Therefore, a value chain analysis should not be made mandatory as long as taxpayers accurately delineate transactions. Also, it should be stated clearly that, if a value chain analysis is required, a tax administration has the obligation to explain the necessity of analysis to a taxpayer. (We are concerned about the fact that a certain country legally obliges taxpayers to perform a value chain analysis.)

Profit splitting factors (Q. 15)

- It should be clearly indicated with some examples how Contribution Profit Split Method and Residual Profit Split Method are applied differently.
- Examples should be provided with the same level of complexity as the actual business. For example, questions arise when a contribution analysis concludes that each party of A and B contribute fifty-fifty, but the currency value in the country where A is located is significantly higher than that in the country where B is located, whether it is appropriate to divide profits by fifty percent.

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