

# Base Erosion and Profit Shifting (BEPS)

COMMENTS RECEIVED ON  
PUBLIC DISCUSSION DRAFT

## BEPS Action 8-10

### Revised Guidance on Profit Splits Part II

8 September 2016





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## **Public comment received from Joseph L. Andrus**

23 August, 2016

Tax Treaties, Transfer Pricing and Financial Transactions Division  
Committee on Tax Policy and Administration  
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This letter provides comments on the 4 July 2016 Discussion Draft captioned “Discussion Draft on the Revised Guidance on Profit Splits.” The letter reflects only the personal views of the author. The letter has not been prepared on behalf of or at the request of any business or other organization.

My comments are as follows:

### **Scope of Guidance**

Paragraph 2.115 of the 2010 OECD Transfer Pricing Guidelines provides a very useful statement of the objectives of the guidance in Chapter 2 on the application of profit split methods. It suggests that:

- (i) the guidance on profit splits does not seek to be comprehensive,
- (ii) the valid application of a profit split methodology will depend on the facts and circumstances of the individual case, and
- (iii) the objective in applying the profit split method in each case should be to approximate as closely as possible the split of profits that would have been realized by independent entities in comparable circumstances.

This simple, clear statement should be retained in its present form in the revised Guidelines. The paragraph should be moved up to become the second paragraph in the draft. The edits that have been made to this paragraph in paragraph 28 of the Discussion Draft obscure its straightforward message and should be eliminated, or at least moved elsewhere. The balance of the guidance provided in the Discussion Draft should be made to adhere to the statement of scope and approach contained in paragraph 2.115 of the 2010 Guidelines. Specifically, any new guidance should be illustrative and non-prescriptive in nature.

As discussed below, my personal view is that several portions of the 4 July Discussion Draft are overly prescriptive, unnecessary, inconsistent with the conduct of independent parties in at least some circumstances, and inconsistent with the statement of scope currently contained in paragraph 2.115.

### **Guidance Should Be Based on Experience**

In preparing guidance on profit splits it is important that the Working Party acknowledge that the transfer pricing experience with profit split approaches is mixed. In some types of cases the transfer pricing community has become comfortable in consistently adopting profit splits as the most appropriate method. The experience with global trading in financial instruments and the guidance on that topic adopted in Part III of the 2010 Report on Attribution of Profits to Permanent Establishments is a good example. In some industries, profit split approaches are consistently utilized by business in negotiating arrangements with independent entities. For example, representatives of the pharmaceutical and oil and gas industries have described in earlier OECD public consultations that profit split approaches are often used in negotiating transactions between independent enterprises in their industries. In other circumstances, experience with profit splits has been less rewarding. For example, the guidance at paragraphs 6.150 and 6.151 of the Final BEPS Report on Actions 8 – 10 appropriately highlights some of the challenges and problems that have been encountered in using profit split methods to value partially developed intangibles.

While the potential difficulties and problems of using profit splits in some circumstances should be fully acknowledged in the new guidance, that guidance should not contain broad proscriptions that would have the effect of preventing the application of profit splits in situations where they work well. I encourage the Working Party to carefully consider all elements of the Discussion Draft in light of those situations where profit splits are routinely and successfully applied, so as not to inadvertently prevent the use of such methods in circumstances where they have proven to be most useful.

The new guidance should specifically encourage the use of profit split approaches in situations where businesses in an industry routinely use such approaches in negotiating the terms of similar third party arrangements. This point is elaborated further in the following section.

### **Circumstances in Which Profit Split Approaches May Be Applied**

The draft suggests that profit split approaches should be considered and may possibly constitute the most appropriate transfer pricing method in at least the following situations:

- (i) where the parties “share the same economically significant risks associated with a business opportunity” (para. 16);

- (ii) where each of the parties separately assumes closely associated risks related to a business opportunity (para. 16);
- (iii) where the operations of the parties are so highly integrated that individual transactions are difficult to analyze and price separately (para. 21), and
- (iv) where two or more participants in the value chain make unique and valuable contributions in the form of valuable intangibles, valuable functions, or make other unique contributions (para. 22).

I agree that the presence of any of these four factors should trigger careful consideration of whether a profit split is the most appropriate method, applying in each case the guidance in Part I of Chapter II to select the most appropriate method. What is missing in the draft, however, is a clear statement (i) that none of these factors standing alone dictates the mandatory use of a profit split methodology, and (ii) that the absence of any one or more of these factors does not prevent using a profit split approach if all the circumstances of a particular case suggest that such an approach is the most appropriate method. The draft should include a clear statement that this list (however it may be modified in the final guidance) is not intended to be comprehensive and that all of the facts of a particular case will inform the most appropriate method determination under Part I of Chapter II. As paragraph 2.115 of the 2010 Guidelines states, application of a profit split method “will depend on the circumstances of the case” including, among other circumstances, the feasibility of applying other methods on a reliable basis.

### **Additional Factors Suggesting Profit Split Methods Should Be Considered**

Other items should also be added to the list of factors that may suggest the consideration and / or adoption of a profit split method. Two such additional items are especially important. First, profit split methods may be especially useful where companies operating in the industry regularly use profit split approaches to negotiate prices for similar transactions between unrelated parties. For example, a small biotech firm may discover and patent a compound with pharmacological qualities. Part way through the development process, it may license the patent to a large pharmaceutical firm to take advantage of the large firm’s skills in securing regulatory approvals, its financial resources, and its skills in marketing the fully developed product. The license arrangement may include some combination of a payment of an upfront royalty, a running royalty in the event the product is successfully brought to market, and milestone payments made as the development process moves forward. The ultimate arrangement negotiated will reflect the views of both parties as to how ultimate profits should be split and as to how future development and other risks should be shared. There may be evidence that these types of arrangements in the industry are often based on a profit sharing model, with adjustments to up front payments, running royalties and milestone payments

to reflect particular aspects of the transaction, including the risk sharing appetite of the parties. Other transactions of the same type in the industry may not qualify as CUP or CUT transactions because of differences in the intangibles in question and differences in the perceived risks and target markets. But the general industry approach based on profit splitting may yield significant insight into how a similar transaction between associated enterprises should be priced for tax purposes and may suggest, given the facts and circumstances of the particular case, that a profit split model would be the most appropriate method of pricing the transaction. Hence, industry usage of profit split approaches should be a relevant factor in the most appropriate method determination.

Second, the new guidance in the Final BEPS Report on Actions 8 – 10 suggests other circumstances where profit split methods may be appropriate. The Final Report suggests that there are circumstances where one party will be contractually assigned a risk, and where it will satisfy the control test by making certain decisions. However, other associated enterprises may also perform functions that relate to control of the risk which may be highly valuable and which, the BEPS Report states, should be compensated with a participation in the upside and downside results of the business, commensurate with the contribution to control.<sup>1</sup> In such a circumstance, depending on other factors including the availability or lack of availability of comparables for the outsourced performance of such control functions, a profit split may be the most appropriate method of determining the share of profits required to properly reward the entity to which performance of important control functions is outsourced.

The same point could also be made with respect to those “important” functions related to intangible development which the Report suggests should be compensated by the intangible owner with a share of the returns from the group’s exploitation of developed intangibles.<sup>2</sup> The guidance on profit splits should reference these provisions of Chapters I and VI and note that the division of such “control” and “important” functions among members of the MNE group may call for application of a profit split method under the circumstances of a particular case even if risks are not technically shared (under the risk guidance in Chapter I) or if technical legal ownership of intangibles is not shared.

### **Arbitrary Prescriptive Requirements Should Not Be Imposed**

The text of paragraphs 2 – 10 and 16 - 20 of the Discussion Draft, describing circumstances in which a split of actual profits may or may not be used, is overly prescriptive and is inconsistent with other provisions of the Guidelines. The proposed rules could be read to proscribe the use of profit split methods by governments conducting audits in circumstances where such methods would be

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<sup>1</sup> See, Final Action 8 – 10 Report, para. 1.105.

<sup>2</sup> See paragraph 6.57 of the Final Report.

entirely appropriate and where profit splits based on actual profits may well be the most appropriate method under the circumstances of the case.

Those paragraphs seek to impose three mandatory fixed requirements relating to the application of a profit split method that divides the actual profits earned in the business. As a condition of permitting a split of actual profits, the proposed guidance requires that:

- (i) the method of determining combined profits and the profit splitting factors must be determined *ex ante*;<sup>3</sup>
- (ii) a transfer pricing method based on a split of actual profits may be applied only where, after applying the rules on allocation of risk contained in Chapter I as modified by the BEPS Report, the relevant associated enterprises are deemed to share the same risks of operating the business, or where they separately assume closely related risks;<sup>4</sup> and
- (iii) a profit split method based on a division of actual profits may not be utilized if the only contribution by one of the parties is of an intangible or rights in an intangible.<sup>5</sup>

The propriety of each of these three requirements is discussed below.

- *Ex ante* determinations of profit split factors

The requirement imposed in the Discussion Draft that the method of calculating combined profits and the profit splitting factors must be determined on an *ex ante* basis is unclear at best. On one hand, that requirement could be read to mean that methods of calculating profits and profit splitting factors must be selected on the basis of information that the taxpayer might reasonably have had at its disposal at the time of the transaction. This would presumably mean in a global trading case, for example, that the parties might have had the possibility, at the time of the transaction, of recognizing that relative compensation expenditures, or trader bonuses, or other such items would be relatively accurate measures of relative value creation and profit contribution. Interpreted in this way, the requirement would not insist that actual compensation figures or bonus determinations for future periods would have to be available when the arrangement begins such that a fixed percentage share of profits could be established in advance. Nor would it require a showing that the taxpayer actually used a profit split approach based on compensation, trader bonuses, or other factors to determine the income reflected in its tax return. If the requirement that split factors “must be determined *ex ante*” is intended to mean that reasonable independent entities might have selected these

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<sup>3</sup> Discussion Draft paragraphs 3 and 10.

<sup>4</sup> Discussion Draft paragraph 16.

<sup>5</sup> Discussion Draft paragraph 19.

specific factors based on information available to them at the commencement of the transaction, the requirement might be largely unobjectionable.

Alternatively, the term “must be determined *ex ante*” could be read literally to require that the taxpayer itself must elect to use a profit split method based on actual profits and make actual determinations regarding the split factors and the method of calculating profits before the relevant business operations are carried out. If the requirement is interpreted in this way, it would be highly inappropriate and misguided.

Governments are and should be free to review and, if necessary, challenge taxpayer determinations regarding the most appropriate transfer pricing method, applying the standards of Part I of Chapter II, in any given case. Moreover, in most countries they may do so on an outcome testing basis.<sup>6</sup> Assume, for example, that a US bank conducts a profitable global trading business in derivative financial products through its New York home office and with the assistance of subsidiaries operating in Tokyo and London. The bank books all of its trades in New York and the New York home office contractually agrees to reimburse the London and Tokyo offices for the expenses they incur in connection with the global dealing business, including compensation and bonus expense, but with no profit markup. Assume further that the taxpayer presents no comparables or other evidence that a cost reimbursement method is consistent with an arm’s length outcome.

Under these circumstances, UK and Japanese revenue authorities would likely be justified in challenging the income allocations to their local subsidiaries under transfer pricing principles. In doing so each of the governments could, depending on the facts, be fully justified in determining that a profit split method based on actual profits is the most appropriate method because of the unique and valuable contributions of the highly compensated traders in Tokyo and London, the role of such traders in controlling the most important risks of the business, and the difficulty of determining separate arm’s length compensation for each of hundreds or thousands of transactions occurring each day using any other method.

Obviously, in these circumstances, the UK or Japanese government would not be able to demonstrate that the specific split factors they propose to use were actually determined *ex ante*, at the time of the transaction. Those governments would not have even known of the transaction at that time, and the taxpayer would not have determined split factors since it did not adopt a profit split method. But the government could determine at the time of its audit which factors would yield an economic outcome that reflects the relative contributions to value made by the three entities, an outcome which is therefore consistent with the arm’s length principle, and is consistent with the objective of the profit split guidance to achieve a

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<sup>6</sup> See paragraphs 3.69 – 3.71 of the Guidelines, see also the final sentence of paragraph 2.6 of the 2010 Guidelines.

result that “approximates as closely as possible the split of profits that would have been realized by independent entities in comparable circumstances.”<sup>7</sup>

A prescriptive requirement that the split factors must actually be determined in advance (*i.e. ex ante*) would prevent a government tax authority from ever applying a profit split method based on actual profits unless the taxpayer had adopted such a method. Hopefully the Working Party does not intend to prevent governments from using profit split methods based on actual profits in every case where the taxpayer uses some other method to set or justify its initial prices. It would be extremely unwise to adopt such a blanket prohibition of government use of profit split methods. Any requirement of actual *ex ante* determination of the split factors should therefore be abandoned.

If it is not the intention to prohibit governments from ever using profit split analyses, then drafting clarification is required. In its present form, the requirement that profit split factors must be determined *ex ante* is an arbitrary and confusing requirement that conflicts with existing statements of the objectives of the Guidelines on profit split methods and would prevent governments from applying the most appropriate method rule as it is intended to be applied.

- Sharing of the same or closely related risks of operating the business

A second arbitrary rule reflected in the Discussion Draft requires that the parties share the same or closely related outcome risks of running the business if a profit split method based on actual profits is to be applied. It is true that in many situations where a profit split approach based on sharing of actual profits is the most appropriate method there will be a sharing of at least some of the risks that affect the outcome of the business. That may not always be the case, however, particularly if the Chapter I definition of risk bearing is the relevant definition.

For example, the BEPS Report recognizes situations where one party is contractually assigned a risk, makes some of the decisions controlling the risk, is therefore deemed to bear the risk, but where other decisions related to control of risk are made by other group members. The Report suggests that in these cases, the control activities of the party not bearing the risk can be sufficiently important that that entity is entitled to share in the profits (and perhaps losses) of the business. This outcome is prescribed notwithstanding the fact that the entity performing outsourced control functions does not “bear” or “assume” the risk under the lexicon of the Guidelines. It is difficult to understand how the prescribed outcome of an appropriate sharing in the profits by the entity performing outsourced control functions can be achieved without applying a profit split methodology based on a sharing of actual profits.

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<sup>7</sup> 2010 Guidelines, paragraph 2.115. See also, 2010 Guidelines paragraph 2.6.

The global trading example above may be a good example of this problem. As the booking entity, the New York parent could be contractually assigned profit and loss related risks associated with the positions in the book. The traders in the New York office help to control many of those risks, but so do the traders in Tokyo and London. The Chapter I guidance on risk would suggest that the risks are “assumed” and “borne” by New York under the circumstances of the example, but a taxing authority might well conclude that Tokyo and London should be assigned an interest in profits as compensation because of the important risk control functions performed by their traders. Application of a profit split method based on actual profits has often been utilized as the most appropriate method to achieve the arm’s length outcome in these types of cases. It would be a mistake to prevent the use of such a method in the future by adopting an arbitrary, prescriptive rule requiring risk sharing.

Depending on the specific facts, the biotech license arrangement described above could be another example where a profit split may be the most appropriate method even though forward looking risks related to actual outcomes are not shared in the manner described in the BEPS Report. For example, it is entirely possible (though not always the case) that the licensor would allow the licensee to make all forward looking determinations regarding the course of future R&D activities, dealings with regulators, and the nature of the marketing of a final product. While the licensor bore substantial early stage development risk, in the lexicon of the BEPS Report it would not bear ongoing outcome related risks since it performs no “control” functions regarding those risks after the license transaction. Nevertheless, it could have a significant financial stake in the outcome if it is compensated through milestone payments and increased running royalties based on the actual success of the venture. In these circumstances, the financial structure of a transaction between independent enterprises may well have been negotiated on a profit split basis. Preventing use of a profit split approach in the transfer pricing analysis in a similar transaction between associated enterprises because outcome risks are not shared in the sense described in the BEPS Report could prevent use of the best available comparable data to price the transaction.

- Preventing application of profit split methods based on actual profits where the only contribution of one party is an intangible or rights in an intangible

Traditionally, the contribution of valuable intangibles by each of the parties to a transaction has been the most typical fact pattern justifying use of a profit split approach based on actual profits. Paragraph 19 of the discussion draft, however, reverses what has been accepted practice, stating that “the contribution alone of an intangible or rights in an intangible by one of the parties is not sufficient to justify splitting of combined actual profits of the parties to the transaction under a transactional profit split of actual profits.” It is difficult to understand the relationship between this curious statement and the guidance in paragraph 22 that the presence of unique and valuable contributions, including the contribution of an



intangible, by more than one party does provide a basis for adopting a profit split methodology. It appears that the drafters believe that unique and valuable contributions on both sides of the transaction are insufficient to justify use of a profit split method, and that, in addition to such contributions, a joint sharing of risk is always required. Apparently the drafters believe that the contributor of an intangible may or may not share in the outcome related risks, and thus the contribution of intangibles by each of the parties will sometimes, but not always, permit application of profit splits based on actual results. If that is the intended argument, it could certainly be stated more clearly. Moreover, the argument is probably incorrect, even if it were to be better articulated.

Assume, for example, that an entity develops patented technology related to one key component to be incorporated in a consumer product. It licenses the patents related to that component on a non-exclusive basis to the developer of the consumer product in exchange for a royalty of 10 percent of the net sales of the consumer product. The licensee uses this technology and other technology it has developed in designing the consumer product. However, the licensor has no control (within the meaning of the BEPS Report) over the design of the consumer product nor does it have control over outcome affecting decisions relating to the manufacture, marketing or sale of the consumer product. The licensee makes all relevant decisions regarding such risks.

Under these circumstances, the licensor does not appear to control the outcome related risks associated with the consumer product under the terms of the BEPS guidance in Chapter I, and therefore apparently cannot be said to share such risks. It does, however, have a strong financial interest in the outcome. Successful development and sale of the consumer product by the licensee will increase its return to the technology it owns. If sales are \$1,000 the technology licensor receives royalties of \$100. If sales are \$5,000 it receives royalties of \$500. And if the development of the consumer product is a failure, the licensor receives little or nothing. Notwithstanding the licensor's financial interest in the level of actual profit, the draft would apparently prevent the use of a profit split based on actual profits. The same result would apparently occur even if the licensor were to receive milestone payments that increase its interest in successful development and commercialization of the consumer product, so long as the licensor is not performing the functions that relate to control over outcome risk. However, in at least some cases, as described above, unrelated parties adopt profit split approaches to determine the royalty rates and milestone payments for similar transactions.

Recent changes to the Guidelines have placed a great deal of emphasis on the *ex ante* vs *ex post* distinction. As I am sure delegates recognize, however, those changes have not yet succeeded in providing any clear or consensus view of what facts determine which entity is in control of risks related to the difference between anticipated and actual outcomes, or how the allocation of such risks is to be determined. The fact that the control requirement contained in Chapter I apparently means that an entity can have a strong financial interest in the level of

actual profit without being given credit for bearing risks related to those outcomes raises a serious question as to whether the allocation of such differences has been thoroughly thought through. If the Guidance now adds even greater weight to that undefined distinction by making the choice of method also turn on the details of the definition of risk bearing, the potential for unending controversy and conflict will be extremely high.

Once again, the Discussion Draft makes unsupported, arbitrary pronouncements. While shared risks may be one factor to consider in determining whether a profit split method based on actual outcomes is appropriate when two entities each contribute intangibles, absolute proscriptions regarding method selection, especially proscriptions based on definitions of control over risk that may not fully reflect unrelated party behavior in every case, should not be adopted.<sup>8</sup>

### **Other Comments**

1. The first sentence of paragraph 36 is not always correct. In most instances, the profits to be split are the profits of two or more associated enterprises from their transactions with unrelated parties. Consider, for example, the typical global trading transaction where the profits of an MNE group from trades with unrelated parties are divided under a profit split method between the associated enterprises contributing to the generation of those profits.
2. Paragraph 51 should refer to and be made consistent with the guidance on cost based methods for valuing intangibles contained in paragraphs 6.142 and 6.143 of Chapter VI, as modified by the BEPS Report.

I am of course happy to respond to any questions delegates may have regarding the comments set out above.

Respectfully submitted,

Joseph L. Andrus

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<sup>8</sup> Consistent with the foregoing comments, the suggested changes to the second bullet point in paragraph 29 [2.116] should not be adopted.

September 5, 2016

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

**Comments on the Public Discussion Draft on BEPS Actions 8–10**  
***Revised Guidance on Profit Splits***

**1. General Comments**

Clarifying the treatment of the transactional profit split method is one of the two most important remaining issues of the Base Erosion and Profit Shifting (BEPS) Project in our opinion, the other being the attribution of profits to permanent establishments. We therefore welcome publication of the proposed revisions to the OECD Transfer Pricing Guidelines.

The transactional profit split method is among the OECD-approved transfer pricing methods. It has already been applied by some Japanese companies to transactions with parties in certain countries, including cases where the method was applied based on mutual agreement through a bilateral advance pricing arrangement. The transactional profit split method can help provide greater certainty for taxpayers if they apply the method of their own volition based on sufficient information about a transaction, in a case where its application is appropriate.

Applying the transactional profit split method, though, entails a number of difficulties, especially in terms of accessing information on foreign affiliates, measuring revenue and costs segmented by transaction, and determining an appropriate profit splitting factor. Our experience tells that there is a material risk that arbitrary enforcement by tax administrations could lead to disputes that cannot be resolved even through mutual agreement procedures such that double taxation remains unsettled.

Another concern is that this method involves the notion of allowing the prices of foreign controlled transactions to be determined without using comparables. This notion, which is close to so-called Formulary Apportionment, could make transfer pricing rules based on the arm's length principle ambiguous. It is for these reasons that

we have long voiced concern about unlimited expansion of the application of the transactional profit split method and pointed out that the refinement of guidance on the method is essential.

This Public Discussion Draft suggests that the circumstances to which the transactional profit split method is applicable remain extremely limited. We appreciate this stance. In particular, from the standpoint of continuing to maintain the most appropriate method approach, we support the statement in paragraph 18 that reads, “A lack of comparables alone is insufficient to warrant the use of a transactional profit split of actual profits.” Another important point is paragraph 3, which sets out that, when applying the transactional profit split method, care should be exercised “in order to avoid the use of hindsight.”

Still, the Public Discussion Draft contains multiple issues that require further explanations and/or more examples. Below are our comments on those specific issues.

## **2. Comments on Specific Issues**

### **(1) Splitting of actual profits and of anticipated profits**

The Public Discussion Draft highlights the contrasts between the splitting of actual profits and that of anticipated profits in a clearer way than the current guidelines, with particular emphasis on the splitting of actual profits that is explained in greater detail. Compared to the splitting of anticipated profits, the splitting of actual profits requires a greater degree of risk sharing between parties to a transaction, which arguably makes this approach all the more difficult to apply. If focusing on that effect, emphasizing the clear distinction between the two approaches can be said to be useful.

However, the appropriateness of the example in paragraph 5 is difficult to judge. This example pertains to the splitting of actual profits. The situation depicted is that Company A transfers rights in an intangible to Company B, and vice versa, with the result that each company commercializes a product using these intangibles in combination. However, from the perspective of Japanese MNE groups, which basically develop and own important intangibles at a parent company, transactions of this kind are rarely expected in practice. Also, in view of the manufacturing and sales functions that both Companies A and B appear to fulfil, the application of the transactional profit

split method may not be needed in the first place; rather, other one-sided methods may provide an appropriate solution, depending on the weight of value created by each function.

At the same time, the splitting of anticipated profits requires further guidance. The Public Discussion Draft describes in paragraph 4 the case of a foreign controlled transaction where one party transfers rights in an intangible to the other. It then concludes that the price of those rights is determined by applying to the transferee's anticipated profits the transactional profit split method in conjunction with a discounted cash flow valuation technique. However, it is unclear how the profits are split, including measures to be taken in the event of ex post result deviating from the anticipated profits. As this issue seems to relate to the task of developing guidance on the commensurate with income standard, too, we hope that numerical examples will be provided.

Furthermore, we urge each country to recognize once again the significance of the statement in paragraph 1 of the Public Discussion Draft, which reads, "References to 'profits' should be taken as applying equally to losses." We have seen some jurisdictions take an inconsistent approach to transfer pricing. Specifically, in the case of a MNE group, when the group's profit margin is higher than that of a company under review, those jurisdictions apply the transactional profit split method in order to allocate more profits to the company; on the other hand, when the group operates at a loss or generates lower profit margin than the company, those jurisdictions apply the transactional net margin method so as to ensure minimum profit for the company. Such an inconsistent practice should be refrained from and clearer guidance on this issue would be desirable.

## **(2) Strengths and weaknesses of transactional profit split method**

Paragraphs 11 to 15 of the Public Discussion Draft outline the strengths and weaknesses of the transactional profit split method on the basis of the current guidelines. We consider that the method's weaknesses, especially difficulties in its application, are well summarized. In addition to those outlined, we would like to point out as another weakness that the method tends to cause disputes between taxpayers and tax administrations over the existence of an intangible and the measurement of its value in the transaction. Further, as paragraph 15 rightly states that "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," the method imposes a significant burden

on taxpayers, which should also be recognized anew.

A weakness also exists in that different ways of applying the transactional profit split method in practice could result in considerably different arm's length prices. Precisely because of such deviation risk, the OECD refers to this approach as *transactional*, not *corporate*, profit split method. Attention needs to be paid again to that fact as well.

### **(3) Sharing of risks**

The Public Discussion Draft proposes the "sharing of economically significant risks" by parties to a transaction be regarded as a factor indicating that a transactional profit split of actual profits may be the most appropriate method. Although this concept seems to provide a potentially useful analytical framework, it needs further improvement and clarification.

For instance, paragraph 16 of the Public Discussion Draft could allow broad interpretation of this concept by stating, "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."

Firstly, whereas the paragraph refers to "share the same economically significant risks," all member companies of a MNE group share more or less risks, and what are economically significant risks partly depends on how the facts are interpreted. We are concerned that, if attention is focused on the mere fact that risk is shared, the transactional profit split method may be applied more broadly than it should be.

Rather, if the sharing of economically significant risks takes place to the extent that justifies the application of the transactional profit split method, that situation may be rephrased more specifically as the "sharing of the function of controlling economically significant risks." In that situation, it would be natural that the outcomes of the business activities are shared as well.

Secondly, as to the phrase "separately assume closely related risks," each stakeholder may differently interpret the words "closely related." For example, even if the tax administration of one country considers that the parent's development and manufacturing risks are totally different from the market risk assumed by the

subsidiary, the tax administration of another country may look at the group as a whole and deem the parent and the subsidiary to separately assume closely related risks. Concrete examples of closely related risks need to be given.

Our third concern is based on the fact that companies belonging to the same MNE group naturally share in the outcomes of the business activities. In that context, if the resulting profits or losses are used as the starting point of analysis, tax administrations may readily conclude that risks are being shared. Whereas it is true that latent risks are difficult to identify, guidance should be clarified to ensure that analyses are not solely based on the outcomes of business activities. Clarification is thus needed in paragraph 9 as well that reads, “The division of combined actual profits . . . requires that the parties share in the outcomes of the business activities and risks associated with those outcomes.”

#### **(4) Highly integrated business operations**

Paragraph 21 of the Public Discussion Draft suggests that, when a transaction is part of highly integrated business operations of the parties thereto, there is a possibility for those parties to share significant risks. The paragraph goes on to present the concept of sequential integration and parallel integration in a value chain, concluding that highly integrated business operations are more likely to be the case where there is parallel integration.

Suppose that a parent and its subsidiary have no commonality in the functions performed, the risks assumed, and the assets used, each of the two clearly playing a different role. In that case, sequential integration can be thought to occur in their value chain, including relationships in development and enhancement as well as in manufacturing and sales. In the sense that the application of the transactional profit split method to cases like this would be limited, the distinction between sequential integration and parallel integration is likely to be of some significance.

In some MNE groups, the parent’s business division and an overseas sales subsidiary work together in managing the production, sales, and inventory processes throughout the value chain with the aim of minimizing inventory levels and maximizing earnings. This means that, conceptually, there are cases in which sequential integration and parallel integration coexist. Even in such cases, however, if the contribution of the subsidiary is not deemed equal to that of the parent, the transactional net margin method and other one-sided approaches would remain sufficient to address the

situation.

#### **(5) Unique and valuable contributions**

The Public Discussion Draft states in paragraph 19 that a sharing of risks by parties to a transaction may be accompanied by the making of unique and valuable contributions by each of the parties. Then in paragraph 22, it defines “unique and valuable contributions” as contributions that are not comparable to those of uncontrolled parties and represent a key source of economic benefits.

This definition still leaves room for arbitrary interpretation. An example is the case of a sales subsidiary that performs routine functions only. Even in this case, the tax administration of the country of residence of the subsidiary may assert the existence of a marketing intangible, thereby determining that unique and valuable contributions are made.

In cases like this, it is important not to be quick to rely on the transactional profit split method; instead, the first step should be to examine existence and value of the intangible, and carefully consider the feasibility of using the transactional net margin method or its adjusted versions. We expect the OECD to continue working on the enhancement of the transactional net margin method, including comparability adjustments, while endeavoring to refine guidance on the transactional profit split method.

In the example mentioned above, even if the sales subsidiary does make unique and valuable contributions, it would be a totally different argument whether the subsidiary “shares economically significant risks” (which, in our opinion, should be referred to as “shares the function of controlling economically significant risks”) with the parent. In general, the making of unique and valuable contributions does not seem to correlate positively with the sharing of economically significant risks.

#### **(6) Group synergies**

Paragraph 23 of the Public Discussion Draft reads, “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.” It seems that this conclusion is reasonable.



However, identifying and extracting the marginal system profits arising from group synergies is difficult in practice, especially when those synergies are unquantifiable, qualitative ones. We would suggest that concrete examples be given, particularly on how to allocate such profits to group companies.

#### **(7) Value chain analyses**

The Public Discussion Draft regards value chain analyses as a tool to assist in delineating controlled transactions. We think that paragraphs 24 to 27 explain, to a certain extent, how those analyses relate to the transactional profit split method. However, each company has a different value chain. An MNE's value chain is highly complex in that it includes unrelated parties, rather than consisting entirely of associated enterprises. Attention should be paid to the fact that creating its simple model is difficult.

Value chain analyses require items that are similar to the contents of the master file, as represented by functional and risk analyses of key value drivers. We understand that the Public Discussion Draft does not go so far as to recommend that value chain analyses be mandated in each country. This point should be swiftly made clear since there is a certain jurisdiction that has already put in place the legal requirement.

#### **(8) Profit splitting factors**

We welcome expanded guidance on cost-based profit splitting factors. For example, with regard to the risk-weighting of costs, paragraph 51 indicates that risks at the development stage are higher than those at the improvement stage. This is consonant with what manufacturers actually feel in business settings.

The remaining issue of this section is to provide examples of calculations for weighting risks, adjusting employee compensation costs, and allocating location savings. Such examples are particularly needed on the issue of location savings, because paragraph 52 states that "the manner in which independent parties would allocate retained location savings would need to be reflected in the profit split." Without concrete guidance on how to treat location savings including in comparability analyses, the interpretation could vary from one country to another.

Sincerely,

Subcommittee on Taxation  
KEIDANREN

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

From KPMG International ("KPMG")

CC Manal Corwin, Stephen Blough, Prita Subramanian, KPMG in the U.S.

Date September 5, 2016

Ref

### Comments on Profit Split Discussion Draft

KPMG International ("KPMG") welcomes the opportunity to comment on the OECD's Discussion Draft titled "BEPS Actions 8-10: Revised Guidance on Profit Splits" (the "Discussion Draft").

#### General Comments:

KPMG commends the OECD for engaging the business community in the drafting of guidance on profit splits. A key point made by KPMG and other commentators in response to the first discussion draft on profit splits was that the new guidance should not introduce an effective bias in favor of the transactional profit split method and against other methods. KPMG appreciates the OECD's attempt to take a more balanced view of the transactional profit split method in the Discussion Draft, discussing both strengths and weaknesses of the transactional profit split and describing situations where profit splits might not be appropriate in addition to situations where they might. The Discussion Draft's clarification that a value chain analysis is a tool for evaluating a transaction, and need not be followed by the application of a profit split approach, is also helpful.

KPMG has the following key comments on the Discussion Draft, which are discussed in greater detail later:

- The absence of any discussion of contractual arrangements in the Discussion Draft is notable. The Discussion Draft makes numerous references to the sharing of risks in the context of an actual split of profits, without ever referencing the role of contracts in the allocation of risks. Chapter I, on the other hand, does explicitly discuss the role of contracts in the allocation of risks. Under Chapter I, where two or more parties to the transaction exercise control over a risk and have the financial capacity to bear risk, then the contractual allocation of risk between them will be respected. The profit split guidance should make the role of contracts in the allocation of risks clear and should not overwrite or give the appearance of overwriting the guidance already provided in Chapter I on the role of contractual allocations of risk.
- The discussion on actual versus anticipated profit splits could be improved by making it less expansive. In practice, it is unusual for unrelated parties outside the financial services industry to set prices using a split of actual profits unless they are participants in a joint venture or a partnership. Further, in some jurisdictions a split of actual profits could be deemed to create a partnership for tax purposes, with potentially complex tax consequences unrelated to transfer pricing. A split of actual profits constitutes a very specific risk allocation, quite different from that of a split of anticipated profits, which must be analyzed under the guidance of Chapter I. The discussion draft should clearly distinguish the recognition of an

September 5, 2016

actual profit split when the parties have agreed to such contractual arrangement, and the imposition by tax authorities of an actual profit split when disregarding the parties' contractual arrangement or in the absence of a contract. The draft should make clear that the latter case would require establishing factual conditions economically similar to the circumstances of a partnership or joint venture.

- The Most Appropriate Method discussion should place greater emphasis on the relative reliability of alternative methods. While this is implicit in paragraph 18, it should be stated explicitly. Section C.3 should be expanded to list factors that may affect the reliability of a transactional profit split method. For example, paragraph 39 refers to the complexity of the determination of profits to be split as a factor potentially affecting the reliability of a transactional profit split method.
- The financial services sector has characteristics that make the guidance in the Discussion Draft of particular concern. The Discussion Draft makes no acknowledgment of the unique characteristics of the financial services sector. We recommend that any revisions such as proposed in this Discussion Draft in respect of appropriateness of profit split methods are explicitly stated not to apply to financial services businesses. At the very least, the guidance should explicitly link back to Chapter I's discussion of financial services or include a statement such as in Chapter I specifically for financial services transactions.
- KPMG has comments on specific paragraphs in the Discussion Draft that are discussed at the end of this letter.

#### **Specific Comments:**

##### ***Role of Contracts***

The Discussion Draft is notable in its lack of discussion of contractual arrangements. The Discussion Draft makes numerous references to the sharing of risks in the context of an actual split of profits. However, the discussion of risks is centered around activities and functions, with no mention of contractual arrangements. For example, paragraph 6 says "...combining the profits of each associated enterprise under a transactional profit split of actual profits requires a high level of integration of activities." Similarly, paragraph 11 says "...circumstances in which the accurate delineation of the actual transaction shows that two or more associated enterprises undertake activities involving the sharing of economically significant risks." As another example, paragraph 22 says "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."

A split of actual profits allocates risks quite differently than a split of anticipated profits, and both allocate risk differently than various alternative bona-fide arrangements that might be contractually agreed. Therefore, any determination regarding the use of a split of actual profits, or of anticipated profits, or some other method must follow the six-step analysis laid out in Chapter I of the Guidelines (1.60 ff.).

By failing to take into account the Chapter I analysis, the Discussion Draft may leave a tax authority with the erroneous impression that the sharing of significant risk control functions or other related activities, without any consideration of contractual arrangements, is sufficient for

concluding that a profit split is appropriate. Instead, the OECD should provide guidance on the application of Chapter I principles to consideration of profit split methods. Such guidance would distinguish (a) circumstances where a contractual split of actual or anticipated profits should be respected based on conduct of the parties, (b) circumstances where alternative contractual arrangements, such as one-sided risk allocations, should be disregarded in favor of a split of actual or anticipated profits, and (c) circumstances where a split of actual or anticipated profits should be imposed where contractual arrangements are lacking.

The profit split guidance should make the role of contracts in the allocation of risks clear and should not overwrite or give the appearance of overwriting the guidance already provided in Chapter I on the respect for contractual allocations of risk.

### ***Actual versus Anticipated Profits***

While the Discussion Draft devotes significant space to discussing the split of actual profits in comparison with the split of anticipated profits, this discussion is often unclear. The discussion could be improved by making it less expansive.

As noted above, a clear distinction should be drawn between cases where a split of actual profits is contractually agreed between the parties, and cases where such a split could be imposed by tax authorities despite different or non-existent contractual arrangements. In either case, careful adherence to the guidance of Chapter I is essential.

Where the parties have contractually agreed to a split of actual profits, that arrangement should be respected as long as the criteria of Chapter I regarding conduct, control, and financial capacity to assume risk are satisfied. Conversely if the parties have agreed to some other contractual arrangement, a split of actual profits should be imposed only when (a) the agreed contractual allocation of risk must be disregarded under Chapter I, AND (b) allocation of risk under Chapter I determines that the parties should be mutually allocated shared *ex post* risk, AND (c) a split of actual profits is determined to be the most appropriate method to determine an arm's length result. KPMG notes that use of actual profit splits between unrelated parties are relatively unusual outside of partnership arrangements, and further that splitting of actual profits may lead to other significant tax implications. The following points are some specific issues related to the discussion of anticipated versus actual profit splits.

The OECD's "actual" profit split triggers concerns that the transaction would in fact be treated as a partnership.

In practice, it is relatively unusual for unrelated parties outside the financial services industry to set prices using a split of actual profits unless they are participants in a joint venture or a partnership. On the other hand, unrelated parties that are not involved in a partnership or a joint venture often do take into consideration their respective perceptions of anticipated profits when entering into a transaction, i.e., they consider the split of anticipated profits when setting the price for a transaction.

Further, in a number of jurisdictions, a contractual split of actual profits could be deemed to create a partnership under local tax rules, with resultant tax impacts and risks having nothing to do with transfer pricing.

For example, in the United States, it is not necessary to form a legal entity to establish a separate taxable entity. Instead, a mere contractual arrangement among two or more parties may create a separate entity if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.<sup>1</sup> If such an arrangement rises to the level of a separate entity, it is generally treated as a partnership in the absence of an election otherwise. In determining whether a person is a partner in a partnership (rather than a participant in some other type of contractual relationship), the US Internal Revenue Service and courts generally have found one factor—namely, whether the person retains a proprietary interest in the net profits and an obligation to share losses of the organization—to be the most important.<sup>2</sup>

Once an arrangement is treated as a partnership for U.S. tax purposes, each nonresident partner is considered to be engaged in a U.S. trade or business, and thus subject to direct U.S. taxation, if the partnership is considered engaged in such a trade or business. Furthermore, the ramifications for each U.S. taxpayer may be complex. For instance, a partnership return must be filed with respect to the contractual arrangement, and the income, gain, loss, and deduction therefrom must be allocated among the participants by applying the sometimes complex rules applicable to partnerships for federal tax purposes.

Thus, not only is a split of actual profits relatively unusual between unrelated parties unless the transaction relates to a partnership or joint venture, the use of a profit split arrangement may increase the risk that a tax authority will impute a partnership or joint venture where the parties do not intend to engage in one.

The discussion makes no distinction between setting and testing prices.

Taxpayers and tax authorities use transfer pricing analyses for broadly two purposes – setting prices and testing prices. Setting of prices refers to the method used to determine the actual prices charged in the transactions between the parties. Testing of prices refers to the use of a method used after the fact to examine consistency of the prices with the arm's length principle, often by establishment of an “arm's length range” and determining whether the prices charged (transactional methods) or resulting profits (profit methods) fell within that range. The Discussion Draft does not distinguish between the setting and testing of prices in its discussion of actual versus anticipated profits. Particularly related to the concern that an intercompany arrangement might be deemed to create a partnership if an actual profit split is used to set prices, the OECD guidance could note that different approaches may be appropriate for setting and testing prices. For example, Chapter VI discusses the potential to consider actual (*ex post*) profit results as evidence on the appropriateness of anticipated (*ex ante*) pricing arrangements.

The anticipated versus actual profit split discussion seems to be conflating two different concepts – the determination of “system” profits to be split and whether the system profits being split should be “actual” or “anticipated.”

Paragraphs 4 and 5 of the Discussion Draft respectively define a split of anticipated profits and a split of actual profits.

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<sup>1</sup> See, sections 761( a) and 7701(a)(2).

<sup>2</sup> See, e.g., *Federal Bulk Carriers, Inc.*, 66 T.C. 283, 292 (1976), *aff'd* 558 F.2d 128 (2d Cir. 1977) (stating that the “central feature” of a joint venture between parties is “a proprietary interest in the net profits of the enterprise coupled with an obligation to share its losses.”); PLR 199911033.

In defining a split of anticipated profits, paragraph 4 states that the profits to be split are “the anticipated profits of *an* enterprise resulting from its own contributions and also from those made by an associated enterprise” (emphasis added). An example is provided illustrating this concept.

In defining a split of actual profits, paragraph 5 states that “the profits of the enterprises are *combined* and the respective contributions of each enterprise are used to split the actual profits.” Another example is provided for this case.

The Discussion Draft makes no reference to the possibility of splitting the *anticipated, combined* profits of the two enterprises, nor to the possibility of splitting the *actual* profits of *an* enterprise. No reason is given why these two possibilities are excluded or why any association of the method of splitting profits and the determination of the profit pool is required.

Consider the following example. Suppose, at the beginning of a year, related parties A and B have expected profits of 100 and 200, respectively. At the close of the year they realize actual profits of 120 and 170, respectively. Suppose A owns Technology A and B owns Technology B. The two situations envisioned by the Discussion Draft would be as follows:

- (i) A licenses Technology A to B; or
- (ii) A licenses Technology A to B and B licenses Technology B to A.

It can be inferred from the Discussion Draft that in the first situation where there is a unidirectional license of intangibles, the two parties will split B's anticipated profits (i.e., will split the 200). However, it is unclear why this is the only option – the parties could agree to split either B's anticipated profits of 200 or B's actual profits of 170 depending on their circumstances, including their relative bargaining power and their contractual arrangements.

The Discussion Draft further states that if there is a bidirectional license of intangibles, i.e., A licenses Technology A to B and B licenses Technology B to A, the two parties will first aggregate their combined actual profits (120 + 170) and split that total. However, again it is unclear why that is necessarily the most appropriate approach. If they do combine the profits of the two entities to come up with system profits, why could the parties not agree to split anticipated system profits under some circumstances? Even in the case of a partnership, one partner may be given a preferred return based on expectations rather than a true share of actual profits. It is also unclear why the entities would necessarily aggregate their profits, and why they could not agree to split each party's anticipated/actual profits (e.g., A could get a share of B's anticipated/actual profits and B would get a share of A's anticipated/actual profits.). Finally, it is not clear that the parties would aggregate their profits at all. If each has independent control over the commercialization of the intangibles, for example in the case of regional entrepreneurs, neither party may be willing to share the benefits of its success or to share in the downside of decisions made by the other party over which it has no control. In fact, cross-licenses between third parties are common in situations where the parties are each responsible for profits or losses they generate from employing the intangibles.

The level of integration need not be a determinant of whether actual or anticipated profits are split at arm's length.

The Discussion Draft makes certain presumptions about circumstances under which a split of actual profits will be appropriate as opposed to a split of anticipated profits. It presumes that a

split of actual profits will be more appropriate than a split of anticipated profits when activities are integrated. However, there is no reason why the degree of integration should be linked to whether parties choose to split anticipated or actual profits at arm's length. For example, there could be some partnerships in which actual profits are split, or others in which one partner gets a preferred return and the other gets the remaining profits. This has to do with the contractual arrangement, not the level of integration. As another example, a venture capitalist and a bank may both invest resources or capital in a business. One is paid as long as there is sufficient cash and the other gets the remaining profits. Similarly, one company could develop a pharmaceutical compound and another could develop a delivery system for that compound. Both are necessary and may be highly integrated. But that does not necessarily mean that the two companies share in actual profits – for instance, one may get paid a royalty that is expected to capture half the profits, but which may capture, say, 90% or 10% of profits depending upon actual outcomes.

Some presumptions made by the Discussion Draft in linking integration/sharing of risks and the use of anticipated or actual profit splits appear inconsistent.

In addition to the integration of activities, the Discussion Draft appears to link the choice of actual or anticipated profit split to the sharing of (control over) risks (see, for example, paragraphs 6 and 16). In the example where A contributes intangibles to B but not vice versa, the assumption seems to be that the activities of A and B are not highly integrated and that B controls all commercial risks, thus A should not share in the actual realization of risk. So they split anticipated profits. In the case where A contributes intangibles to B's operations and B contributes intangibles to A's, the assumption is that their activities are highly integrated and both have control over the commercial risks in their combined operations so share in the uncertain outcomes through a profit split.

However, as noted above, using the draft's own logic, the companies could have potentially split A's and B's anticipated profits separately in the situation with the bidirectional contribution of intangibles.

Further, even in the unidirectional intangible contribution example, we could expect A to control risks related to the development and protection of its intangibles. Thus, both A and B could control economically significant risks in this situation. Further, the activities of A and B could potentially be more integrated in the unidirectional license situation than in the bidirectional license situation. For example, if A was developing a pharmaceutical compound that would only be used in a medical device being developed by B, their activities could be highly integrated. On the other hand, if A was licensing a widely-used trademark to B and B was licensing an unrelated technology to A, their activities might not be integrated at all. Thus, the premise of the example regarding integration and the sharing of control over risks (or lack thereof) in the two situations appears flawed.

As another example of the logical inconsistencies in the Discussion Draft, paragraph 10 notes 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." However, if the parties had agreed to a given sharing of anticipated profits in accordance with the guidance in the Discussion Draft and had continued to share in the profits based on their initial agreement, the Discussion Draft in the sentence cited here would appear to suggest that a sharing of actual profits would be more appropriate instead.



### Summary and recommendations

The Discussion Draft should be revised to emphasize consistency with Chapter I, especially with regard to the role of contracts and allocation of risk. In particular, splits of actual and anticipated profits produce substantially different allocations of risk between parties, and both differ from the allocations of risk resulting from alternative bona-fide arrangements that might be contractually agreed. As made clear in Chapter I, any of these contractual allocations of risk should be respected if the criteria regarding conduct, control and financial capacity are met. Particular caution is warranted with respect to requiring a split of actual profits where the parties have not agreed to such an arrangement. In some jurisdictions a split of actual profits could be deemed to create a partnership for tax purposes, with potentially complex tax consequences unrelated to transfer pricing. By including an expansive discussion of when actual profit splits might be more appropriate than anticipated profit splits, the Discussion Draft runs the risk of duplicating or contradicting guidance already provided in Chapter I and creating tax issues unrelated to transfer pricing, such as those associated with partnerships. The guidance on actual and anticipated profit splits could be improved by shortening it to a discussion of the concepts of splitting actual profits or splitting anticipated profits. Which approach will be more appropriate should follow from an accurate delineation of the transaction under the principles of Chapter I, including an evaluation of contractual arrangements, and should simply reference the guidance under Chapter I.

The definitions of splits of actual and anticipated profits in paragraphs 4 and 5 should be changed to eliminate the association with the determination of the pool of profits to be split. The examples provided in those paragraphs do not aid the cause of clarity and should be deleted.

### ***Most Appropriate Method Discussion***

The Most Appropriate Method discussion would be improved by greater emphasis on the relative reliability of alternative methods. Section C.2 discusses strengths and weaknesses of the transactional profit split method and Section C.3 discusses situations in which the transactional profit split might be appropriate and situations where it might not. However, the overarching principle in the selection of the most appropriate method in all situations is the determination of the approach that will provide the most reliable estimate of arm's length pricing given the specific circumstances of the transaction. Thus, the selection of the most appropriate method for a particular transaction involves a relative evaluation of methods. While this principle is implicit in paragraph 18, it should be explicitly spelled out as a principle. Further, at the end of paragraph 39 there is a reference to the complexity of determination of profits to be split, and this should be called out as a reliability factor. In addition, there are numerous data issues around the use of actual profits. For example, data on actual profits may not be available by the time prices are set; the taxpayers may need to make numerous determinations regarding data, such as whether they will use parent company or local GAAP, what happens if the taxpayer acquires a company part way through the year, whether the taxpayer adjust profits downward based on an audit conducted after it has filed its tax return, whether revenue recognition is based on tax accounting or financial statement accounting, how write-offs of corporate assets are treated, whether the financial statement amortization of goodwill is included, etc. The key point is that companies do not often split actual profits at arm's length because they can be very challenging to measure. The profit split guidance should explicitly call out the complexity of implementing a profit split as a reliability factor.

**Financial Services Transactions**

The financial services sector has characteristics that make the guidance in the Discussion Draft of particular concern. The core functions of financial services involve the assumption, transfer and management of different types of risk – risk is effectively their stock in trade. Moreover, financial institutions necessarily transfer risk to achieve benefits of diversification and enable the effective management of those risks. Financial businesses need to centralize risk assumption and management to be capital efficient and to be able to meet potential losses from the risks assumed from the non-financial sector. Further, financial services businesses, because of the key role they play globally in assuming financial risks from the non-financial sector, are highly regulated in regard to the amount of capital they hold, where they hold it, and how they manage their risks.

Chapter I recognizes the unique characteristics of the financial services sector noting in footnote 2 in Section D.1.2.1. “The guidance in this chapter, and in this section on risk in particular, is not specific to any particular industry sector. While the basic concept that a party bearing risks must have the ability to effectively deal with those risks applies to insurance, banking, and other financial services businesses, these regulated sectors are required to follow rules prescribing arrangements for risks, and how risks are recognised, measured, and disclosed. The regulatory approach to risk allocation for regulated entities should be taken into account and reference made as appropriate to the transfer pricing guidance specific to financial services businesses in the Report on the Attribution of Profits to Permanent Establishments (OECD, 2010).” Further, footnote 3 in paragraph 1.70 states “Further guidance will be provided on the economically relevant characteristics for determining the arm’s length conditions for financial transactions. This work will be undertaken in 2016 and 2017.”

Any approach based on splitting profits could have the result of attributing a loss to one of the parties. This is obviously true of a split of actual profits; it is also true of a split based on anticipated profits in the event that actual profits are lower than forecast or the combined activities of the parties gives rise to an overall loss. However, it may be that one of the parties does not have the necessary regulatory permissions to put itself at risk of such a loss, and consequently lacks the financial capacity to assume the loss. At arm’s length, this party would not enter into an agreement which could result in its bearing a loss in contravention of its regulatory licence and for which it does not have the necessary capital. It is therefore essential to take into account the contractual arrangements between the parties, as noted in Chapter I. These arrangements may, for example, shield one party from losses and provide that “the party insulated from losses would not expect such a big share of the profits in profitable years”, as noted at paragraph 195 in Part III of the Report on Attribution of Profits to Permanent Establishments (OECD 2010) (“the PE Report”).

Where, the parties have both the legal and financial capacity to bear losses, the guidance in the PE Report notes that a profit split may be appropriate, for instance in the case of global trading under the ‘integrated model’ between separate enterprises. It is common for the profit split method to be applied for transfer pricing purposes in the financial services industry using actual profits or losses, and this is implicit in the PE Report. One example is the discussion in paragraph 166 of Part III of the PE Report, which discusses the issues surrounding the calculation of the profit to be split including the use of the mark to market basis: financial assets cannot be marked to market by anticipation, only by reference to actual market movements. As

noted earlier in these comments, the use of anticipated profits may be more usual outside the financial sector. However, the decision to use anticipated or actual profits in a profit split for financial services enterprises should be determined according to the facts and circumstances, including contractual arrangements.

The Discussion Draft makes no acknowledgment of the unique characteristics of the financial services sector. For the reasons stated above we recommend that any revisions such as proposed in this Discussion Draft in respect of appropriateness of profit split methods are explicitly stated not to apply to financial services businesses. At the very least, the guidance should explicitly link back to Chapter I's discussion of financial services or include a statement such as the one cited above for financial services transactions.

### ***Comments Related to Specific Paragraphs***

- Paragraph 11 states "...the sharing of significant risks is less likely when one party does not make a unique contribution (e.g., contract manufacturing...)" This statement appears unfounded. To start with, contract manufacturing is a specific type of contractual relationship and does not necessarily say anything about "unique" contributions. The contract manufacturer can ask for an ensured profit even if it owns a unique intangible that means its costs are half of those of its competitors. A company can choose to incur and accept risk even if it does not own intangibles or a company can choose to lock in a certain outcome even if it does own a unique intangible.
- Questions 4 and 5 ask for additional strengths and weaknesses of profit splits. For anticipated profit splits, quality of forecasts can be a reliability issue and thus a weakness, whereas timely availability of financial information could be an issue for actual profit splits.
- Paragraph 16 states that if parties "separately assume closely related risks" they "consequently should share in resulting profits and losses." Nothing supports this conclusion. Risks may be closely related and yet susceptible to separate contractual assumption and actual management. The paragraph further states that "The application of a transactional profit split of actual profits when not supported by the features derived from the functional analysis, for example in cases where other methods are difficult to apply because reliable comparables are scarce, is unlikely to produce an arm's-length outcome since the appropriate use of a profit split is determined by the existence of a specific commercial relationship between the parties." This sentence is unclear and would benefit from additional clarification, including reference to contractual terms.
- Paragraph 18 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." It is unclear why this guidance would apply to the split of actual profits only and not anticipated profits. We suggest rephrasing this sentence to "A lack of comparables alone is insufficient to warrant the use of a transactional profit split method under the arm's length principle."
- Paragraph 22, Question 11 asks if there are 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. Such situations arise often in the real world. For example, an airline manufacturer makes planes, but does not share in the profits or losses of airlines; a shipping company provides logistical services to a number of manufacturers that are critical to getting inputs to their manufacturing plants and their product to market but does not share in profits; a semiconductor manufacturer makes microprocessors, but does not share in the profits and losses of computer makers; an automotive component supplier supplies important components to car companies but does

not share in their profits. Selling a critical component to a business does not mean sharing in the success or failure of that business.

- Paragraph 23 states “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. It is merely necessary to apply an appropriate allocation key to the marginal system profits arising from those synergies.” We agree with this statement and would suggest replacing “marginal system profits” with “marginal system profits or cost savings.”
- Paragraph 32: states “In cases where the relative value of the contributions can be measured directly, it may not be necessary to estimate the actual market value of each participant’s contributions.” While we agree with this statement in principle, we caution that it should not be used by tax authorities to rely on rules of thumb (which would be contrary to paragraph 2.9A of the OECD guidelines).
- Paragraph 40 links the type of risks and the level of profit to be split, i.e., “gross” or “operating” profit. This reads like a limited two-option scenario, when in fact there could be other measures of profits. The types of risks shared (and thereby controlled under Chapter I) by the parties shall indicate the types of expenses to account for in the determination of profit to be split. This shows that a true profit split is not as “easy” to implement as one might assume.
- Paragraph 41 states “Using a profit split based on combined operating profits after all expenses of both parties would have the potential result of sharing the consequences of risks that are controlled by only one of the parties.” We suggest changing it to “Using a profit split based on combined operating profits after all expenses of both parties would have the potential result of sharing the consequences of risks that are not in any way connected to the integrated activities or operations.”
- Paragraph 48 states “...at arm’s length parties may be expected to split profit based on relative contributions.” We suggest replacing the word “contributions” with “contributions and risks” or “contributions adjusted for the assumption of risk” in this sentence. It will be helpful to further qualify this statement by limiting it to contributions of the parties sharing the profits since not all parties contributing to a business need share the profits of the business.
- Paragraph 51 states “A profit splitting factor based on expenses may be appropriate where it is possible to identify a strong correlation between the relative expenses incurred and relative value contributed.” It will be helpful to note that, for instance, €1 spent in France need not be the same as the €1-equivalent spent in China in terms of impact on sales/profits generation – even where there is strong correlation between expenses incurred and value contributed.

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## About KPMG

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 155 countries and have more than 162,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.



**Date:** August 29, 2016

**To:** Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA.

**From:** David R. Jarczyk, ktMINE, CEO

**Subject:** Comment on Public Discussion Draft: BEPS ACTION 8-10 Revised Guidance on Profit Splits

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To Whom It May Concern:

The generally accepted understanding regarding the availability of market data on independent party behavior has been reset. Furthermore, the need to submit fact-based evidence related to independent party behavior has come to the forefront of transfer pricing analyses. Whether part of an industry analysis, a value chain analysis, or the application of a transfer pricing method, the bar has been raised with respect to the information available to answer questions specific to independent parties' handling of 1) functions, 2) risks, 3) unique vs. not unique intangibles, and 4) pricing.

Indeed, there is a critical need to educate transfer pricing practitioners with respect to available market data in order to improve the quality of transfer pricing analysis and, therefore, transfer pricing outcomes. I submit the following revisions for consideration.

Sincerely,

A handwritten signature in blue ink, appearing to read 'D. Jarczyk', with a stylized flourish at the end.

David R. Jarczyk

ktMINE, CEO



## PROPOSED EDITS

Paragraph 43: remove this paragraph and replace with a separate section specifically discussing available sources of information, as follows:

### ***Finding Evidence of Independent Parties' Behavior: Functions Performed, Risks Assumed, Assets Employed, and Pricing***

In order to properly and prudently complete a transfer pricing analysis - including the selection of the most appropriate method, an analysis of industry behavior and trends, and the resulting determination of arm's length pricing - the transactional behavior of similarly situated independent parties provides strong evidence that the related parties' transactions are conducted in an arm's length manner. The use of market evidence of such arm's length behavior strengthens the overall transfer pricing position and addresses questions such as: 1) how would independent parties structure similar transactions? and 2) given the structure, how would independent parties price such a transaction?

Furthermore, under the framework of the OECD's BEPS project, it is necessary to derive definitions for and provide evidence of:

1. routine vs. non-routine functions performed by independent parties within a particular industry;
2. routine vs. non-routine risks assumed by independent parties within a particular industry;
3. how independent parties share and assign functions and risks;
4. unique vs. not unique intangibles within a particular industry; and
5. arm's length remuneration and the pricing mechanisms to achieve such remuneration within a particular industry.

There is an abundance of data and information in the public domain to address many of the points above, and databases exist that have cataloged such data for transfer pricing purposes. This data covers most geographies and most transaction types.

Independent parties' behavior can be researched with respect to the following transaction types:

1. Toll/Contract Manufacturing
2. Cost Sharing
3. Joint Development
4. Sales Agent
5. Buying Agent
6. R&D Services
7. Management Services
8. Back Office Services
9. Procurement Services



10. Distribution
11. Placement Agent
12. Plan of Merger
13. Supply
14. Settlement
15. Software
16. Reseller
17. License of Intangibles
18. Financial Services
19. Cross License
20. Guaranty
21. Credit or Loan
22. Asset Purchase

If the proper definitions of routine vs non-routine functions and risks, as well as unique vs not unique intangibles, has not been addressed, the application of the transactional profit split method or any other method will be unreliable. This research methodology can be considered part of the industry analysis or part of the value chain analysis. In either case, research as to market behavior should be performed to bolster market evidence of independent party behavior and pricing.

**PARAGRAPH 44: Remove the first sentence and replace with:**

Where comparables data is available, it can be relevant in the profit split analysis to assess how independent parties split profits.

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As evidence for the need for the aforementioned edits, there are numerous examples within the discussion draft where the above mentioned research process could be performed. Such research could also be performed when applying other transfer pricing methods.

- Paragraph 7: (“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. However, both parties will generally continue to run their separate business activities, including the assumption of the associated risks in their individual activities, to maximise their individual profits within the parameters set by the terms of the price discount.”) *Market evidence should be analyzed to determine the accuracy of such a statement. Market data exists with respect to discounts, sharing of revenues and profits, as well as the functions and risks performed by both parties.*



- Paragraph 8: (“Although in some cases an uncontrolled party may mitigate its individual risks through agreed variations in prices, this generally does not result in the other party sharing in the outcomes of its business activities or sharing in its risks. Thus, when setting the price for bars of chocolate, the producer may take into account, among other things, the anticipated impact of future changes in cocoa prices on available profits, but the reseller is not expected when buying the products at the agreed price to share in the actual outcomes of the business activities and risks of the producer.”) *Market data exists in the public domain to prove or disprove this statement under a given factual base. One can review reseller agreements in a particular industry, as well as pricing mechanisms with respect to manufacturing input prices.*
- Paragraph 12: (“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.”) *One cannot determine the definition of “unique” without analyzing market evidence. Data exists to answer the question: what is routine vs non-routine in a particular industry?*
- Question 6.1: (“Do commentators have any suggestions for clarifying the notion of risk sharing in this context?”) *As presented above, data exists that can be analyzed with respect to risk sharing, risk profiles, and the definition of routine vs non-routine risks by industry, by transaction type, and by company.*
- Paragraph 27: (“A value chain analysis might usefully provide information about the following aspects of the business activity, relevant to determining whether the transactional profit split is the most appropriate method: The key value drivers in relation to the transaction, including how the associated enterprises differentiate themselves from others in the market.”) *Information is available to determine routine vs. non-routine functions and risks, as well as unique vs not unique intangibles, by industry and transaction type.*



## Public comment received from Lorraine Eden

September 5, 2016

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### **Comments on the OECD's BEPS Public Discussion Draft BEPS Actions 8-10, "Revised Guidance on Profit Splits", issued on 4 July 2016.**

Dear Dr. Hickman:

Thank you for the opportunity to comment on the OECD's BEPS Public Discussion Draft for BEPS Actions 8-10, "Revised Guidance on Profit Splits" (for short, OECD-PSM), issued on 4 July 2016. I would like to offer a few comments on four topics in the draft.

#### 1. Value Chain

The "value chain" is a well-known concept, first developed by Michael Porter in his 1985 book, *Competitive Advantage*, which is now taught in all courses in strategic management in business schools. In Porter's value chain, value-adding activities are divided into two types: primary and support. A firm that in-house performs sequential primary activities in the value chain (e.g. resource extraction and processing or manufacturing and distribution) is said to be "vertically integrated". A vertically integrated multinational enterprise (MNE) typically performs several primary activities in the value chain in-house through majority or wholly owned affiliates, and is said to have "greater vertical scope" or "greater sequential interdependence." The MNE is said to be "horizontally integrated" if it has multiple plants at the same stage of the value chain, for example, multiple retail banking outlets or multiple assembly plants. Most MNEs are both vertically and horizontally integrated to some extent, which international business scholars refer to as "complex integration", depending on the relative costs of doing value-adding activities in-house versus through various forms of non-equity relationships version open market purchases.

In paragraph 21 of the document, the terms "sequential integration" and "parallel integration" are used. These terms are not used in the business school literature on value chains, and I am not sure how they related to vertical and horizontal integration.

The definition of "sequential integration" may be similar to that of vertical integration, but this is not clear to me. Paragraph 21 says that sequential integration occurs when "parties perform discrete functions in an integrated value chain", which could mean activities that are performed at the same stage of the value chain (horizontal integration) but are "discrete." If sequential integration is the same as vertical integration, it might be simpler to use the familiar term.

The term "parallel integration" is also not familiar. The document in paragraph 21 says that parallel integration is defined as "multiple parties to the transaction are involved in the same stage of the value chain." This is clearly different from horizontal integration where different retail banks, for example, or Starbucks coffee shops, may be relatively independent of one another.

I believe the term “parallel integration” may be referring to a situation, for example, where a MNE has four R&D locations, which regularly share scientists, locations and co-develop intangibles together. The related parties pool their assets and resources and all benefit from the innovations that are generated by their combined activities. The four related parties engage in co-development activities that are so interdependent it is not possible to identify or separate their activities. If this is meant to be the definition of “parallel integration,” I recommend shifting to the term “integrated network.” Multinationals, especially from small open economies such as the Scandinavian countries, often structure their high value-adding activities using integrated networks of R&D affiliates to develop new technologies.

## 2. Value Chain Analysis

The term “global value chain” or GVC, on the other hand, refers to all the value-adding activities involved in the production and sale of a particular product or product line worldwide, for example, the mapping of the GVC in coffee or automotive components or footwear. GVCs typically show all the main value-adding activities and the entities (which could range from MNEs and large state owned enterprises to small firms and farmers) engaged in all the stages from inception to final sale.

The term “value chain analysis” (or VCA), which appears in section C.3.4 of the document, is a new term and one that appears to have conflicting meanings at least among business faculty. Performing a VCA could mean, for example, mapping out the global value chain in the footwear industry. Or performing a VCA could mean mapping out the value chain within a multinational enterprise.

Paragraphs 25-27 in the document explain what kinds of information a VCA could “usefully provide”, but do not clearly differentiate a VCA from a functional analysis. I would like to propose that the document be revised to more carefully differentiate between a functional analysis and a VCA, as follows.

A value chain analysis (VCA) is designed to map the value-adding activities involved in a particular transaction (that is, product line or line of business) that are performed by related parties in a multinational enterprise (MNE). A VCA includes a functional analysis that maps the *conduct* of the related parties in terms of their functions performed, assets contributed and risks assumed. A VCA also includes identifying the entity or entities that *control* these value-adding activities (including managerial, operational and strategic control) and the *capacity* of the entity or entities to bear the risks associated with those value-adding activities.

A key distinction between a VCA and a functional analysis is that a functional analysis typically focuses only on the two related parties directly involved in the transaction: the seller (typically, the manufacturer) and the buyer (typically, the distributor); in other words, a dyadic relationship. A VCA, on the other hand, maps out all the activities for all the related parties involved in a particular value chain, with the purpose of identifying the activities and entities within the chain that are likely to be earn above-normal rents, reflecting sustainable competitive advantage. These key sources of economic advantage are likely to depend on three factors: conduct (FAR), control and capacity. The location of significant people functions (SPFs) within the various entities of the MNE group is likely to be a bellwether for determining the location of value-adding contributions to group profits.

### 3. Contributions

The OECD's 2010 *Transfer Pricing Guidelines* for the profit split method and the IRS Section 482 Regulations both recommend that the allocation key for dividing profits among the related parties be based on the parties' contributions. The word "contribution" appears nearly 80 times in the July 2016 draft for the Profit Split Method also, suggesting that contributions of the related parties are an important driver of how related parties should split the profits (whether anticipated or actual).

In the July 2016 document, however, the term contribution appears to be more closely tied to what each of the parties spent (their costs) than to the value of what each of the parties spent. In the 2010 TPG and the Section 482 Regulations it is clear that the transfer pricing policy should be paid on the value of the contributions of the related parties. That value may or may not be closely tied to what each of the parties spent.

For example, three parties might each spend \$100 million on R&D, but only one of the three parties develops a successful commercialized invention. The other two parties spent money with nothing to show for it. How should the profits be split among them? What would independent enterprises have done? Would they have agreed ahead of time to split the profits based on what each of them spent? In that case, an allocation key based on spending would give them each 1/3 of the profits. An allocation key based on inputs, however, encourages each of the parties to spend more since the more they spend the greater their share of the profits, even if their spending is unsuccessful. Independent enterprises would be unlikely to continue contracts that divided their profits based on what each of them spent, ignoring the productivity of their spending.

Both the 482 Regulations and 2010 TPG stress that contribution should be measured not based on what was spent, but on the value of that spending. If costs and value were related to one another, then share of costs would be a practical way to measure each party's relative contribution. However, in cases where costs (inputs) and value (outputs) are not necessarily related –which is typically the case for high value added, risky intangibles – contribution should be measured by estimating the value of that contribution not what was spent.

I would like to see a stronger statement in this document reaffirming that the definition of contribution is in terms of the value added by that function performed, asset used or risk assumed, rather than by the cost incurred. The section on "cost-based profit splitting factors" (paragraphs 51-53) should make the point that using cost is likely to be a less reliable method where costs are a poor proxy for value added. The section on "asset-based factors" should make the point that contribution is to be measured by the value-added by the assets used, which for intangibles may involve estimating projected income from the intangibles. More generally, earlier in the document, a clear definition of "contribution" would be helpful.

### 4. Profit Split Method

My last comment is with respect to the strengths and weaknesses of the profit split method. I believe that a key weakness of the profit split method is that there are multiple steps involved in applying the method. A mistake made at any of these steps can generate compounding errors that can greatly reduce the reliability of the method. This is particularly true for the residual profit split method (RPSM) because it is an "umbrella method" that contains other methods within it.

The basic steps in the RPSM are the following:

1. Determine the transaction or group of transactions to which the RPSM will apply
2. Determine which related parties are involved in the transaction or transactions
3. Determine which costs and revenues are applicable to that transaction or transactions
4. Where some costs or revenues are shared or fixed, determine the share of those costs or revenues that apply to this transaction or transactions and include only those that apply
5. Determine the group profits for the transaction or transactions
6. Determine which functions, activities and risks of each of the related parties can be considered routine functions, assets and risks
7. For each of those routine functions, assets and risks, determine its routine return using one of the other transfer pricing methods (e.g., resale price method, cost plus method, TNMM)
8. Subtract the sum of all the routine returns from the group profits to determine the group residual profit
9. Decide on an appropriate allocation key for splitting the residual profits
10. Apply that allocation key to the residual group profits to allocate them among the non-routine functions, assets and risks
11. Each entity's profit consists of its share of the routine profits plus its share of the Nonroutine profits.

There are 11 steps in this method and a mistake in the top-level decisions should cascade through the lower-level decisions. Mistakes at any of the stages reduces the reliability of the method.

Moreover, this is an umbrella method with other methods hidden within it. Deciding what are routine functions, assets and risks; what methods should be used for each case; and applying those methods (each of which may involve interquartile ranges of its own), suggests the complexity of the decision making involved in this method.

Historically, the profit split method was seen as a method of last resort, primarily because the data involved were based on internal firm-level data and not on outside market-based prices. However, I see the profit split method – particular RPSM, the version most commonly used -- as inherently problematic due to the complexity of the method, the likelihood of compounding errors, and the fact that it is an umbrella method with multiple other transfer pricing methods buried inside.

Thank you for the opportunity to comment on the draft.

Sincerely yours,

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August 29, 2016

Delivered via e-mail:

**Re: Commentary on BEPS Actions 8- 10 – Discussion Draft on Revised Guidance on Profit Splits**

**Mark Bronson<sup>1</sup>**

I appreciate the opportunity to offer commentary on select aspects of the OECD's discussion draft of revised guidance on profit splits ("the draft guidance"). I understand and appreciate the OECD's efforts to align the profit split guidance with the revisions to Chapter I of the Transfer Pricing Guidelines (TPG) that were made in the final BEPS deliverables released in October of 2015. It is clearly the case that the implementation of profit splits on actual profits imposes certain risk sharing arrangements on the parties to that profit split. Given the changes in the TPG with respect to risk allocation, it is sensible that the risk allocations imposed by a profit split, when applied, be consistent with risk allocations under the accurately delineated transaction based upon the guidance set forth and factual analysis required by Chapter 1, Sections D.1 and D.2.

I would like to start by saying I think that WP6 has made very good progress on this draft, and the language crystalizes several important points. In particular, I think that the following points are both correct and of fundamental importance:

- Transactional profit splits applied to anticipated profits and transactional profit splits applied to actual profits are distinct approaches, with different considerations as to their applicability (see below for suggestions for making this point clearer);
- Even when profit splits are to be applied to actual profits, the split that will be applied will be determined based upon ex-ante information.
- The application of profit splits on an ex-post basis is something that is done because it is appropriate to the facts and circumstances of the accurately delineated transaction. It is not something that is done due to the scarcity of available comparables data.

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<sup>1</sup> The opinions expressed in this paper are those of the author and do not necessarily reflect the views of Duff & Phelps as a whole or those of its clients.

Nonetheless, there are areas of the guidance that could be improved or made clearer. The first questions specifically put forth in the guidelines are whether or not the distinction between transaction profit splits of anticipated profits and transactional profit splits applied to actual profits is both (a) clear, and (b) useful. The answer to the second question is undoubtedly yes – as discussed in the draft guidance and elaborated on below, the two different versions of profit splits should address very different concerns, and it is vitally important that the guidance be as clear about those differences as possible.

Recommendations about improvements that could be made with respect to the applicability of the transactional profit split on anticipated profits and on actual profits are discussed further below.

- 1) The current guidance appears to contemplate profit splits of anticipated profits in a wider set of circumstances than are appropriate.

Currently, the guidance mentions situations where more than one party makes valuable and non-routine contributions as “another situation in which the transactional profit split may be the most appropriate method.” I would state that, for the application of transactional profit splits to anticipated profits, this is the **only** circumstance in which such an application is appropriate.

In making this statement, it is important to understand that the use of anticipated profits in a transfer methodology is not always an application of the transactional profit splits to anticipated profits. Methodologies that rely on anticipated profits (such as valuation approaches) where only one party makes valuable non-routine contributions are valuable and important. They are not, however, the application of a profit split to anticipated profits but are rather special applications of a one-sided method.

One could think of valuation approaches in such instances as a multi-period form of TNMM. If one forces these important one-sided approaches to be lumped in as applications of the transactional profit split methods to anticipated profits, the important distinction between anticipated vs. actual profit splits is necessarily murkier than it needs to be. If instead, they are recognized for what they are (i.e. something other than a transactional profit split applied to anticipated profits), and if those types of approaches are therefore not contemplated within the discussion of the transactional profit split applied to anticipated profits, it would more clearly allow the application to anticipated profits to be only in appropriate situations – i.e. when more than one party makes significant non-routine contributions.

If only one party makes unique and valuable non-routine contributions, and if all other parties to a transaction make contributions that can be reasonably benchmarked, then appropriate

methods are necessarily transactional method (like the CUP) or one-sided methods (like the TNMM or its multi-period cousin in some sense – a valuation approach establishing the value of intangibles through reference to the valuation of a residual profit stream).

In Section C.4.1., the draft guidance discusses two commonly used approaches for splitting profits. I focus here on those discussions as it would relate to splitting of anticipated profits.

One is a contribution analysis, whereby the combined profits from the transactions are divided between the associated enterprises based upon “a reasonable approximation of the division of profits that independent enterprises would have expected to realise from engaging in comparable transactions. This division can be supported by comparables data where available.”

In circumstances where only one party makes non-routine contributions, comparables data should be used to indicate the appropriate return to parties making routine contributions. In this instance, one would assign appropriate expected returns to these routine contributions, and anything remaining would necessarily be assigned to the party making unique and valuable contributions. In this instance, the resulting method is not an application of a transactional profit split to anticipated profits, but rather a one sided method using anticipated profits.

Similarly, the draft guidance discusses a “residual analysis” as a type of approach for splitting profits. Under this approach, “where the contributions of the parties are such that some can be directly and reliably valued by reference to comparables, while others cannot, the application of a residual analysis may be appropriate. Under this approach, routine functions are rewarded, and then the remainder is allocated among the parties making non-routine contributions. Where only one party makes such contributions, this method once again reduces to a one-sided method and should not be labelled as a profit split of anticipated profits.

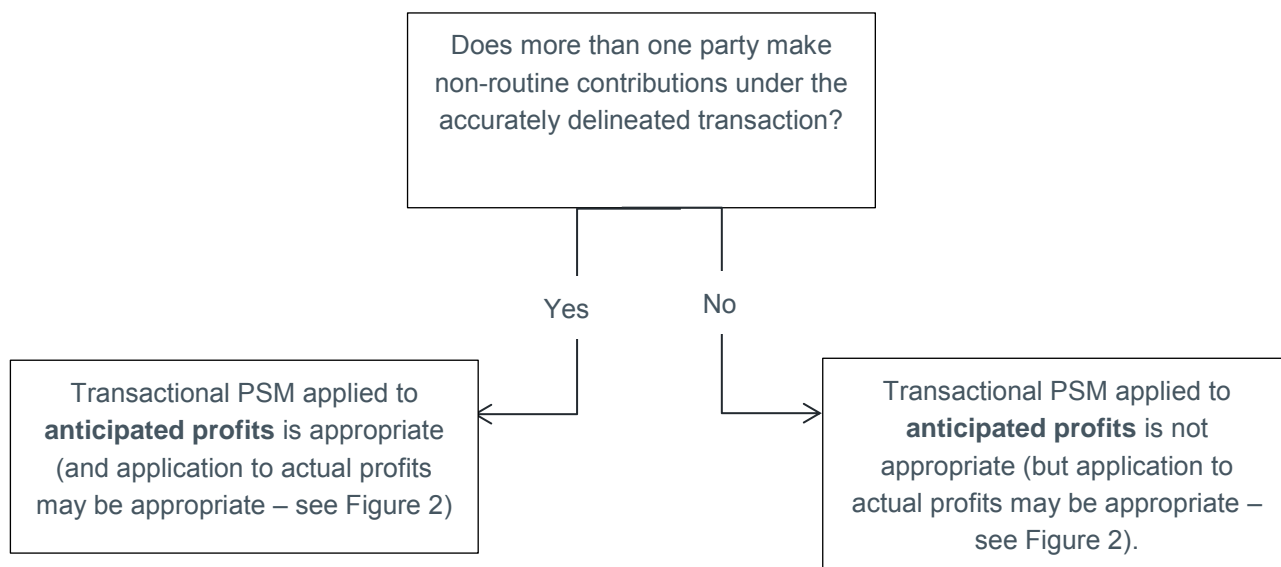
- 2) The current guidance intermingles the discussion of the two profit split approaches – it confuses the distinction between the two approaches in a way that may leave readers confused.

One might think about the appropriate applicability of profit splits through a flow chart or decision tree.<sup>2</sup> I present a very simple depiction of what these flow charts might look like in **Figures 1 and 2** below, based upon what I believe the draft guidance should convey about profit splits:

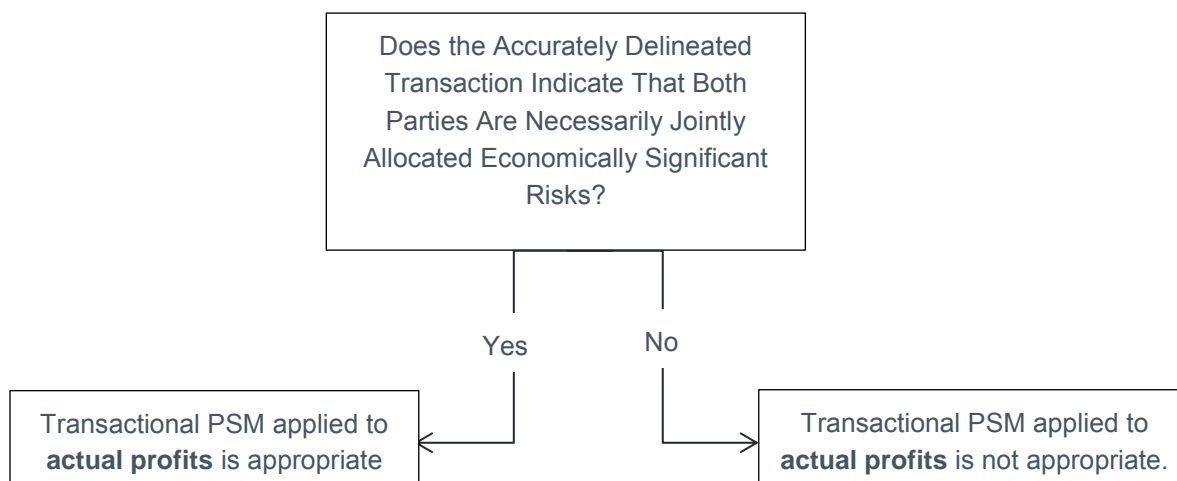
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<sup>2</sup> Please note that in writing about the appropriate application of profit splits, I am taking the principals regarding the allocation of risk for transfer pricing purposes (now embedded in Sections D.1. and D.2 of Chapter I) as a given, without any further commentary on the appropriateness of that guidance.

**Figure 1**  
**Applicability of PSM to Anticipated Profits**



**Figure 2**  
**Applicability of PSM to Actual Profits**



The guidelines try to be clear that there are important distinctions between profit splits as applied to anticipated profits vs. profit splits applied to actual profits. There are places, however, where this distinction is unnecessarily murky. The current draft muddles integration, joint risk assumption, and multiple parties making valuable non-routine contributions. As a



result, the current draft guidance intermingles the two approaches as if they are more related than they should be.

Further down in this commentary I discuss how the focus on integration as a “top box” question is inappropriate. As shown in Figures 1 and 2 above, joint risk assumption and multiple non-routine contributions are distinct considerations, and each only applies to one type of profit split (i.e. anticipated vs. actual profits).

For instance, paragraph 6 in Section C.1 clearly states that “combining the profits of each associated enterprise under a transactional profit split of actual profits **requires a high level of integration of activities.**” In other places, as discussed below, I disagree with this characterization (and think that it should require a joint control of risk), but for purposes of this current point, let’s assume integration was the appropriate necessary and sufficient condition.

Paragraph 11 in Section C.2 states:

“[T]he main strength of the transactional profit split of actual profits is that it can offer a pricing solution in circumstances in which the accurate delineation of the actual transaction shows that two or more associated enterprises undertake activities involving the sharing of economically significant risks. This *may* happen in highly integrated operations in which the parties each perform similar functions, and in some instances share core assets used to produce the income stream....This *may also happen in cases where both parties to a transaction make unique and valuable contributions*, because in such a case independent parties *might wish to share the profits of the transaction* in proportion to their respective contributions.” [emphasis added by author]

I would first note that I agree with paragraph 11 that the transactional profit split applied to actual profits is to be used in circumstances where economically significant risks are jointly shared), but that is distinct from the statement that it “requires a high level of integration of activities.” These two things may be related, but it is not necessarily the case.

The language in paragraph 6 leaves the reader with the impression that if there is more than one party making unique and valuable contributions, it is perhaps necessarily<sup>3</sup> the case that they should perform a profit split on the actual profits regardless of the actual integration of

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<sup>3</sup> I say “perhaps necessarily the case” because this language doesn’t attempt to distinguish between conditions under which parties might wish to share vs. those where they might not. The current discussion therefore potentially creates situations where revenue authorities are left to address the question of what independent parties might or might not want to do in such a situation – a question where a selection of reasonable people could arrive at quite different answers.

the two parties' activities. Any such conclusion would be inappropriate unless risks were jointly shared across the parties under the appropriately delineated transaction.

The language should be very clear about conditions that would or would not lead to a conclusion that a transactional profit split should be applied, and those conditions should not rely on highly subjective determinations as to what parties might or might not wish to do had they been independent. Instead, the idea expressed at the beginning of paragraph 6 (i.e. the accurate delineation of the actual transaction shows that two or more associated enterprises undertake activities involving the sharing of economically significant risks) should govern.

Another place in the guidance where the distinctions get murky are paragraphs 21 and 22. Paragraph 21 discusses the application of transactional profit splits when operations are highly integrated (the wrong primary consideration, and one which only applies to one type of profit split). Paragraph 22 states that "another situation in which transactional profit splits method may be the most appropriate method is where multiple parties make unique and valuable contributions." I of course agree with this statement from paragraph 22, but it is not "another" condition in addition to the consideration in paragraph 21. Rather, each is a consideration for a different application of a profit split. Paragraph 22 tries to make a link between the presence of multiple non-routine contributions and a sharing of risk: While this link may be appropriate in some instances, it is not universally so.

Take, for instance, a circumstance in which a manufacturer of pharmaceuticals has developed a highly unique, patented treatment. The sales and marketing efforts associated with this therapy in a given territory will involve the use of unique sales and marketing intangibles that are possessed by an affiliate of the manufacturer. The manufacturer fully controlled the R&D and manufacturing risks. The sales and marketing entity fully controls the risks associated with those functions and with the development of its sales and marketing-related intangibles. In this circumstance, a profit split of anticipated profits might be appropriate. The determination of what happens on an ex-post basis should allow each party to assume the risks that it controls – not force them into an ex-post profit split regardless of contractual and actual risk allocations under the appropriately delineated transaction. Companies frequently enter into transactions with third parties where both parties are contributing something non-routine to the transaction, but consideration is nonetheless fixed for one of the parties.

The question posed in Figure 2 is (or should at least be allowed to be) quite independent of the question in Figure 1, and reaching an end point in Figure 1 should still leave one with the need to make a determination of the answer to the question posed in Figure 2.

Figure 1 is a determination about the appropriate profit allocation between parties to a transaction on an ex-ante basis. In Figure 1, the profit split method is one of a number of possible methods that might be applicable to determine this ex-ante allocation. The selection of the profit split method in response to the question posed in Figure 1 doesn't need to be

determinative of the answer to the question posed in Figure 2. This is because Figure 2 is addressing something completely different. Figure 2 is wholly about what happens to any difference between what was anticipated and what has actually occurred.

If one determines, for instance, that a profit split of anticipated profits is not appropriate because only one party makes non-routine contributions, it may still be the case that profit splits might be applicable to actual profits due to the integration of the activities of the parties to the transaction. In this scenario, one would first determine the allocation of anticipated profits in accordance with the most appropriate transfer pricing methodology (perhaps, for instance, a “one sided” valuation approach), but then a transactional profit split would be applied on an ex-post basis (using the relative value of contributions from the ex-ante analysis) to enable the risk sharing that is appropriate given the integration of the parties. There could also be situations where profit splits are applied on an ex-ante basis only (due to multiple non-routine contributions), but risks are nonetheless separately managed in a way that allows one party to assume the economically significant risks under the accurately delineated transaction. This circumstance doesn’t appear to be contemplated in the current guidelines but should be.

The two profit split approaches should be presented distinctly and separately, and the integration of these two discussions should be kept to a minimum outside of laying out the decision framework set forth above. . .

- 3) Joint risk sharing under the accurately delineated transaction, not Integration, should be the determining factor in the application of the Transactional Profit Split to actual profits.

The guidance strongly conveys (though not consistently as discussed above) that integration is a necessary and sufficient condition that leads to the application of a transaction profit split to actual profits.

The current centerpiece of the “ex-post” application decision (i.e. integration) should be considered a potential cause of the conditions that should necessitate integration rather than the determinative factor itself. Under Chapter I, the appropriate allocation of risk for transfer pricing purposes should be determined in accordance with steps set forth for analyzing risk in the accurately delineated actual transaction. The condition that necessitates the application of a profit split on an ex-post basis should be that the accurately delineated transaction shows that one or more economically significant risks are determined to be jointly allocated under the analytical steps set forth in paragraph 1.60. Highly integrated businesses are perhaps more likely to demonstrate characteristics that make this determination more likely (and it may be the case that likelihood is higher for entities demonstrating parallel rather than serial integration), but it should not be viewed as a sufficient condition for the application of a transactional profit splits to actual profits. Rather, a finding that economically significant risks

are jointly born in the accurately delineated transaction should be the necessary and sufficient condition.

There may be situations in which even highly integrated businesses still demonstrate distinct controls (perhaps by only one party) over economically significant risks. In these circumstances, application of the existing language might lead to inappropriate application of the profit split to actual profits because the current draft language inappropriately treats integration as a sufficient condition.

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Thank you for the opportunity to provide commentary on this discussion draft as the OECD continues its important work.

I am happy to discuss the issues that I have raised in this paper in more detail. Please contact me at [Mark.Bronson@DuffandPhelps.com](mailto:Mark.Bronson@DuffandPhelps.com) for more information.

# By E-Mail

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## BEPS Action 8-10 Discussion Draft (Revised Guidance on Profit Splits)

To whom it may concern,

RBSM – RoeverBroennerSusatMazars and WeiserMazars welcome the opportunity to submit comments on the Discussion Draft “BEPS Action 8-10: Revised Guidance on Profit Splits”. We appreciate this opportunity to share our views and hope you find our comments useful in your work on BEPS.

We remain at your disposal for any further discussion of these issues.

Yours sincerely,



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Dr. Oliver Treidler

*Transfer Pricing Manager*

Questions for Consultation:

*Actual vs. Anticipated Profits*

1. While the distinction between applying the transactional profit split method on actual and anticipated profits contained in this section is accurate, the distinction is not clear and complicated in its application. In order to provide clear guidance on the application of the profit split method, the section should focus on highlighting its essential characteristics i.e., a profit split must reflect the value-added contributions of the different parties from an ex ante perspective instead of elaborating on comparatively minor conceptual differences between applying the profit split method on actual or anticipated profits.

In our view, the 2010 Guidance [2.127] sufficiently points out that “[d]epending on the facts and circumstances, profit splits using either actual or projected profits are observed in practice” and thus should be sustained. In our experience, the application of the transactional profit split method on anticipated profits is mostly relevant to business restructurings and transfers (sale) of intangible assets. The references to Chapter VI and the discounted cash flow valuation techniques contained in the draft are sensible and should be added to the current guidance. Additionally, an explicit reference to Chapter IX should be added.

2. The main consequence of providing a detailed distinction between applying the profit split method on actual or anticipated profits is that it strictly limits its application to cases involving a high level of integration of business activities. While profit split is most sensible for integrated business activities and basing such a profit split on actual profits is most adequate for highly integrated activities, the current wording of the section could potentially be interpreted to require a prohibitively high degree of integration. This problem is exacerbated in conjunction with Section C.3.1 (referenced in paragraph [6]), which factually limits the applicability of a profit split based on actual profits to sequentially integrated value chains (see response to no. 8 below).

3. More specific guidance should be provided on the selection of anticipated vs. actual profits depending on the situation/circumstance. As already pointed out, a profit split based on anticipated profits is mostly relevant for business restructurings and transfers (sale) of intangible assets where there are no opportunities for adjustments if the actual profits are significantly different than anticipated profits. The application of a profit split based on actual profits should conceptually have a rather broad scope as it is potentially the most appropriate method for integrated transactions, for which adequate comparables are not feasible to identify and for which one-sided methods cannot be reliably applied. However, it should also be borne in mind that a profit split can be readily utilized for validating the results obtained from applying other transfer pricing methods (secondary analysis) by determining the economically relevant contributions of individual parties in the context of a value chain analysis (see response to no. 13 below).

#### *Strengths and Weaknesses*

4. Section C.2 accurately summarizes the main strengths and weaknesses of the profit split method. However, the identification of the difficulty of identifying and obtaining sufficiently detailed (segmented) data as a weakness gives the impression that such difficulty exists only in the case of a profit split method which is not the case as such difficulty applies (in varying degrees) to all transfer pricing methods.
5. As pointed out above, the fundamental concept of profit applies to both anticipated profits as well as actual profits. If anything, the flexibility offered by the profit split method on anticipated profits is particularly advantageous when there is a high degree of uncertainty and complexity involved in valuing intangible assets (i.e. for business restructurings). On the other hand, the profit split method on actual profits provides an opportunity for on-going business activities and operations to consider adjustments at year end if there is a significant divergence between anticipated and actual profits.

### *Most Appropriate Method*

6. Introducing the idea of sharing economic risks as a factor for indicating whether the transactional profit split method may be most appropriate generally appears sensible. However, the heavy emphasis on sharing risks throughout the entire section C.3 could be interpreted as not merely providing “a factor” but rather the most crucial precondition for applying the profit split method. To avoid interpretations that excessively limit the application of a profit split method, it should be clarified that in line with the conceptual strengths of the method, the appropriateness of applying the profit split method should primarily depend on whether both parties make unique and valuable contributions and whether in such cases independent parties would consent to sharing the profits of the transaction in proportion to the value added as unique and valuable contribution is closely tied to assumption of risk.

We agree that a lack of comparables alone is insufficient for justifying an application of the transactional profit split method. Specifically, if one party of a transaction can be classified as a routine entity, the approach outlined in paragraph [18] appears most suitable for ensuring an arm’s length allocation of profits. However, if none of the parties of a transaction can be reliably classified as a routine entity, it should be clarified whether the profit split method may (in the sense of paragraph [13]) in fact be more reliable than relying on inexact comparable data.

7. German administrative principles for transfers of function [Verwaltungsgrundsätze-Funktionsverlagerung] provide a detailed example for applying a hypothetical arm’s length test that bears a close resemblance to applying the profit split method on anticipated profits (please refer to the attachment of the Verwaltungsgrundsätze-Funktionsverlagerung for details). U.S. principles for cost sharing arrangements also provide examples for the application of a transactional profit split of anticipated profits.



### *Highly Integrated Operations*

8. We agree that there is a distinction between parallel and sequential integration and that a high commonality of functions is more likely in the case of parallel integration. However, in the case of sequential integration, the common notion of possibly finding reliable comparables for each stage or element in the value chain is not accurate in the context of determining the most appropriate method. Based on our experience, it is often difficult to identify reliable comparables even for sequentially integrated value chains, especially when multiple parties perform non-routine functions. Therefore, the distinction between parallel and sequential integration should not restrict the applicability of the transactional profit split method to parallel integrated value chains by emphasizing that the non-routine nature of the parties' contributions based on a functional analysis should take precedence in determining whether the profit split method is the most appropriate method. The selection of the most appropriate method should not be restricted by the type of integration (parallel/sequential). The selection of the most appropriate method should be based on functions, risks, and assets owned and contributed by each entity.
  
9. Defining parallel integration further would highlight its distinction to sequential integration and give it added weight when determining the most appropriate method. It is our position that this distinction should not be emphasized further to allow the applicability of the transactional profit split method to sequentially integrated value chains. The valuable contributions of the individual parties should be the focus and should take precedence.

### *Unique and Valuable Contributions*

10. The importance attributed to the parties sharing economically significant risks should not be overemphasized in the context of determining whether the transactional profit split method is the most appropriate method for multiple parties making unique and valuable contributions. What is problematic and confusing is that paragraph 19 of the draft states that the contribution alone of an intangible asset by one of the parties is insufficient for applying the transactional profit split method on actual profits, whereas paragraph 20 states that contribution of intangibles is relevant for anticipated profits. By definition,

when splitting a transactional profit, all parties including parties contributing a unique and valuable intangible asset without performing additional functions, share in the profits (and losses) realized from the transaction. In other words, even parties contributing only one intangible asset are not isolated from economic risks. Instead of restricting the use of the profit split method in such a situation, it would be more useful to emphasize that a party merely contributing one intangible asset will, *ceteris paribus*, receive a comparatively smaller share of the total profit. In this context, it would be worthwhile to integrate a cross-reference to Chapter VI and the concept of the DEMPE – Functions.

11. As previously pointed out, the distinction between actual and anticipated profits complicates and obfuscates the process of selecting the appropriate method. In order to ensure unambiguous guidance for identifying the most appropriate method, it should therefore be clarified that in cases where multiple parties make unique and valuable contributions, the transactional profit split method may constitute the most appropriate method irrespective of whether it is applied on actual or anticipated profits.

#### *Group Synergies*

12. We agree with the analytical framework for allocating group synergies to the entities of the group in proportion to their contribution in creating such synergies and applying an appropriate allocation key to the marginal system profits arising from these synergies. However, additional guidance should be provided in respect of allocating these synergies in the context of one-sided methods similar to adjustments for location specific advantages (as outlined in the Chinese Country Chapter of the UN Manual). Certain group synergies that are difficult to quantify should also be considered on a case by case basis.

The guidance should recognize the difficulty in practice of ensuring a sufficiently clear delineation of the actual transaction. Moreover, a complete split of total system profits could be sensible in cases when marginal system profits arising from group synergies reflect a significant portion of total system profits.

## *Value Chain Analyses*

13. This section heavily emphasizes that a value chain analysis constitutes a “mere” or “simple” tool for delineating actual transactions and for identifying features relevant in determining whether the transactional profit split method is appropriate. While the section adequately stresses the main contributions of a value chain analysis, notably determining the level of integration as well as the economically relevant contributions made by the individual parties, it contains some additional provisions that could be interpreted as a requirement for conducting a rather complex analysis i.e., considering economic circumstances that may create opportunities for capturing excess profits, the effect of market entry barriers as well as the effects of first mover advantages. In order to ensure that a value chain analysis can efficiently be used by taxpayers as a pragmatic tool, it should be more heavily emphasized that it can best be understood as an extension of a functional analysis. In this context, paragraph [27] generally provides helpful and sufficient guidance on an appropriate analytical framework. The last bullet point should, however, be deleted as it appears redundant and unnecessarily focused on parallel integration.

The section could be extended further in order to clarify that an adequate level of detail will ultimately depend on the context in which an analysis is applied. It appears reasonable to require greater analytical depth if a value chain analysis is used for determining the specific factors to be used in splitting profits (paragraph [26]) as opposed to performing an analysis for merely determining whether the profit split method is applicable at all. In this context it would be welcome to have a reference to the overriding objective for applying the profit split, namely for approximating as closely as possible how profits would be split among independent parties in comparable situations (paragraph [28]). Adding such a reference could emphasize that by conducting a value chain analysis, taxpayers ensure that they provide tax administrations with sufficient explanations with respect to their rationale for applying the profit split method.

14. As implied in paragraph [26] as well as in paragraph [48], we see ample scope for using a value chain analysis for determining the specific factors to be used to split the profits. Once the economically relevant contributions are identified by using a value chain analysis, it appears to be an intuitive next step to quantify the respective contributions of the individual parties – i.e. by applying simple scoring models (i.e. applying a weighted scale based on the DEMPE functions). Moreover, more specific guidance/quantitative examples would be helpful.

#### *Different Measures of Profits*

15. => no Comment

#### *Profit Splitting Factors*

16. The examples provided by the draft are sufficiently clear and comprehensive. Additional guidance on how to comply with the requirement for providing a reliable and verifiable measurement would be welcome, particularly if the splitting factors determined are based on a value chain analysis. By clarifying that a value chain analysis, which documents that the analytical framework as outlined in paragraph [27] has been observed, shall generally be considered to be sufficiently verifiable and reliable, additional certainty could be provided for taxpayers.
17. Considering that CbC-Reporting will be available to tax authorities in the near future, it would be worthwhile to clearly state that applying multiple profit splitting factors does not enhance the reliability of the results in the case of key value drivers not being appropriately reflected – as emphasized in paragraph [48]. In other words, the use of formulary apportionment should be explicitly discouraged. Each business is unique and applying a simple allocation methodology such as formulary apportionment would not reflect the accurate measure of contribution by each entity.

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18. See response to question 7 above.



2 August 2016

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**Re: Revised Guidance on Profit Splits, issued on 4 July 2016**

Dear Mr. VanderWolk,

Please forward this on to the Head of the Transfer Pricing Unit once that position is filled.

Although the profit split is not widely used in Canada and other countries<sup>1</sup>, its time is coming, with a growing body of knowledge provided by the OECD intended for greater and more frequent use.

Please read the attached document for my comments on the Revised Guidance on Profit Splits. I have good experience in using profit splits and welcome the opportunity to discuss this further during the OECD's public consultation on profit splits to be held in Paris on 11 - 12 October 2016.

I am a Chartered Professional Accountant (CPA, CA) and Chartered Business Valuator (CBV) who has specialized in transfer pricing since 1996, an expert witness in the Tax Court of Canada, and founder of MDW Consulting Inc., an independent firm that specializes in transfer pricing.

Sincerely,

Matthew Wall CPA, CA, CBV

Cc: Michael McDonald, Chair of Working Party No. 6

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<sup>1</sup> The MAP Program Report published by the Canada Revenue Agency shows that, of all the transfer pricing methods used during the resolution of double taxation between Canada and opposing countries, the profit split was used only 4 of 100 times in 2014-15, 3 of 73 in 2013-14, and 2 of 92 in 2012-13.

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## Introduction

Although the profit split is not widely used in Canada and other countries<sup>2</sup>, its time is coming, with a growing body of knowledge provided by the OECD intended for greater and more frequent use.

The following chart shows the guidance on profit splits has increased significantly with each revision of the OECD Guidelines in 1995 and 2010, with even more guidance arriving in 2017 following the Discussion Draft, Public Comments and Public Discussion in 2016.

Number of paragraphs in the OECD Guidelines on Profit Splits	1979 OECD Guidelines	1995 OECD Guidelines	2010 OECD Guidelines	2016 D. Draft
In general	-	1	1	10
Strengths and weaknesses	-	5	6	5
Most appropriate method	-	-	-	12
Guidance for application	-	15	31	30
Total	-	21	38	57

The above chart suggests the most significant change in 2016 might be a longer introduction as part of “in general” plus a new section on the “most appropriate method,” with possibly minor changes on “strengths and weaknesses” and “guidance for application” when using profit splits.

However, by tracking the paragraphs from 2010 to 2016, the following chart shows all four sections have been reviewed and revised including the “guidance for application” when using profit splits.

Number of paragraphs in the OECD Guidelines on Profit Splits	2010 OECD Guidelines	Moved	Deleted	Added	2016 D. Draft
In general	1	1	-	8	10
Strengths and weaknesses	6	(2)	-	1	5
Most appropriate method	-	-	-	12	12
Guidance for application	31	1	(9)	7	30
Total	38	-	(9)	28	57

Below are my comments (by section) on the OECD’s revised guidance on profit splits, including my comments in response to the “Questions to commentators” from the 2016 Discussion Draft.

<sup>2</sup> The MAP Program Report published by the Canada Revenue Agency shows that, of all the transfer pricing methods used during the resolution of double taxation between Canada and opposing countries, the profit split was used only 4 of 100 times in 2014-15, 3 of 73 in 2013-14, and 2 of 92 in 2012-13.





## In General

The following was added to para. 2.108 to become the first sentence on profit splits:

*This section provides guidance on the selection and application of the transactional profit split method as the most appropriate method (see paragraph 2.2). [Underlining added for emphasis.]*

The part underlined gives the profit split a certain prominence that is unjustified. Please remove it, or include a similar sentence as guidance for each transfer pricing method in the OECD Guidelines.

If a tax administration intends to use the profit split method for their analysis, they must first demonstrate the taxpayer's method is not reliable based on the facts and circumstances and, secondly demonstrate the profit split is more reliable based on the facts and circumstances. The 2016 Discussion Draft has overlooked this and needs to include guidance on this to mitigate the risk of a prolonged audit and protracted dispute over which method is the most appropriate.

### **Question 1: Is the distinction between anticipated profit splits vs actual profit splits clear? Is the distinction between the two profit splits described useful?**

In brief, [New] paragraphs 2 to 10 introduce the following concepts:

- a) What profits should be split – e.g., anticipated or actual profits [New para. 2];
- b) An example showing how to split anticipated profits [New para. 4];
- c) An example showing how to split actual profits [New para. 5]; and,
- d) Guidance to explain some of the challenges when splitting profits [New paras. 6 to 10].

Paras. 1 to 3 are in the right place and with the right level of detail under the heading “In General”. However, paras. 4 to 10 might be confusing for those not familiar with these concepts and, after some editing, these should come later in the section titled “Guidance for Application” under the heading “Actual or Projected Profits” where it is currently placed in the 2010 OECD Guidelines.

Key point: the OECD have introduced a very significant change on what profits to split.

The 2010 OECD Guidelines provides clear guidance in paras. 2.128 to 2.130 that currently restricts the tax administration from splitting actual profits to limited circumstances under specific guidance. However, the 2016 Discussion Draft removes these restrictions by deleting paras. 2.128 and 2.129 and adds [New] para. 2 to say the focus will be on splitting actual profits as the “most appropriate



method,” giving the tax administration new freedom to select the profit split method using actual profits as an alternative to the taxpayer’s transfer pricing method, analysis and documentation.

**2010 OECD Guidelines currently restricts splitting the actual profits:**

Para. 2.128 states *“it is critical for the tax administration to acknowledge that the taxpayer could not have known what the actual profit experience of the business activity would be”* and, because of this, went on to say *“Such an application would be contrary to the arm’s length principle.”*

Para. 2.129 states *“using a transactional profit split method will be easiest for a tax administration where the associated enterprises have originally determined such conditions on the same basis.”*

Para. 2.130 states *“Where the associated enterprises have determined the conditions in their controlled transactions on a basis other than the transactional profit split method, the tax administration would evaluate such conditions on the basis of the actual profit experience of the enterprise. However, care would need to be exercised to ensure that the application of a transactional profit split method is performed in a context that is similar to what 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.*

**2016 Discussion Draft would require splitting the actual profits:**

[New] para. 2 states *“the focus will be on the application of the transactional profit split of actual profits as the “most appropriate method” for evaluating pricing of an accurately delineated transaction.”*

Respectfully, deleting paras. 2.128 and 2.129 from the 2010 OECD Guidelines has removed a measure of caution and guidance for the tax administration, which should alarm taxpayers of the increased risk, when audited, that a tax administration might split the actual profits as a substitute for the taxpayer’s method, possibly using information that was not known and not foreseeable at the time of the transaction (i.e., hindsight), which is “contrary to the arm’s length principal”.

Please restore the original wording from the 2010 OECD Guidelines for paras. 2.128 to 2.130 and edit the 2016 Discussion Draft in the [New] para. 2 and other places, where appropriate.

**Question 2: Comments are also invited on the links between integration of business activities (and the sharing of risks) and the appropriate application of a transaction profit split of actual profits.**

There already exists a fair amount of commentary on this subject, as shown below.



The current guidance in para. 2.4 of the 2010 OECD Guidelines suggests the profit split might be more appropriate where each of the parties engage in highly integrated activities.

*“2.4 There are situations where transactional profit methods are found to be more appropriate than traditional transaction methods. For example, cases where each of the parties makes valuable and unique contributions in relation to the controlled transaction, or where the parties engage in highly integrated activities, may make a transactional profit split more appropriate than a one-sided method.”*

Further guidance and examples are in the newly approved and amended OECD Guidelines on 15 June 2016 including, for example, para. 1.55 of the 2015 BEPS Report on Actions 8-10.

*1.55 The functional analysis may show that the MNE group has fragmented highly integrated functions across several group companies. There may be considerable interdependencies between the fragmented activities. For example, the separation into different legal entities of logistics, warehousing, marketing, and sales functions may require considerable co-ordination in order that the separate activities interact effectively ... Risk may be mitigated through contributions from all the parties, or risk mitigation activities may be undertaken mainly by the co-ordination function. Therefore, when conducting a functional analysis to identify the commercial or financial relations in fragmented activities, it will be important to determine whether those activities are highly interdependent, and, if so, the nature of the interdependencies and how the commercial activity to which the associated enterprises contribute is co-ordinated.*

I also agree with para. 8 from the Scope of Work for Guidance on the Transactional Profit Split Method, and suggest this also be included – as is – in the 2016 Discussion Draft on Profit Splits.

*While the current Guidelines state that transactional profit split methods may be found to be the most appropriate method where business operations are highly integrated, integration alone may be insufficient to warrant the use of such a method. All MNE groups are integrated to a greater or lesser degree, and so it is unclear how the criterion of integration should be applied.*

Finally, it would help to copy the above guidance and comments (i.e., paras. 2.4 + 1.55 + para. 8 of the Scope of Work) into the “In General” section of the 2016 Discussion Draft on Profit Splits.

**Question 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.**

Examples of this type might not be well suited for the “In General” section on Profit Splits.



## Strengths and Weaknesses

### Question 4: Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarized?

The following comparison of the 2010 OECD Guidelines vs 2016 Discussion Draft demonstrates the revisions impose an unfair bias that favors the tax administration – e.g., narrowing the focus on actual profits, while broadening or “softening” the guidance for greater and more frequent use.

#### 2010 OECD Guidelines

Para. 2.109 refers to:

- a) transactional profit split method

The 2010 guidance refers to a method without specifying which profit to split, something which should be decided based on the facts and circumstances in each case, while the 2016 Draft imposes a bias, clearly stating the method should be splitting the actual (not anticipated) profits.

Para. 2.109 refers to:

- b) can offer a solution for highly integrated operations for which a one-sided method would not be appropriate

The 2010 guidance provides an alternative to a one-sided method, which is generally understood to be the TNMM, and only after determining there are no reliable transactional methods. However, the 2016 Draft could be “loosely” interpreted as any two or more related parties regardless of the method and/or circumstances.

Para. 2.109 refers to:

- c) would ordinarily not be used in cases 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 ...

The 2010 guidance would not use this method when, for example, one of the related parties does not contribute to unique and valuable intangibles. However, the 2016 Draft softens this to less likely, which increases the risk this method might be used for transactions involving routine or low-value activities.

Para. 2.113 refers to:

- d) This two-sided approach may also be used to achieve a division of the profits ... that satisfies both the taxpayer and tax administrations.

#### 2016 Discussion Draft

Para. 11 [2.109] refers to:

- a) transaction profit split of actual profits

Para. 11 [2.109] refers to:

- b) can offer a pricing solution in circumstances in which ... two or more associated enterprises undertake activities involving the sharing of economically significant risks

Para. 11 [2.109] refers to:

- c) is less likely to occur 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 ...

Para. 13 [2.113] refers to:

- d) deleted



The 2010 guidance includes “collaborative” guidance intended to mitigate the risk of a dispute by suggesting the tax administration and taxpayer co-operate with one another when requesting and using financial information to ensure the profit split results in an equitable return for the related parties, something that everyone might agree to. By removing this, the 2016 Draft increases the risk and opportunity for the tax administration to work independently of the taxpayer with less concern for their involvement and support. This increases the risk of prolonged audits and protracted disputes.

Para. 2.114 refers to:

- e) ... it may be difficult to measure combined revenue and costs ... would require stating books and records on a common basis and making adjustments in accounting practices and currencies.

Para. 14 and 15 [2.114] refers to:

- e) ... it may be difficult to measure combined revenue and costs ... 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.

This paragraph in the 2010 guidance and 2016 Draft overlooks the obvious challenge, inherent weakness, and risk when using the profit split method. Challenge - this method requires requesting information from non-resident taxpayer(s), information the taxpayer might not have. Weakness - using this method requires various assumptions, allocations and estimates that can be subjective and questions its reliability if not properly supported. Risk – the profit split results in a pro-forma financial statement for the related parties that might go beyond a price adjustment and effectively re-characterize the transaction or series of transactions.

Further guidance addressing these concerns is required to improve its usefulness and reliability.

Para. 2.114 refers to:

- f) blank

Para. 14 and 15 [2.114] refers to:

- f) For example, a profit split between a global manufacturer and a regional distributor ...

The 2016 Draft introduces an example that “loosely” applies to most taxpayers, since all multi-national enterprises (MNEs) provide or sell products and/or services of some kind through an international network. There is a risk the profit split method may become overused by tax administrations when auditing taxpayers.

Para. 2.114 refers to:

- g) blank

Para. 14 and 15 [2.114] refers to:

- g) The required financial information may be difficult to access ... will not be able to perform the analysis or verify the information without full co-operation from the taxpayer.

Further guidance is required to (i) define what is considered to be “full co-operation” by the taxpayer and, (ii) after demonstrating a “reasonable effort”, (iii) when the profit split should be abandoned due to significant deficiencies in the information, estimates, assumptions, supporting details, etc. that might render this method unreliable due to facts and circumstances in the case that are beyond the taxpayer’s control. This is important, since transfer pricing penalties are assessed for various reasons including when a taxpayer is deemed to be “uncooperative.”



**Question 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?**

Comments are pending once the OECD revises para. 2 and elsewhere within the 2016 Draft to remove the bias on actual profits as the “most appropriate method” and allow for the selection and use of anticipated or actual profits depending on the facts and circumstances in each case.

## **Most Appropriate Method**

### **In General**

**Question 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? Do commentators find the Draft helps the circumstances where the transactional profit split method is the most appropriate method? Please provide explanations and/or examples supporting your views.**

The reference to economically significant risks is not clearly defined or explained and might be confusing for those not familiar with this concept. To help with this, including examples that you asked for, please consider judgments from the tax court on this topic. Below is one such example.

In brief, *Transalta Corporation v. The Queen* [2010 TCC 375, 2010-07-13] involved the valuation of goodwill resulting from a transaction, which was dependent upon the facts and circumstances in the case as it relates to the economic benefits or risks born by the participants to the transaction.

The expert for the Appellant (taxpayer) valued the goodwill at \$190,000,000 after concluding the economic benefits or risks accrue to the customer based on the facts and circumstances.

The expert for the Crown (tax authority) concluded nominal amount was received for goodwill after considering the financial synergies, operating synergies, and strategic synergies.

Based on the evidence presented, the tax court valued the goodwill at \$140,824,476, allowed the appeal, and referred the matter back to the Minister for reassessment.

It might help to read the full text of the judgement in *Transalta Corporation v. The Queen* to gain a better understanding of economically significant risks, the opposing views held by the parties based on different interpretations of the facts and circumstances, and the final judgment.



**Question 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.**

Please consider the above example provided by *Transalta Corporation v. The Queen*. Not only did it involve economically significant risks, the judgment in this case relied on valuation techniques including a discounted cash flow that was used to support the value of \$190,000,000. While this was a valuation dispute per se, the issues and concepts lend themselves to transfer pricing.

### Highly Integrated Operations

**Question 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?**

Parallel and sequential are commonly used and easily understood as medical terms, for example:

Parallel treatment – a patient with both issues of mental health (e.g., depression) and substance abuse (e.g., alcohol and/or drugs) are treated at the same time, but by different professionals or teams.

Sequential treatment – a person with both issues must receive treatment for one issue (e.g., substance abuse) before receiving treatment for the other issue (e.g., mental health).

However, these are not commonly used and are not easily understood as transfer pricing terms.

Respectfully, I would not recommend using these phrases and encourage deleting [New] para. 21.

Finally, if these are to be used, please provide the following revisions to the 2016 Discussion Draft:

1. Paragraph(s) with a definition and example for “parallel integration”;
2. Paragraph(s) with a definition and example for “sequential integration”; and,
3. Paragraph(s) with guidance stating, for example, based on the facts and circumstances in each case, the profit split method might be appropriate when there is “parallel integration” of the transaction or series of transactions between related parties, but is not appropriate when there is “sequential integration” of the transaction or series of transactions between related parties.

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

Please see the above comments.



## Unique and Valuable Contributions

**Question 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.**

[New] para. 22 refers to para. 6.17 of the OECD Guidelines for “unique and valuable intangibles”:

6.17 In certain instances these Guidelines refer to “unique and valuable” intangibles. “Unique and valuable” intangibles are those intangibles (i) that are not comparable to intangibles used by or available to parties to potentially comparable transactions, and (ii) whose use in business operations (e.g. manufacturing, provision of services, marketing, sales or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible.

[New] para. 22 adapts the above definition to define “unique and valuable contributions”:

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. The two factors are often linked: comparables for such contributions are seldom found because they are a key source of economic advantage. In such cases, it may be 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. For example, the developer and manufacturer of a key component together with the developer and manufacturer of the rest of the product both ...

Although the structure in [New] para. 22 is similar to para. 6.17 of the OECD Guidelines, the original meaning and purpose is diminished by substituting phrases that imply “contributions to intangibles” have the same or similar economic benefits as the “ownership of intangibles”.

Further, the full text of [New] para. 22 relies on the following assumptions that might be individually or collectively supported or disputed depending on the facts and circumstances in each case.

1. Multiple parties to the transaction make unique and valuable contributions;
2. The contributions are a key source of actual or potential economic benefit;
3. Comparables for such contributions are seldom found;
4. It may be that the associated risks cannot be controlled by the other party or parties; and,
5. For the above reasons the profit split method may be the most appropriate method.





Of the five points listed above, the first two on contributions and benefits are assumptions that must be supported by the facts and circumstances before using the profit split method (e.g., a priority). However, respectfully, the latter three on comparables, risk and method are often stated and assumed without a serious effort to search for, consider and support. Please use stronger language in the Draft to require adequate support for all five points individually and collectively.

Further, the Discussion Draft takes a stronger position on risk that might be unfounded by deleting para. 2.111 for identifying related parties that assume risk and raises the standard to [New] para. 22 for identifying related parties that control risk including those parties that do not control risk. However, I am concerned – in the absence of further guidance – controlling risk or lack thereof can be difficult to prove, easily disputed, or both based on the facts and circumstances in each case.

Para. 2.111 of the 2010 OECD Guidelines

“... the allocation of profits may be based on the division of functions (taking account of the assets used and risks assumed) between the associated enterprises ...”

[New] para. 22 of the 2016 Discussion Draft

“... it may be 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 ...”

Finally, the remainder in [New] para. 22 includes an example that I anticipate will be challenged by public comments to be received from specific industries (pharmaceutical, software, etc.).

**Question 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 outcome of that transaction? If so, what guidance on the appropriate use of profit splits in such a situation should be provided?**

Please see the above comments on risk.



## Group Synergies

**Question 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.**

I agree that synergies alone should not be the basis for selecting and using the profit split method. However, to avoid misunderstanding and misuse, please remove [New] para. 23 from the 2016 Discussion Draft, recognizing there is ample guidance on this subject in paras. 1.157 to 1.173 under section “D.8 MNE group synergies” and elsewhere in the OECD Guidelines.

Further, please consider the caution expressed by business valuers regarding synergies in respect of M&A transactions between parties at a point in time that, subsequent to an acquisition, lends itself to transfer pricing with similar concern for related parties spanning a period of time.

The following comments are taken from a well-known text book used by business valuers in Canada as it relates to synergies from a merger or acquisition of privately-held businesses.<sup>3</sup>

The term “synergies” is over-used and often misunderstood. What must be clearly understood is that synergies or value-added provide a purchaser with the upper end of the price range. One should never assume, however, that it is the “norm” that the value-added component will be fully paid for. If anything, the opposite is true. Most often, the purchaser will not pay for the value-added, or will only pay for a portion of it. As a purchaser increases the price, the risk associated with the acquisition increases because of the reduction in the cash flow “buffer” available to the purchaser (being the value-added from the transaction). In many instances, the anticipated value-added at the time of the transaction is not created, and costs escalate at a faster rate than expected. The implementation of the theory of synergies or value-added must be applied with caution to each individual situation.

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<sup>3</sup> W.P. Albo and A.R. Henderson, *Mergers and Acquisitions of Privately-Held Businesses, Second Edition*, Canadian Institute of Chartered Accountants, Toronto, 1989, p. 151.



## Value Chain Analysis

**Question 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?**

Please revise [New] paras. 24 to 27 of the 2016 Discuss Draft to substitute “supply chain” for “value chain” and, where appropriate, explain how value can be identified within the supply chain.

For example, the 2016 Discussion Draft uses “value chain” to identify the one or more entities that contribute significant value within the “supply chain” that, as a result, might reward the one or more entities with a share of the intangible profits when the profit split is the most reliable method.

This would avoid the confusion caused by using “value chain” in Chapter II of the OECD Guidelines for guidance on the profit split method, while “supply chain” is used everywhere else in the OECD Guidelines including Chapter I for the arm’s length principle, Chapter II for commodity transactions, Chapter VI for intangibles, Chapter VII for services, and Chapter IX for business restructuring.

The meaning and use of “value chain” in the 2016 Discussion Draft might be the anti-thesis to the meaning and use of “supply chain” throughout the current OECD Guidelines, for example:

- a) What if the taxpayer refers to the OECD Guidelines on “supply chain” to demonstrate that the conduct of the related parties is consistent with the legal form of their contract(s);
- b) While the tax administrator refers to the 2016 Discussion Draft on “value chain” to demonstrate that the conduct of the related parties differs from the legal form of their contract(s);
- c) Both will say they have “delineated the actual transaction between associated enterprises”, despite taking opposing views based on the OECD Guidelines for supply chain vs value chain;
- d) Next the tax administrator requests information including the financial results of the other entities (i.e., non-residents) in the supply chain to identify the total profits earned from the supply chain;
- e) Then the tax administrator uses the profit split as the most reliable method to determine a higher value for the taxpayer’s services that includes a share of the intangible profits; and,
- f) Finally, the tax administrator issues a Reassessment for the incremental amount (e.g., higher value of services less actual amount received) plus additional taxes, interest and penalties owing.

Respectfully, in the above illustration, the [New] paras. 24 to 27 of the 2016 Discussion Draft does not help delineate the actual transaction, rather it defines the dispute between a tax administrator and the taxpayer.



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

Below are excerpts from the U.S. Tax Court Ruling on transfer pricing involving a “value chain” dispute between *Medtronic Inc. v. Commissioner* [T.C. Memo 2016-112, dated 6/9/16], illustrating the potential meaning, use and risk of the value chain proposed in the 2016 Discussion Draft.

Respectfully, based on this Ruling, I am most concerned that guidance on the value chain might lead to prolonged audits and protracted disputes similar to Medtronic’s, which ended with the U.S. Tax Court upholding the taxpayer’s position and denying the tax administrator’s reassessment.

Petitioner’s Position

- p.73 Petitioner also contends that respondent’s allocations in the notice of deficiency using the CPM are much greater than arm’s length and are therefore arbitrary, capricious, and unreasonable. Specifically, petitioner argues that respondent’s **value chain** approach fails to respect and view separately the intercompany transactions between Medtronic Puerto Rico, Medtronic US, and Med USA.

Respondent’s Position

- p.89 As part of the CPM respondent used a **value chain** analysis, which segments a company’s operations into functional activities, allowing qualitative assessment of each participant’s economic contributions to the profits of the consolidated enterprise.
- p.89 Respondent contends that Medtronic US and Med USA performed most of the functions of the CRDM and Neuro **value chain**, and bore the risks related to the functions they performed.

Heimert’s Economic Analysis

- p.91 [the respondent’s expert witness] Heimert’s analysis was based on his findings that Medtronic Puerto Rico performed one important function—finished manufacturing—among many important functions within the highly integrated **value chain**. This approach treated Medtronic Puerto Rico as equivalent to many other third-party medical device manufacturers who do not create nonroutine assets and who do not bear additional risks that would require the assignment of additional profits.
- p.92 In the first step Heimert calculated the **value chain** operating profit. In the second step Heimert applied the CPM to Medtronic US’ sale of components to Medtronic Puerto Rico for the production of finished devices and leads. This analysis resulted in the amount of profits that Medtronic US would earn ...
- p.95 ... He calculated the arm’s-length results for the intercompany transactions by breaking out the arm’s-length **value chain** of operating profits between Medtronic Puerto Rico, the routine aspects of U.S. distribution, component manufacturing, and the return for all of Medtronic US’ and Med USA’s nonroutine intangibles, including any additional contributions by the component manufacturers and distribution beyond the routine or benchmarked returns for distribution and manufacturing activities. He converted these arm’s-length results into a royalty payment ...



### Concerns With Heimert's Economic Analysis

- p.97 Under Heimert's value chain approach, petitioner's operations are segmented into functional activities with a qualitative assessment of each controlled party's contributions. The section 482 regulations do not include a description of a **value chain** approach. We must examine the facts and circumstances and determine whether respondent's application of the CPM is arbitrary, capricious, or unreasonable.
- p.102 Accordingly, Heimert's comparables spread out the quality risk throughout the entire **value chain**, in contrast to petitioner's focus on risk associated with final assembly at Medtronic Puerto Rico.
- p.111 Heimert contends that because his comparable companies own all of the intangibles and bear all of the risks throughout the entire **value chain**, his application of the CPM may overstate the returns to Medtronic Puerto Rico. The Court disagrees and concludes that his comparable companies are not consistent with the regulations.
- p.119 Heimert used a **value chain** analysis which resulted in a super royalty. Petitioner's expert Louis P. Berneman testified that in the medical device industry, generally, "97% of the licenses are for royalty rates of 15% or less." Heimert concluded the royalty rates for the licensing of intangibles needed to be adjusted to 49.4% for 2005 and 58.9% for 2006 for the transactions to be arm's length.

### Respondent's Failure To Provide an Adjustment to Petitioner's Methodology

- p.130 Respondent took an all-or-nothing approach by advocating a result based on the CPM using **value chain** method and by refusing to suggest adjustments to petitioner's CUT method for the devices and leads licenses. Respondent consistently criticized petitioner's transfer pricing method and contended that respondent's method was the best. Because of respondent's approach ...

### Adjustments

- p.138 With the aforementioned adjustments, the CUT method is the best method for determining the arm's-length rate. We note that our adjustments result in rates that are close to the rates that the parties previously negotiated in the MOU. This is coincidental. The adjustments were not made to mimic the MOU but rather to reflect the facts and expert testimony.

### Transfer of Intangible Property

- p.139 The notice of deficiency makes an alternative allocation under section 367(d) that may apply if we do not sustain respondent's section 482 allocations in their entirety. The notice of deficiency states alternatively "that significant value has been transferred to Medtronic Puerto Rico, [and] then it is determined that such value transferred (exclusive of tangible assets transferred) is taxable under I.R.C. [section] 367(d)." The notice of deficiency further states that "Medtronic must include in taxable income amounts not to exceed \$496,529,306 for the taxable year ended April 29, 2005, and \$750,741,381 for the taxable years ended April 28, 2006."
- p.143 On the record before us, we are not persuaded that intangibles were transferred that should be subject to section 367(d).



## Guidance for Application

In brief, the 2016 Discussion Draft deleted 9 paras. from the existing OECD Guidelines and introduced 7 [New] paras. in the Guidance for Application of the profit split method.

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

Question 15 covers paras. 28 to 41 of the 2016 Discussion Draft regarding the various approaches for splitting the profits, determining the profits to be split, and different measures of profit.

Overall, I find the 2010 OECD Guidelines is already helpful for when I use the profit split method. Respectfully, I do not feel this guidance requires much revision and suspect others will soon agree as they begin using this method. I suspect the OECD needs to give the transfer pricing community time to use this method before making further changes to the 2010 OECD Guidelines.

### In general

There is a small but important change that raises concern. For example, the current guidance says:

2.115 ... Application of the method will depend on the circumstances of the case and the information available, but the overriding objective should be ...

However, [New] para. 28 has edited the underlined portion of this paragraph to say the following:

28. [2.115] ... 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 ...

My concerns are explained on pages 14 to 16 – e.g., the taxpayer and tax administration will both say they have “delineated the actual transaction between associated enterprises” despite taking opposing views based on the OECD Guidelines for supply chain vs value chain. Respectfully, this will not help “delineate the actual transaction ...”, rather it will define the dispute between them. The greater concern would be if more audits followed the path taken in *Medtronic Inc. v Commissioner*.

Please edit the [New] para. 28 to restore “will depend on the circumstances of the case and the information available” in place of “will depend on the accurate delineation of the actual transaction ...”

Please edit the [New] para. 29 to restore “Be consistent with the functional analysis of the controlled transaction under review, and in particular reflect the allocation of risk among the parties” in place of “Be consistent with the accurate delineation of the actual transaction ...”



**Question 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.**

**Question 17: What further guidance would be useful in this section relating to identifying and measuring profit splitting factors?**

Questions 16 and 17 covers paras. 42 to 57 of the 2016 Discussion Draft regarding splitting profits, profit splitting factors, and reliance on data from a taxpayer's own operations.

### **Splitting profits**

Respectfully, the following statement in [New] para. 44 was once true, many years ago:

44. [2.110 and 2.111] However, it is rare to find reliable comparables data can be used in this manner.

While the article *Tax authorities using CUPs for pricing transactions*<sup>4</sup> begins by explaining that searching commercial databases was once a frustrating and time consuming exercise with poor results, it goes on to explain that in more recent years commercial databases have improved significantly in terms of the quantity and quality of third party agreements. Tax authorities have sought training and are now finding and using third party agreements with greater frequency.

Please remove the first sentence in [New] para. 44 and restore the current wording in para. 2.110 shown below, which provides more objective guidance willing to consider all available information:

2.110 Where comparables data are available, they can be relevant in the profit split analysis to support the division of profits that would have been achieved between independent parties in comparable circumstances ...

### **Profit splitting factors**

The “profit splitting factor” is mentioned 20 times in paras. 42 to 57 of the 2016 Discussion Draft.

Other than changing the name, it is not clear what the difference is between the current phrase “allocation key” and the proposed phrase “profit splitting factors”. Please elaborate if changing the name has changed other aspects of the allocation key in respect of the profit split method.

---

<sup>4</sup> M. Wall and D. Jarczyk, *Tax authorities using CUPs for pricing transactions*, TP Week, 12 March 2013.



**Question 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 consider the lessons learned from *Medtronic Inc. v. Commissioner* when evaluating the examples to be provided from the Public Comments and considered during the Public Discussion.







September 5, 2016.

Mr. Jefferson VanderWolk.  
Head of the Transfer Pricing  
and Financial Transactions Division, OECD/CTPA.

Dear Mr. VanderWolk:

Reference is made to the discussion draft of the revised guidance on profit splits released for public comments on July 4, 2016. In that respect, on behalf of the Transfer Pricing Committee of the Mexican Institute of Public Accountants (IMCP), please find below our comments:

1.- As you know, the necessary elements and stages associated to a reasonable application of this method are complex to obtain and to manage. In this regard, for the sake of clarity, we consider that a recommended “typical process summary for the application” of this method should be inserted at the beginning of the new guidance, irrespective of the split-approach to be used (similar to the typical comparability process addressed in paragraph 3.4 of the OECD Guidelines).

In such “typical process”, key references may be inserted to important aspects of the application of this complex methodology, such as the preparation of combined accounting information, identification of the relevant accounting standards to be used, identification of the main functional currency, quantification/valuation by the involved parties of their contributions to the creation of intangible property, selection of the relevant date for the computation of results, identification of relevant split keys to be used, etc. This recommendation may affect bracketed paragraphs [2.116] and [2.117], but in our opinion, it is desirable to have a panoramic view of the application of this method at the beginning of the respective chapter.

In addition, we consider that the recommended “typical process summary for the application” of this method may enhance the importance of subsequent bracketed paragraphs (e.g. [2.124] through [2.126]).

2.- Although complex in nature, the new guidance included in brackets on pages 3 through 9, provide useful language on the two profit split approaches addressed in the report (anticipated or actual profits), making reference to some hypothetical examples. However, in our opinion the new bracketed guidance should be complemented by additional guidance, on listed real-life scenarios (in the telecom, pharma, mining, oil & gas, broadcasting industries, among others), in which it is better to use the anticipated-profits approach and scenarios in which the actual-profits approach should be used. Such lists of possible scenarios (broken-down per specific split approach), could be illustrative and not exhaustive. In our opinion, the absence of this type of scenario-recommendations may decrease the possible application of this methodology, which may be contrary to the expected results of the new guidance on this method.

As a mere recommendation, both recommended lists may be inserted at the beginning of the new guidance, possibly right after paragraph 3 ([2.130]), on page 3 of the draft report, since paragraph 4 is the introductory paragraph dealing with the application of the anticipated-profits approach.

3.- On page 10 of the draft report, reference is made to the differences between the degrees of integration of the operations performed by the entities in controlled transactions (parallel vs sequential integration). In our opinion, the distinction between both concepts is not clear and should be further refined. For such purposes, we consider that it may be useful for the reader of the report to have some clear real-life examples in which both concepts typically apply. In our view, if these abstract concepts remain the same in the draft, without linking them to real-life examples, it would be extremely difficult for the reader to understand both concepts.

Hoping you find these comments useful, please do not hesitate to contact me in case you have additional comments.

Best regards,

A handwritten signature in black ink, appearing to read 'Agustin', with a stylized flourish extending from the end.

Agustin Espino, CPA.  
Presidente de la Comisión de Precios de Transferencia del  
Instituto Mexicano de Contadores Públicos (IMCP).\*

\*Head of the Transfer Pricing Committee  
of the Mexican Institute of Public Accountants.



September 2, 2016

Organisation for Economic Cooperation and Development  
Centre for Tax Policy and Administration  
Attn. Mr. Jefferson VanderWolk  
Head, Tax Treaties, Transfer Pricing, and Financial Transactions Division  
2, Rue André Pascal  
75775 Paris, France

Re: Comments on Discussion Draft on BEPS Actions 8-10: Revised Guidance on Profit Splits

Dear Mr. VanderWolk:

The National Foreign Trade Council (the "NFTC") is pleased to provide written comments on the Discussion Draft on BEPS Actions 8-10: Revised Guidance on Profit Splits, published July 4, 2016 (the "Discussion Draft").

The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations, and we appreciate the opportunity to comment on this important project. A list of the companies comprising the NFTC's Board of Directors is attached as an Appendix.

This letter is divided into two parts. The first part provides general comments and observations regarding the Discussion Draft. The second part provides responses to some of the questions for commentators in the Discussion Draft.

### **General Comments**

The NFTC supports the overall direction and content of the Discussion Draft, which we consider a significant improvement over the December 2014 Discussion Draft. The Discussion Draft importantly reinforces the need for the transactional profit split method ("TPSM") to be consistent with the arm's length principle and reflect what independent enterprises may have done under similar circumstances. We agree that the use of a profit split of actual profits is likely to be appropriate only where the parties to a transaction share and manage the outcomes of business risks and where each party is making unique and valuable contributions through the

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contribution of intangibles or otherwise. We agree that a lack of comparables alone is not sufficient to warrant the use of a transactional profit split of actual profits under the arm's length principle, and further agree that the presence of group synergies alone is not sufficient to warrant the use of a transactional profit split of actual profits under the arm's length principle. We also agree that determining the actual profits (or losses) to be split can be complex and difficult, and that this complexity may make it difficult (if not impossible) to reliably apply a profit split of actual profits. We agree that a value chain analysis can be useful as a tool for determining whether and how best to apply the TPSM, consistent with the functional analysis; however, it is only a tool to assist in delineating the transactions.

## **Specific Comments**

### C. Transactional profit split method

#### C.1 In general

*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:*

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

The NFTC believes that it would be helpful if there was greater clarity on the differences between a profit split of anticipated profits and a profit split of actual profits. There are significant conceptual and practical differences between a profit split of anticipated profits and a profit split of actual profits. A profit split of anticipated profits requires a forecast of anticipated profits from one or more transactions, a basis for determining how such anticipated profits are to be split, and a mechanism (explicit or implicit) for addressing profits in excess of those anticipated (or shortfalls in profits). In practice, the results of a profit split of anticipated profits may not differ significantly from the results derived under other methods, for example, an application of the CUP method or the TNMM to a license of intangible property where the royalty to the transferor is evaluated using a forecast of cash flows of the licensee. The application of one of these other methods is likely to be simpler and therefore more appropriate.

A profit split of actual profits, on the other hand, does not require forecasts of anticipated profits. Instead, it requires the determination of actual profits from one or more transactions and a basis for determining how those actual profits are to be split. A profit split of actual



profits is appropriate only where there is a high level of integration of activities, including activities related to the control and management of the economically significant risks associated with the transaction, such that parties would be willing to share those risks. Moreover, a profit split of actual profits is practical only where it is possible to reliably determine the actual profits from the transactions being evaluated.

Given the considerable differences between a profit split of anticipated profits and a profit split of actual profits, the NFTC recommends that the Discussion Draft be revised to clarify when references to the TPSM cover both applications of the method or only one. Further, in cases where the Discussion Draft provides guidance with respect to one application of the TPSM, it should explicitly state whether or the extent to which such guidance applies to the other application. For example, paragraph 10 states that it would be contrary to the general guidance on risk “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 [economically significant] risks.” The NFTC strongly agrees with this statement. It is important to clarify the extent to which this statement applies in the case of a profit split of anticipated profits. The NFTC believes that risk sharing is an important factor in determining whether a profit split of anticipated profits is more appropriate than other transactional methods. If one party to the transaction does not control economically significant risks, then one of the other methods will likely be more appropriate. Even if both parties control economically significant risks, such risk may be reliably accounted for by one of the other methods because (for example) comparable companies may also bear similar risks.

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

The NFTC believes that the distinction between the two approaches is useful, but would be more useful if the two approaches are further clarified.

*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 NFTC agrees that a transactional profit split of actual profits is likely appropriate only if there is a close integration of business activities related to the control and management of the economically significant risks in the transaction. Common ownership and common overall management of two enterprises is not the same as a close integration of the business activities of these enterprises. In addition, a transactional profit split of actual profits is likely to be more appropriate than another method only if there are unique contributions made by both parties and only if there is sufficient and reliable financial data to determine the actual profits from the transactions being evaluated.



## C.2 Summary of strengths and weaknesses

*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?*

A significant weakness of both applications of the TPSM is the financial data that is required. The profit split of anticipated profits requires forecasts of anticipated profit. It is possible that such forecasts may be prepared and maintained for commercial purposes (or to facilitate the application of another transfer pricing method). If that is not the case, or if the forecasts require significant adjustments to isolate the anticipated profits from the transactions being evaluated, then it would be very difficult to reliably apply the profit split of anticipated profit.

The profit split of actual profits requires a determination of the actual profits from the transactions being evaluated. In most industries, it is very likely that such financial data is not maintained in the normal course of business. When such financial data is not maintained, it will be difficult to construct that data on a retrospective basis. For example, in the case of a regional manufacturer that supplies products to several local country distributors, it may not be possible to accurately determine the profits of the manufacturer attributable to products sold to any one distributor (any such determination would likely rely on simplifying assumptions, such as assumptions regarding the appropriate allocation of operating expenses).

## 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.*

*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.*

The NFTC believes that the sharing of economically significant risks between two parties must be premised on the performance by each party of activities related to the management and control of such risks. Moreover, the profit split of actual profits is likely to be more appropriate than other methods where the economically significant risks managed and controlled by one party are difficult to quantify and price using one of the other methods. In practice this is likely



to be the case only where both parties are making unique and valuable contributions to the transaction, for example by contributing unique and valuable intangible property, that would be difficult to account for under the other methods.

### 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.*

As noted above, the NFTC believes that the profit split of actual profits is likely to be appropriate only where both parties to a transaction share in economically significant risks and make unique and valuable contributions. Where one party does not share in economically significant risks, then it would not be appropriate for that party to be allocated actual profits resulting from those risks. Moreover, even if both parties share in economically significant risks, those risks may be reliably accounted for by other methods unless both parties make unique and valuable contributions to the transaction, typically the contribution of one or more unique and valuable intangibles.

*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 NFTC believes that parties may make unique and valuable contributions to a transaction without agreeing to share the economically significant risks associated with that transaction, or without undertaking any risk management or control functions related to such risks. An example may be the license of a trademark to a licensee operating in a local market; the licensee may be making a unique and valuable contribution, but may choose not to undertake activities related to the management or control of the risks faced by the licensee in its market. In this case, it would be inappropriate to apply the profit split of actual profits. It may be appropriate to consider the profit split of anticipated profits as well as other methods.

### 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 NFTC strongly agrees that the presence of group synergies does not support the combining and splitting of all profits under a TPSM. If that were not the case, a TPSM would be applicable in virtually every case, which is not consistent with the arm's length principle.

#### 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?*

*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 NFTC agrees that 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." ¶ 24. As noted in the Discussion Draft, a global value chain alone does not justify application of a TPSM. Otherwise, "a profit split would apply in almost every case and risk producing results contrary to the arm's length principle." ¶ 25. To minimize the risk that the mere presence of a value chain leads to an inappropriate profit split, and because a value chain analysis is a tool in the functional analysis, we believe it is better suited for Chapter I. Placement of the value chain guidance in Chapter I would also make it clearer that this analysis may be relevant to all transfer pricing methods, not just the TPSM.

In addition, further guidance on when a value chain analysis is necessary and how it is different from a functional analysis would be helpful. The Discussion Draft does not mandate a value chain analysis in every case. The NFTC agrees that a value chain analysis should not be a requirement for all cases. There are many cases where entities that are part of a multinational enterprise are engaged in transactions that can be appropriately evaluated under a transfer pricing method, such as a CUP or TNMM, that may not be informed by a value chain analysis. A thorough understanding of the functions undertaken, assets employed, and risks borne by the parties to a controlled transaction is fundamental to a complete functional analysis. If a value chain analysis requires more, the Discussion Draft should so state and should elaborate on the differences. Placement of the value chain guidance in Chapter I, as suggested above, may assist in clarifying the distinction, if any, between a value chain and functional analyses.





#### 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.*

The NFTC has two observations on the guidance on applying the TPSM. First, in general a contribution analysis (as described in paragraph 32) is likely not practical in most industries as there will rarely be information on profit splits between unrelated enterprises that are comparable.

Second, the NFTC agrees that, with respect to a profit split of actual profits, the actual profits to be split are the profits from the transaction being evaluated. In practice, this will limit the application of this approach on a retrospective basis because it is unlikely that such financial information is prepared in the ordinary course of business or that reliable adjustments can be made to the financial information that is prepared. We would welcome further discussion of these difficulties, as well as guidance clarifying that it is not acceptable in such cases to resort to including profits in a profit split analysis that are not related to the transactions being evaluated.

#### C.4.4 – 4.5 Splitting profits and profit splitting factors

*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 noted in paragraphs 29-30 and 48, profit splitting factors should be factually related to the relative contributions of the parties to the transaction that contribute to the profits being split. This criteria is as important as the criteria set out in paragraph 42 (factors should be based on objective data, be verifiable, and be supported by external or internal data), and should therefore be emphasized in paragraph 42.

We note that the guidance on factors focuses on asset-based factors (relative contribution measured with reference to relative asset value) and cost-based factors (relative contribution measured with reference to relative costs). As noted in the Discussion Draft, in general, asset-based factors that rely on balance sheet valuations will not be reliable as balance sheets do not account for the value of intangibles in a consistent manner. A common method of allocating actual or anticipated residual profits resulting from the exploitation of unique and valuable intangibles contributed by two parties to a transaction is to determine the relative value of the intangibles based on the capitalized intangible development costs incurred by each party. This approach is addressed generally in paragraph 51. While it may not be appropriate to determine the absolute value of intangibles on the basis of intangible development costs, the TPSM



requires only the determination of the relative value of the unique and valuable contributions by each party. Moreover, the relative amount of investment in intangible development by each party can be a proxy for the level of risk undertaken by each party, thereby tying this factor to the underlying facts and circumstances of the arrangement that suggest a TPSM may be appropriate. It would be helpful to consider the utility of this approach and to provide additional technical guidance on its application.

Sincerely,

A handwritten signature in black ink, reading "Catherine G. Schultz", is displayed within a light gray rectangular box.

Catherine G. Schultz  
Vice President for Tax Policy  
National Foreign Trade Council  
[cschultz@nftc.org](mailto:cschultz@nftc.org)  
202-887-0278 ext. 2023



## **Appendix**

### **NFTC Board Member Companies as of August 30, 2016**

ABB Incorporated	Hanesbrands Inc.
AbbVie Inc.	HP Inc.
Applied Materials	Johnson & Johnson
British American Tobacco Company	KPMG LLP
Baxter International, Incorporated	Mars Incorporated
Caterpillar Incorporated	Mayer Brown
Chevron Corporation	McCormick & Company, Inc.
Cisco Systems, Inc.	Microsoft Corporation
The Coca-Cola Company	National Foreign Trade Council
ConocoPhillips, Inc.	Occidental Petroleum Corporation
Deloitte & Touche	Oracle Corporation
Dentons US LLP	Pernod Ricard USA
DHL North America	Pfizer International Incorporated
eBay Inc.	PricewaterhouseCoopers LLP
E.I. du Pont de Nemours & Company	Procter & Gamble Company
Ernst & Young LLP	Qualcomm Incorporated
ExxonMobil Corporation	Siemens Corporation
FCA US LLC	TE Connectivity
FedEx Express	Toyota Motor Sales, USA, Incorporated
Fluor Corporation	Tyco International
Ford Motor Company	United Parcel Service, Inc.
General Electric Company	United Technologies Corporation
Google Inc.	Visa Inc.
Halliburton Company	Wal-Mart Stores, Incorporated

## Discussion Draft on the Revised Guidance on Profit Splits Comments by NERA Economic Consulting<sup>1</sup>

September 5, 2016

to TransferPricing@oecd.org

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

Dear Sir, Dear Madam,

In the context of the BEPS Action Plan, Working Party No. 6 of the OECD has released on July 4, 2016, a document for public review outlining proposed guidance on the application of the transactional profit split method as amendments to Chapter II of the OECD Transfer Pricing Guidelines (“the Draft”). The OECD asks for the comments and discussions of several issues that will be taken into account for the revisions to the relevant guidance in Chapter II of the TPG.

We thank you for the opportunity to provide comments on this document.

### **1. Introduction**

In recent years, taxpayers have increasingly used transactional profit splits to set transfer prices or to test if they are at arm’s length. The profit split method is technically more complex in its application compared to standard methods, but standards and compromises for its pragmatic use have been developed by taxpayers, consultants, and tax authorities. In a number of cases, profit splits are the best method since they can determine and test the prices, which lead to the allocation of a fair share of profits between related parties.

Consequently, we believe a revision and detailed discussion of profit splits and their application to help progressing the transfer pricing debate, anchoring it in sound economic reasoning. As such, we would like to offer the following comments.

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<sup>1</sup> These comments represent views of the authors and do not necessarily reflect the views of NERA Economic Consulting.

## **2. We believe the presented new guidance to be of great quality**

As a general comment, we welcome the OECD's continuing focus on the profit split method, and consider the method to be of increasing relevance, as companies increasingly conduct valuable operations jointly across countries. With this draft, the OECD has done remarkable work in laying out the additional guidance:

- Regarding point 26, we especially appreciate the emphasis on Value Chain Analysis as an important analytical tool, particularly to identify the potential suitability of a profit split and the relative value contributions. In this context, we also support the observation that value chain is a "tool to assist in delineating the controlled transaction" and that the value chain analysis "does not, of itself, indicate that the transactional profit split is the most appropriate method"
- Regarding point 11, the discussion of 'unique and valuable contributions' as important factors in the applications of profit splits is of significant value to developing the transfer pricing consensus.

## **3. Practical aspects would deserve a stronger emphasis**

In our view the OECD does a very good job at presenting an overview of the theoretical overview of the method. While we realize a comprehensive overview of the practical application would be beyond the current scope of the draft guidelines, we nevertheless want to point out the importance of the factors to taxpayers. In particular, the mode of payments (royalties, pricing of goods, services), timing and form of adjustment payments and compatibility with customs declarations are aspects which can be solved, but which taxpayers should consider.

### **3.1. Determining value contributions by surveys**

Regarding points 54 through 57, we agree with the OECD that the determination of the variables that enter into the calculation of the split factor in particular is of great importance. In our experience, every enterprise creates value differently and relies on core activities that are multi-faceted. We therefore believe that the guidance on transfer pricing methods should not be too prescriptive – especially not for the profit split method, which is often applied in view of the core and unique aspects of a company's activities. Overall, the OECD is therefore correct in presenting multiple potential ways to determine profit split factors, profits to be split and other variables.

However, we believe the OECD should emphasize one of the most practicable and accurate approaches to determining value contributions to a larger degree. Expert surveys can be an important and appropriate tool to determine the relative value of various activities. Multinational

groups strive to conduct unique activities or build up valuable intangibles. These factors are often *systematically* different from market data, precisely because companies use them to differentiate themselves from the market. In these circumstances, external data would be of little value to accurately assess the economic value of the respective activities. Arguably, industry or company experts have the closest insight into how independent parties would behave in the respective industry.

Companies that employ unique assets or render unique services are almost by definition not comparable to other market participants. While we agree that “a lack of comparables alone is insufficient to warrant the use of a transactional profit split”, it should be noted that the absence of comparable market data *can* indicate the presence of unique factors in the tested party, which could consequently be tested by surveying industry experts. Hence, this approach can also be useful in the application of the profit split method, notably with regards to the determination of the split factor.

We therefore urge to recognize the use of surveys in the discussion in C.5 (Reliance on data from a taxpayer’s own operation). Survey data from internal or external experts should be accepted as a potentially valuable basis to derive profit splits, precisely because the relative value of intangibles and core activities is often subjective to the company. Surveys avoid arbitrary conclusions if done correctly, following scientific standards, and analyzed statistically. We agree that these factors, from the selection of experts, the drafting of questionnaires, to the actual conduct must be appropriately documented to limit arbitrariness.

### **3.2. Profits Splits based on the relative value determined with Game Theory**

Regarding points 29, 30, and 42 through 45, additionally to the potential use of internal or external expert surveys to assess the relative value contributions, as outlined above, we also invite the OECD to include the use of ‘Game Theory’ in the discussion of splitting profits (C.4.4). Game theory has been a corner point of economic theory for decades and explicitly analyses bargaining situation and outcomes. It is therefore particularly suitable to analyze the arm’s length results in potential bargaining situations.

Companies that possess the capability to conduct unique services or that can contribute intangibles which are not otherwise available would economically be expected to negotiate explicitly over the outcome of a shared activity. In particular in the absence of a wider market, bargaining would be a central element. In these circumstances is therefore reasonable to assess the likely outcome in terms of the profit share through bargaining theory, and apply game-theoretical concepts. Notably, a correct application of profit splits based on game theory should lead to results that are in line with other appropriate methods.

We draw particular attention to concepts such as Shapley Value, which was pioneered by the late Nobel laureate Lloyd Shapley, and seeks to distribute the value that is generated by multiple parties according to their respective bargaining situation. This can be measured by the potential value generation with and without the respective party. These values can be identified for example in financial statements, databases or through surveys.

### **3.3. Profits Splits for Sequential Integration**

Regarding point 21, we appreciate the OECD's effort to consider the typical delineation of risks associated with various forms of business integration in the new discussions. It is correct to assume that businesses that show a high degree of parallel integration can often be appropriately captured by a profit split.

However, we disagree with the assumption 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". Where this is the case, residual profit systems can be used. However, in fact, many groups conduct highly integrated sequential operations, which are nevertheless best captured through the application of profit splits, and for which little comparable data exists. Indeed, many Joint-Ventures are conducted between independent third parties who contribute 'sequential' value chain elements, such as the development and marketing of specific goods, and which are remunerated through a share in the jointly achieved profits.

Likewise, it should be recognized that intercompany transactions of multinational companies that have a highly integrated sequential value chain can and should sometimes be analyzed through a profit split. For example, companies in the digital economy very frequently exhibit a highly integrated business model, where specific product development, technological platforms, content generation, and commercialization are theoretically conducted in sequence. In practice these activities can often *not* be identified in isolation on the market, as they are highly specific to the company and so deeply ingrained in the overall value chain that they are not in fact conducted in the wider market.

In these circumstances it is not just difficult to identify market data, it would also be appropriate to use the profit split method, as the contributions of each party are unique and give rise to a joint product. Economically it is very likely that each party would therefore claim a share in the potential success of the overall activity. We note that these facts are recognized in the examples provided in point 10, and therefore ask the OECD to review its wording in point 21.

### **3.4. Unexpected Uncertainty**

Regarding point 5 and 17, the connection between the delineation of the actual transaction and the application of the profit split, we would agree that the general allocation of risks is an important factor to be considered. However, it should also be noted that contracting parties might not always foresee all relevant risks, and might fail to contractually account for all of these.

Such ‘unknown unknowns’ can significantly increase or decrease the relative value of contributions. In such cases, the parties should be analyzed according to similar behavior of similar third parties, i.e. to what extent the splitting would be changed, irrespective of existing contracts. Surveys may determine the typical range of usual behavior.

### **3.5. Applicability to PE profit attribution**

We think that it is important to note that the insights offered by the Draft are applicable integrally to the subject of profit attribution to permanent establishments. We strongly recommend alignment of the Discussion Draft on the Attribution of Profits to Permanent Establishments, issued simultaneously, with the current Draft, in particular where it concerns the importance of Value Chain Analysis, the economic significance of risk and the application of profit split as a method in situations of integrated operations.

In the present Draft on its turn, it might be useful to refer to the potential importance of profit splits when dealing with solutions for profit attribution to PEs. Such reference would be useful, *e.g.*, in points 10, 16 and 21 of the present Draft.

### **3.6. Loss Splits**

Regarding point 1, the latest draft continues to hold that “References to ‘profits’ should be taken as applying equally to losses.” While we agree that in many circumstances such an equal treatment of profits and losses is economically reasonable, it should be noted that this is not categorically true, and there should be room for exceptions.

Independent third parties often provide valuable intangibles under variable-royalty licenses, which typically contain a positive remuneration for the use of an intangible, but usually do *not* stipulate a loss-participation by the licensor. Similarly, joint-ventures between independent parties sometimes contain very asymmetric assumptions of risks (and chances), which can mean that losses are distributed differently than profits are. On the other hand, independent third parties sometimes do contain provisions that a licensor participates in startup losses, *e.g.* through initial subsidies.



In some circumstances it is therefore appropriate to make special consideration for loss situations. Taxpayers should be allowed to structure the transaction as sensible for their business, if this corresponds to what independent third parties would do, which might be evaluated through surveys (see above). However, care should be taken that the outcome is economically sensible. For example, if a party does not participate in the losses, it should be expected to earn a lower share in the profits compared to a party that is at full risks to losses.

*Philip de Homont, Tom Braukmann, Emmanuel Llinares*  
*Frankfurt, Paris*

## **Appendix A. Additional specific textual suggestions**

- Point 1, 2<sup>nd</sup> line: *Add...the transactional profit split method as “an appropriate, or even” the most appropriate, method...*
- Point 1, 6<sup>th</sup> line: *Add....transactions “in similar commercial or financial relations”.*
- Point 8, 5<sup>th</sup> line: *Add....reseller is “a priori” not expected...*
- Point 8, add: *“This may be different depending on character of the long term relationship between the parties involved and the degree of economic dependency of reseller.”*
- Point 26, 1<sup>st</sup> and 7<sup>th</sup> line: *Reverse order between “where” and “how”.*
- Point 26, 13<sup>th</sup> line: *Add....simply a tool “(even if in many cases the most essential one)” to....*

**Public comment received from Patrick Breslin**

September 5, 2016

**BEPS Actions 8-10: Revised guidance on profit splits<sup>1</sup>**

**Comments by Pat Breslin of NERA Economic Consulting<sup>2</sup>**

Dear members of OECD Committee on Fiscal Affairs and WP6,

I would like to thank you once again for the opportunity to comment on the above-mentioned public discussion draft. A brief summary of my comments is provided below, followed by comments and responses to questions raised in the draft revisions to guidance on profit splits.

As in my prior comments, my perspective relies upon my experience negotiating many arm's length transactions involving technology and other intangible property, as an entrepreneur and executive in the software, and digital media and commerce industries. These views are combined with my significant experience as an expert in transfer pricing and intellectual property matters.

The efforts and progress on this important topic are evident in the draft and reflect the continued diligence of the OECD throughout the BEPS process. In the view of these comments, the draft's attempts at drawing distinctions between different approaches to applying a transaction profit split (TPS) method are welcome and provide a helpful reference point for discussion regarding revising the guidance. While the specific examples provided may require refinement, these also provide helpful references for illustrating alternative analytical approaches and variations in views, as these comments have attempted to do.

Admittedly, these comments do not fully endorse the proposed emphases on certain TPS approaches, related descriptions and distinctions. But the confluence of these views with many other supportive views will hopefully reflect the spirit and intent of the overall process we have experienced throughout the OECD's ongoing international tax reform efforts. Thus, the constructive critiques here are complemented with references to the good work done on this draft and the revisions to other chapters of the guidelines already completed.

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<sup>1</sup> Hereinafter, these comments will refer to the draft revisions to sections of Chapter II of the OECD guidelines as "the draft."

<sup>2</sup> These comments represent the independent views of the author and do not reflect the views of NERA Economic Consulting or any of the author's colleagues. The author would like to thank Trevor Wagener and Sharon Brown-Hruska of NERA in Washington, DC for helpful assistance and support.

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Other subjects highlighted in these comments include:

- Variations on the guidance examples demonstrating alternative arm's length approaches
- Illustrations of hypothetical negotiations, both parties' perspectives, realistic alternatives
- Stress-testing whether certain conditions (*e.g.* "level of integration" and "shared risks") are more conducive to the applicability of a TPS relative to other transfer pricing methods
- Comments supporting extending existing references to key arm's length analysis concepts and elements of revisions to other chapters of the guidelines, with emphasis on:
  - Thorough consideration of facts, circumstances, functions, assets and risks pertaining to controlled transactions and the subject parties
  - Closely regarding options realistically available in an arm's length analysis
  - Properly distinguishing arm's length conditions from "controlled conditions" endemic to multinational enterprises as justification for selecting appropriate methods
  - Thorough consideration of available arm's length evidence in determining appropriate transfer pricing methods

*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 the transactional profit splits of actual profits clear?*
- 2) Is the distinction between the two profit split approaches described useful?*

Certain distinctions between the two approaches seem fairly clear in some respects for discussion purposes and may be useful in this context. In other respects, distinctions made are less clear and may risk being perceived as ambiguous as currently drafted. It is also worth exploring whether or

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not the key aspects of the TPS of anticipated profits are already sufficiently addressed in the revised guidance in Chapters I and VI, for example.

The two TPS approaches are introduced briefly in paragraph 2 of the draft, which states,

Splitting profits on an economically valid basis can be described in two broad ways. One approach to splitting profits is to combine and split **anticipated** profits. The second approach involves combining and splitting **actual** profits. (Emphases added)

In the statement immediately following, however, the draft seems somewhat ambiguous as to the relevance of describing these two approaches in the draft guidance on profit splits. It states in paragraph 2,

Although some considerations surrounding transactional profit splits of anticipated profits will be presented in this section, the focus will be on the application of the transactional profit split of actual profits as the “most appropriate method” for evaluating pricing of an accurately delineated transaction.

The reasons behind the draft’s greater emphasis on a TPS of actual profits as the “most appropriate method” (as opposed to a TPS of anticipated profits) are not stated or clearly supported.

Additionally, strong reservations about the last statement in paragraph 2 are hereby expressed—as whether or not any TPS method application is the “most appropriate method” would clearly be determined on a case by case basis giving consideration to Chapters I-III, and likely Chapter VI as well. As noted throughout the guidelines, such a determination must result from full consideration of the facts and circumstances of the case; the functions, assets and risks of—and options realistically available to—the transacting parties; the availability of arm’s length evidence to apply other methods and any related adjustments; etc.—as described in the guidelines.

On the other hand, the author concurs with the draft making a clear reference to relevant sections in the 2015 revisions to Chapter VI of the guidelines—particularly with respect to the TPS of anticipated profits—as the draft notes at the bottom of paragraph 4. Paragraphs 3-5 will be discussed in more detail below, after addressing certain items in paragraph 6.

### *Significant differences*

After the draft provides further descriptions of the two TPS approaches, Paragraph 6 highlights some of their “significant differences”,

- a) A significant difference between the two approaches to the application of the transactional profit split method is that combining the profits of each associated enterprise under a transactional profit split of actual profits requires **a high level of**

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**integration of activities.** This is discussed in Section C.3.1.

- b) A further difference between the two approaches is that there is **a greater sharing of uncertain outcomes resulting from risks** associated with the transaction under a transactional profit split of actual profits, than under a transactional profit split of anticipated profits. (letter bullets added)

Addressing the second difference in item b first, a question arises as to whether the draft is sufficiently clear or consistent in supporting its point that “a greater sharing of uncertain outcomes resulting from risks associated with the transaction” pertains to a TPS of actual profits relative to a TPS of anticipated profits. Without better establishing that such key differences exist between the two approaches, additional questions are raised about the overall importance of the distinction, as described further below.

*Risk allocations and predictability in payment terms*

The draft seems to indicate that a key factor in distinguishing between the splitting of anticipated profits *versus* actual profits relates to differences in the predictability of the profits or compensation realized by the parties under each approach. Such differences would be analogous to comparisons of fixed *versus* variable payment terms and associated risks—and could be potentially relevant to any analysis.

Of course, the terms and form of payment associated with any transaction play an important role in determining how certain risks are contractually assumed and experienced between the parties—whether in a controlled transaction or an arm’s length transaction. For example, receiving a fixed or predictable payment stream is less risky to the seller of a product or service than a variable payment stream contingent on uncertain outcomes—when this issue is considered in isolation.

As paragraph 4 describes, the TPS of anticipated profits is used to “determine a **price** for the contributions” of associated enterprises in a controlled transaction on an *ex ante* basis. Accordingly, the TPS of anticipated “profits”, as described, perhaps could reflect a more predictable (and potentially fixed) form of compensation—though the draft may not always achieve consistency on this point.

In so far as this approach sets a “price” to be paid to a transferor of an intangible—and assuming that only the transferee experiences uncertainty regarding the compensation (profits) it will realize—one might also anticipate technical arguments as to whether the anticipated profits approach should be considered a profit split *per se*.

Conversely, the TPS of actual profits, while also agreed *ex ante* as would occur at arm’s length, results in an *ex post* sharing of actual (and not anticipated) profits. Thus, the TPS of actual profits provides *both* of the parties’ with more variable compensation that is contingent on uncertain

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outcomes—both parties experience any potential losses as well. Consequently, according to the draft, the parties share risks to a greater degree under the TPS of actual profits approach—relative to the anticipated profits approach.

But the draft later acknowledges that use of a TPS of anticipated profits may also result in contingent compensation to the transferor (and thus both parties). This may somewhat diminish the clarity of the distinction between the two approaches. Paragraph 6 states,

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.

Thus, the additional “certainty” surrounding expected royalties established under a TPS of anticipated profits could evaporate in the face of recalls or other quality issues regarding the counterparty’s product.

If the draft’s meaning with respect to “sharing of risks” is limited to this context (*i.e.* predictability of expected profits or payments to the parties)—it should be stated as such more clearly and explicitly. If the risk-sharing context is not intended to be so limited and/or includes sharing risks in other respects, these other risks (and respects) too should be clearly stated and described.

It is worth noting here that a wide variety of risks other than those directly associated with the payment structure or compensation terms may be addressed in arm’s length contracts and relationships. These may include, among others, risks relating to the parties’ rights and obligations—risks that would clearly have an effect on compensation to varying degrees (if indirectly). There are other risks that may be less likely to be shared.

For example, risks related to the term (duration) and termination rights in a contract (or relationship) can impact each party in different ways under any compensation structure, profit split or otherwise. Termination rights may relate to risks that one of the parties fails to perform its role in the relationship—thus, there are key risks that may be realized due to the actions (or inaction) of only one of the parties. Could this not also occur under a TPS (*i.e.* non-performance of key functions) and are such risks and consequences shared?

For example, what if one party simply does not make payments due to another party under a TPS (or any payment structure)? In this case, are such risks shared—and does it matter whether or not the payments were structured in a more predictable manner *ex ante*? In either event, one party does not receive payments it expected—and the other keeps payments it was presumably obliged to pay.

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To be fair, the draft’s intended meaning may be that *certain* risks are shared to a greater degree under the TPS of actual profits approach—and not other risks. But the draft must ultimately be consistent in making assertions regarding whether the TPS of actual profits entails a “greater sharing of risks” between the parties as a general matter—and in relation to other transfer pricing methods. Especially if, according to the draft, this issue necessarily carries significant weight in determining how and whether a TPS approach should be applied.

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.*

Item 2 will be revisited in later comments. The following comments will first address certain aspects of item 3 above (examples of scenarios) as well as aspects of item 18 from later in the draft.

3. *(Item 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.*

*(Item 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.*

**Note:** *It is important to caveat that the comments herein do not take the view that examples provided in the draft reflect TPS approaches that would be considered “most appropriate”—in any particular context or in general—regardless of the wording in comment request items 3 and 18. That said, the author attempts to shed light on important arm’s length conditions and approaches that could appropriately be applied in arm’s length analysis based on variations in the draft’s examples—though such examples are necessarily limited.*

As noted above, the two TPS approaches are introduced in paragraph 2 of the draft, which states,

Splitting profits on an economically valid basis can be described in two broad ways. One approach to splitting profits is to combine and split **anticipated** profits. The second approach involves combining and splitting **actual** profits. (Emphases added)

Paragraph 4 further elaborates on conditions that might support a TPS of anticipated profits,

[T]he profits [are] anticipated to be generated by Company B from commercialising products using its own intangible and the rights to an intangible contributed by Company A over an appropriate period are determined. The respective contributions made by each of the associated enterprises (both Company A and Company B contribute intangibles, and Company B makes additional inputs to commercialise the product using both intangibles) are then used to

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determine a **pricing arrangement at the time of the transfer** based on the anticipated profits of Company B resulting from the combined contributions of the enterprises that seeks appropriately to **reward each company for its contribution** to those anticipated profits at the time of the transfer. (Emphases added)

Paragraph 4 on TPS of anticipated profits continues,

Further guidance on the potential application of transactional profit split methods to transactions involving intangibles is provided at Section D.2.6.2 of Chapter VI. Typically a transactional profit split of anticipated profits will be used in conjunction with a discounted cash flow valuation technique as described in Sections D.2.6.3 to D.2.6.4 of Chapter VI and discussed further in paragraph 20 of this Section.

Here again, there is some ambiguity as to the need for this revised section of Chapter II to address this particular TPS approach—as most (if not all) necessary facets of performing an arm’s length analysis under such a scenario were substantially addressed in revised guidelines (Chapters I and VI) as finalized in 2015. Caveat here as well that the description in the draft is incomplete in addressing arm’s length concepts and thus in determining whether or not the described approach is “appropriate,” much less “most appropriate.” Such missing concepts are not limited to whether or not DCF and/or other valuation techniques are applied.

Thus, there are additional interactions between arm’s length concepts and conditions covered in revised chapters VI and I that would be particularly relevant here. Such concepts include the fact that independent would naturally consider the options realistically available to them in engaging in any similar arrangement under arm’s length conditions.

*Comparing options realistically available at arm’s length (examples based on paragraph 4)*

Based on the facts described in paragraph 4, it is easy to see alternative arm’s length analyses that exist and thus the use of a TPS of anticipated profits *per se*—strictly as described in the draft—may not apply under the same fact pattern.<sup>3</sup> Example scenarios described below focus more squarely on core elements of arm’s length behaviour—such as considering alternatives realistically available to the parties in arriving at arm’s length prices.

For example, assume that the company in Country A (Company A, or “Alpha”) and the company in Country B (Company B, or “Beta”) are independent parties operating at arm’s length. In this case, it would be very common for Beta to compare its net present value (NPV) from

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<sup>3</sup> Paragraph 4 itself is clear that the draft is “Assuming that the facts of this case lead to the conclusion that a transactional profit split of anticipated profits is the most appropriate method to apply...” and thus implicitly acknowledges the potential that other methods could be more appropriate.



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commercializing the products using Alpha’s technology—referred to below as “Case A”—to its NPV under other options realistically available to Beta. Thus, at arm’s length, Beta would consider alternatives that might include, for example,

- Using Beta’s own technology (or some functionally equivalent internal approach or resource)—hereinafter referred to as “Case B”—instead of employing Alpha’s technology;
- Licensing a comparable technology from a third party (*e.g.* Company C) in place of A’s technology—referred to below as “Case C”—etc.

Of course, Beta’s internal analyses would likely compare these scenarios using a discounted cash flow approach—as described in sections of Chapter VI and noted in paragraph 4—for each of the available cases. The NPV approach is of course necessary to compare the different profit or payment streams in cases A, B and C—given that each scenario will likely entail a different pattern of cash flows over a multiyear period, making an NPV calculation necessary for an “apples to apples” comparison. But the insight from an arm’s length perspective is that each party compares its own alternatives once these options are expressed on this comparable basis (*i.e.* present value).

Thus, assume that under Case A, Beta’s internal analysis of a license to use Alpha’s unique and commercially developed technology would optimally seek an annualized royalty payment of \$1 million, or 5% of projected annual sales of \$20 million. Assume that this scenario would produce expected annual profits of \$3.5 million and an NPV above \$50 million for Beta.<sup>4</sup>

Beta has also considered other alternatives as it has historically used its own, less advanced technology coupled with more traditional production techniques—*i.e.* Case B above. If Beta stays the course with Case B and does not use A’s technology, it will experience lower sales and sales growth—annualized at \$18 million a year, contributing to lower profits of \$2.3 million a year, in spite of lower annual costs related to technology alternatives. The NPV of Case B would be about \$40 million for Beta. Naturally, given the assumptions in Beta’s internal analysis, Case A is superior.

But wait. Alpha does not think so—as Beta learns in its initial negotiations with Alpha. Alpha licenses its technology in some markets, such as Country B, but it also arranges its own production and distribution in Country A and other markets. Alpha’s alternative to Case A is Case D—wherein it pursues making its own product entry in Country B to compete with Beta and other players in that market.

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<sup>4</sup> To extend the example a bit further, Company B might project expected revenues, costs and profits over a multi-year period, for example, with a terminal value assuming continued renewal of the license—and discount these cash flows at its required rate of return to arrive at an NPV under the Case A, 5% royalty scenario.

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Under Case A, Alpha expects to realize royalty revenues from Beta of \$1 million annually—and with annual tech support and maintenance costs of about \$200 thousand, it would expect profits of \$800 thousand per year.<sup>5</sup> Under Case D, Alpha projects revenues of \$18 million annualized over about 8 years. Though Alpha would also have somewhat higher production and distribution costs in Country B than Beta, Alpha could still make a profit of \$1.3 million annualized under Case D. Alpha summarily rejects Beta’s offer of a 5% of sales (or \$1 million expected) royalty. Alpha’s management considers this might be the year to expand operations in Country B.

As arm’s length negotiations go—the parties’ alternatives inform the prices they are willing to pay (receive). Alpha’s counter offer is a 15% royalty on Beta revenues (or an expected value of \$3 million in annual royalties)—but Beta rejects this as such royalty costs would reduce its annual profits from this product category to \$1.5 million, with an NPV of about \$30 million. With this scenario, Beta’s annual profits sink well below the \$2.3 million expected in its Case B alternative

Ultimately, the parties agree on an annual royalty of 10% of Beta sales, producing annual licensing costs of \$2 million for Beta (on \$20 million in sales in Country B) and yielding Beta annualized profits of \$2.5 million and an NPV of about \$45 million. With \$2 million in royalty revenues per year, Alpha expects \$1.8 million in annual profits from Beta royalty revenues after its related technology costs.

Paragraph 5 describes the circumstances that would apply to a TPS of *actual* profits as follows:

As an example, consider the following scenario involving the transfer of rights in an intangible by Company A to an associated enterprise, Company B and the transfer of rights in an intangible by Company B to Company A, in circumstances where each company commercialises a product using the intangibles in combination.

In comparing the descriptions of the two TPS approaches, it becomes apparent that the previous fact pattern (*i.e.* for the description of a TPS of anticipated profits in paragraph 4) is fully embedded as one part of the example in paragraph 5—with expanded facts being added.

According to the draft, the underlying conditions relating to a TPS of *actual* profits are more complex and extensive—expanding the prior example to encompass product revenues generated by both Alpha and Beta in countries A and B, respectively. The facts also include a second intangible contribution, this time transferred *from Beta to Alpha*. Thus, facts and circumstances here entail that “each company commercialises a product using [both Alpha’s and Beta’s] intangibles in combination.”

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<sup>5</sup> For simplicity, Alpha’s alternatives are described in annualized figures only—though these would presumably be derived from its own application of discounted cash flow approaches.

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It would seem under the latter example that, while the parties each use each other's intangibles, they separately exploit these in their respective country-markets without competing within either market. Once again, the example doesn't necessarily relate directly to the need to apply a profit split.

Regardless, at arm's length, these parties would likely negotiate a license (or other transfer of rights in Beta's intangible) *from Beta to Alpha*, in much the same manner as discussed above regarding the technology license from Alpha to Beta.

That is, they would negotiate based on their respective conditions and perspectives while considering the options realistically available to each of them. The parties might agree on a range of possible combinations—*e.g.* from cross-licensing each other's intangibles to not concluding any transaction at all (due to preferable alternatives with other parties), including various combinations in between assuming they meet terms and conditions acceptable to both.

What is the relevance of paragraph 5's example to the applicability of profit splits more generally, for example? In other words, do parties at arm's length carry out multiple transactions with each other? Of course. Do cross-flows involving multiple transactions between the parties (whether involving products, services or intangibles) affect consideration received (paid) for other transacted items (monetary and/or non-monetary) or the benefits of the overall relationship? Absolutely. Do these potential arm's length conditions result in any use of profit splits or similar transaction structures by independent parties? Based on observable public information?—rarely, if at all.

*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. (From **Item 2** above)*

As mentioned in the question item 2 and in various references in the draft, a “high level of integration” is often noted in conjunction with a “greater sharing of risks.” The draft also frequently discusses aspects of “highly integrated” activities in conjunction with the potential selection of the TPS as an “appropriate method.” It is not entirely clear that these potential links justify the appropriateness of a TPS any more than they would justify use of any other method, with the possible exception of sharing risks when applicable.

Further, considerable caution is expressed regarding many references in the draft suggesting that a high level of integration should help justify the selection of the TPS of actual profits as the “most appropriate method” (*e.g.* see paragraph 19).

As discussed in the introduction to these comments, as well as in paragraph 1 of the draft, arm's length analysis should “seek to eliminate the effect on profits of special conditions made or imposed in a controlled transaction”—*i.e.* controlled conditions. Clearly, a “high level of

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integration” of business activities is a controlled condition. Indeed it is a major motivation upon which the existence of MNEs depends.

By integrating vertically across a value chain, MNEs internalize access to upstream resources and suppliers and downstream sales and distribution channels, for example—creating efficiencies by controlling such relationships through common ownership. It is these controlled conditions—and their natural effects on transfer prices—that call for analysis of transactions and parties under arm’s length conditions in the first place.

Of course, integrated activities are nearly unavoidable among many MNE affiliates, as they necessarily operate under controlled conditions. In that sense, in almost every case in which a transfer pricing method is selected as most appropriate, these same conditions might also apply, regardless of whether the method selected is a TPS or otherwise.

4. *Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarized?*
5. *Do the transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses? If so, what are they?*

Please see comments above regarding question items 4 and 5. To these I would add that “flexibility” is less convincing as a “strength” of applying a TPS (as noted in paragraph 12). All methods must make comparisons involving parties operating under controlled conditions and those facing arm’s length conditions. Thus, where the controlled parties to any analysis are concerned, that they may operate under “specific” and “unique” facts and circumstances seems to be a general condition. Doesn’t this then mean that all other methods also provide “flexibility” in the face of specific and unique facts and circumstances?

Paragraph 13 appears to suggest that applications of the TPS are less likely to produce improbable results. This statement may be outdated and may not be supported (absent further clarification). The paragraph also may err too much on the side of the TPS for assessing the value of contributions from *both* parties to a transaction. Especially given new guidelines in other chapters, there is an increasing recognition that two- or multi-sided analyses are not solely the domain of the TPS.

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?*

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Please see previous comments above and additional comments below.

- 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.*

In the author's view, the draft relies heavily on fashioning a connection between certain concepts including its focus on sharing economically significant risks by the parties to the subject transaction; as well as highly integrated activities among the parties; and unique and valuable contributions by more than one party.

While these concepts themselves may be important in some cases, in referencing them repeatedly the draft does not seem to make its reasoning clear enough to establish whether or why they might justify selection of a TPS approach as the "most appropriate method" in general.

Furthermore, the draft tends to make assertions about these concepts—including assertions about risk-sharing—in multiple and sometimes only tangentially-related contexts. For example, paragraph 6 focuses heavily on the asserted "greater degree of risk sharing" in a TPS of actual profits *versus* anticipated profits as follows (in part):

...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. For example, in the scenario outlined above where both Company A and Company B combine their profits from commercialisation of the product, then if either company varies its marketing spend, this may affect the resulting profits to be split between the enterprises where the profits are split at the net rather than the gross level...

Such detailed discussion strictly for comparing one TPS approach to another risks creating confusion as to whether or not such assertions relate to the potential use of a TPS as the "most appropriate method" in general (*i.e.* relative to the other transfer pricing methods). Certainly, assertions regarding use of a TPS in general would be of greater importance. If needed, distinguishing TPS approaches could reside in later technical guidance on application. In the current draft, these potentially secondary comparisons of two TPS approaches precede discussion of whether and when a TPS should be used at all.

Later in paragraph 16, the draft provides a much less emphatic description of the importance of risk-sharing in the context of a TPS of actual profits—here in a subsection entitled "most appropriate method" (Section C.3). At this point, the draft presumably *is* attempting address one of its major purposes when it states,

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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. (Emphases added)

However, it is not at all clear that when parties “separately assume closely related risks” it necessarily entails that they “should share in the resulting profits or losses.” These statements therefore do not clearly support the use of a TPS as more “appropriate” than other transfer pricing methods.

For example, developing and maintaining product quality and brand recognition, respectively, very often entail two or more parties that “separately assume closely related risks” that are associated with the same product revenues and profits. However, there is no inherent connection between such a relationship and the parties’ willingness to share profits or structure their respective compensation by any other means—certainly not at arm’s length where such structures rarely occur in any event. Issues beyond the scope of these comments arise with respect to whether there are limits in the ability of the TPS to reliably assess arm’s length value, regardless of what it implies or imposes regarding transactional structure and variable compensation streams.

Paragraph 16 thus appears to make assertions that are tenuous as currently drafted. As a related editorial comment, the last sentence of paragraph 16 is rather confusing as drafted—while other portions of the paragraph appear to very properly emphasize the importance of Chapter I, Section D, for example.

Paragraph 17 revisits the association between contingent remuneration and sharing in the outcomes of risks associated with business activities—which it notes as “required for the transactional profit split of actual profits to be the most appropriate method.” However, it is rather strange that this actual profits approach and related risk-sharing concept are illustrated through an example describing “non-contingent remuneration to one of the parties” that would “not be sharing” in the outcomes of such risks. Perhaps this description should be removed or replaced—currently it better describes a TPS of anticipated profits which is a distinction that seems to have less significance at this point in the draft.

It is also worth noting additional consistency issues in that paragraph 17 references Example 1 (from paragraph 1.83 of Chapter I). This example exhibits key characteristics that are also noted in paragraph 16—however, paragraphs 16 and 17 draw opposite conclusions regarding these very similar issues.

Paragraph 16 suggests that when parties “separately assume closely related risks” they “should share in the resulting profits or losses.” But as paragraph 17 highlights, the R&D development risk of a transacting party on the one hand, and the performance risk of a counterparty contracted to perform that same R&D on the other, may well be interpreted as risks that are “separately assumed



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[and] closely related.” Yet in paragraph 17 this contract R&D transaction is rejected as a case in which “a transactional profit split would not be the most appropriate method to apply.”

That said, this section also offers well-made points including the need to consider and possibly adjust inexact comparables rather than apply an inappropriate application of a TPS—and when it rejects justifying use of a TPS due to a lack of sufficient comparable data alone.

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.*

Please see earlier examples and comments provided above.

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?*

Please see earlier comments provided above regarding whether the degree of integration informs appropriateness of transfer pricing methods as a general matter.

There may be some usefulness with respect to the concepts of “sequential” and “parallel” integration in certain contexts—but in its current form the draft does not make their usefulness for transfer pricing purposes clear. Paragraph 21 notes that “parallel integration” involves “multiple parties to the transaction [operating] at the same stage of the value chain.” Does it include a group of MNE distributors based in a number of different countries?

Under parallel integration, parties would also each share significant risks with the result that a TPS of actual profits “may be found to be the most appropriate method.” Couldn’t the distributors effectively share risks (or “separately assume closely related risks”) such as the risk that the products of their common related suppliers have product quality or recall problems? Whether one considers these risks as “shared” among the various distributors at one stage in the value chain (parallel integration according to the draft), or shared between the distributors and manufacturers (sequential integration according to the draft), here parties that face a potentially wide range of conditions clearly could also face the consequences of these product quality issues and related risks. How does this specifically relate to profit splits?

In paragraph 21, the draft acknowledges that “most business operations undertaken by an MNE group are integrated to some degree.” If the important condition is that parties “perform functions, use assets and assume risks” that are “interlinked” with those of other parties—this again would need further clarification. “Interlinked” is a fairly broad and ambiguous term. Does it mean “interdependent,” for example?

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Further, a “high degree of commonality” is tied to “parallel integration” but neither of these terms have a very clear meaning for transfer pricing analysis. The author’s concern is that the draft would introduce new jargon into the guidelines that can be misinterpreted or taken out of context. “Commonality” and all forms of “integration” would seem to be classifiers that have very broad application to most affiliates within any MNE group—such that that it is unclear that use of such terms would add insight regarding the application of the arm’s length principle outside of these controlled conditions.

- 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?*

As with question 9, these questions 10 and 11 highlight the need for greater clarity on what it means for risks to be “shared” and “economically significant” if such concepts will be considered in determining whether a TPS is more appropriate than another method.

At arm’s length, surely a computer chipmaker and a laptop manufacturer / retailer each may make unique and valuable (tangible and intangible) contributions. They would each assume economically significant risks associated with the transaction (e.g. a computer chip supply arrangement). Some risks would pertain separately to each and some to both parties. Some would be “shared” in some senses, “separately assumed but closely related” in others, and some risks would be managed or mitigated by one or both parties.

- 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.*

No further comments on this point.

- 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?*



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- 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 comment)*

On this point, the draft provides a fair assessment of the purpose and usefulness of value chain analysis in transfer pricing contexts, subject to editorial refinements over the normal course of this project.

- 15. What further guidance or clarification of existing guidance would be helpful in these sections? Please provide practical examples in support of the response.*
- 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? Please illustrate your response with examples.*
- 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 comments provided above that address many of the issues addressed in items 15 through 18. Additionally, significant comments responsive to item 18 were provided earlier in the comments in conjunction with item 3.

Once again, thank you for the opportunity to provide comments with respect to this interesting project regarding this important section of the OECD guidelines.

Sincerely,

**Patrick Breslin**  
Washington, DC  
September 5, 2016



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5 September 2016

Dear Mr. VanderWolk,

***PwC's Comments on the Organisation for Economic Co-operation and Development (OECD) Public Discussion Draft on BEPS Actions 8 – 10 – Revised Guidance on Profit Splits***

PricewaterhouseCoopers International Limited, on behalf of the Network Member Firms of PwC ('PwC'), thanks the OECD for the opportunity to provide comments on the Public Discussion Draft on BEPS Actions 8 -10 *Revised Guidance on Profit Splits*.

The Discussion Draft sets out to explain and open up a dialogue on the OECD's revised guidance on transactional profit split methods. This Discussion Draft makes a distinction between profit split methods based upon projected profits and actual profits. It also addresses issues related to the integration of business activities, global value chains analysis and cases where the profit split methodology could be the most appropriate transfer pricing method under particular circumstances. The analysis in the Discussion Draft attempts to connect the use of the Profit Split Method ('PSM') to the new guidance developed under the Revised Chapter I (in particular Risk) and Chapter VI (Intangibles).

PwC welcomes the Discussion Draft, which appears to have achieved an appropriate tone and balance, in most instances. However, some concerns arise with regard to the use of unclear or subjective wording or concepts without further explanation. For example, the Discussion Draft still uses concepts, such as 'integration' and 'global value chain', which may make it easier for tax administrations to apply the PSM rather than improving the guidance on the selection of the most appropriate transfer pricing method applied to the circumstances of the case. The guidance would not reach its aim if a PSM were used to overrule one-sided methodologies that are appropriately selected and applied. Emphasizing the use of PSMs may encourage tax administrations to use a profit split approach in cases where it does not assist in applying the Arm's Length Standard ('ALS') and, hence, not achieve tax parity between associated and independent enterprises, while at the same time leading to more controversy between the tax authorities.

There are a number of concepts raised in the Discussion Draft which cause a specific concern, particularly when taken together. In a number of territories there is a recurring concern that a profit split arrangement could give rise to a deemed partnership between the parties with a range of complex and adverse consequences for all concerned. Consequently, we believe it is very important that the OECD emphasises the fact that the transfer pricing method called the Transactional Profit Split Method is a method of arriving at a price for a transaction and is not an actual distribution of profits amongst a group of participants.

The areas in the Discussion Draft that add weight to this concern include those of ‘risk sharing’ and ‘parallel integration’ together with the sense the draft seems to convey at times that what is intended is simply a general splitting of profits rather than an exercise in setting a price.

In the Discussion Draft, the ‘Risk’ element receives a great deal of attention. It should be noted that risk is just one element of the functional analysis and, although the importance of risk should be recognised, the Discussion Draft must ensure that a balanced discussion on the three factors (functions, assets and risks) is maintained. It is important to stress, in the guidance, that simply because (important and/ or significant) risks are identified in a transaction this should not automatically lead to the adoption of the PSM as the most appropriate method.

In the following pages, PwC has identified various approaches to many of the questions raised in the Discussion Draft. Our detailed comments are presented in a format that parallels the Discussion Draft’s structure.

**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?**

The formal difference between the PSM on anticipated profits and on actual profits is clear. However, businesses do not usually use a PSM in their arrangements, except under the terms of an Advance Pricing Agreement (‘APA’). Applying a PSM between multiple entities of a Multinational Enterprise (‘MNE’) may come close to Global Formulary Apportionment methodology (‘GFA’) and the PSM should be clearly distinguished from a GFA. Care should be taken such that the PSM does not become a default or fall-back method whenever a tax administration does not like the transfer pricing outcome.

The distinction in practice between the two approaches may be rather confusing. Its application should be the same, in theory, regardless of whether it is based on actual or anticipated profits. PwC notes that in practice a split of anticipated profits is a prospective basis for setting a price (for example a royalty rate) while a split of actual profits is more likely to involve retrospective adjustments to the price of a transaction.

PwC would like to reinforce that a PSM is a ‘transactional’ transfer pricing method which means it is a methodology to arrive at a price for a specific intra-group transaction (or transactions that are appropriately aggregated in accordance with the Guidance in the OECD Transfer Pricing Guidelines (‘TPG’)). It is not an actual distribution of profits amongst a group of participants.

**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.**

A lot of emphasis is placed on the sharing of risk. It must be recognised that risk is an important factor, but not the only factor. The link between the integration of business activities and the appropriate application of a PSM (be it on actual or anticipated profits) lies in the functional analysis (functions, assets and risks) and not in the risk alone.

PwC considers it would be helpful to provide additional clarity on what exactly the OECD means by risk sharing. For example, many companies within a group may be exposed to the same or similar business risks. That does not mean they are ‘sharing’ them. Many other independent companies in the industry are likely to be exposed to the same risks and this fact will not hinder them in doing business with each other without resorting to a PSM. Similarly, the effect of using a PSM is that the parties share in the relevant risks, but this is a consequence and cannot be a reason to use that method.

The discussion in paras 9 and 10 of the Discussion Draft is helpful in referring to the revised Chapters I-III by saying that two or more parties must jointly control the risk(s) in question and provide the financial capacity to bear the risk(s). The guidance could be made more explicit by indicating that the joint control of the risk and the financial capacity to bear the risk is one of the indicators pointing towards use of the PSM. It would be helpful to clarify that this is what is meant by ‘risk sharing’. This section of the Discussion Draft also provides examples of different ways in which such situations are handled by independent parties. This demonstrates that risk ‘sharing’ of this type is a necessary but not a sufficient condition. In other words it will not always result in a PSM and cannot be conclusive in and of itself. The Discussion Draft could be clarified in that respect.

**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.**

One example on the use of the PSM on anticipated profits is royalty rate setting. This approach considers the contributions of both (or more) parties to the transactions and uses the residual profit to determine the value of the intangible(s) concerned and set the appropriate royalty rate.

A useful reference can also be made to paragraph 6.141 (reference to residual value) and section D.2.6.2 of the revised Chapter VI of the OECD TPG.

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

The draft guidance in this section is mostly based on the existing guidance in the 2010 version of the OECD TPG. However, given the other developments in the Discussion Draft and the issues outlined elsewhere in these comments (see the introduction/ general comments and the response to Question 1), it would be helpful to stress that in the situations described in paras 12 and 13 of the Discussion Draft the goal is still to determine the price for a controlled transaction (or transactions) and that the PSM may be a way of determining that price albeit not a methodology that unrelated parties would necessarily have used.

A weakness of the PSM which should be noted here is that in the absence of reliable comparables or industry data it will often rely on subjective judgement and can be sensitive to changes in the factors used or the relative weightings given to them. Where the method is appropriately used it would be helpful if the OECD were to:

- reiterate that the absence of reliable comparables or industry data should not in itself be a factor that triggers the application of the PSM, and
- state that a reasonable selection of factors and weightings should be respected by a tax authority.

This is one reason why APAs are often sought where this method is to be used.

**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 Discussion Draft seems to suggest that a PSM based on anticipated profits and actual profits are different methodologies, while in principle they should be the same. Arguably there is a bigger difference between:

- a split of anticipated profits to fix a price for the medium to long term (say 5-10 or more years) versus one year, and
- using anticipated profit to (re)set a price one year at a time versus splitting actual profits.

One additional weakness of using a PSM of anticipated profits (for the medium to long term) lies in its reliance on the accurateness of the financial projections (reference can be made to Chapter VI on the valuation methods).

**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.**

Sharing of economically significant risk may be an important factor in the selection of the PSM as the most appropriate method, but it is not the only factor. As indicated in paragraph 16, the use of the PSM will depend on the accurately delineated transaction, based upon a functional analysis. Notably, the other paragraphs of the section only discuss risk, which is one factor of the functional analysis. This risk factor should be put in its right and balanced context.

In light of the emphasis on (the sharing of) risk, it would seem that the other situations in which a PSM may be appropriate are left unilluminated. It may be useful to introduce the discussion of (the sharing of) risk in a separate subsection.

**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.**

In most, but not all, instances this will be in an APA context.

Royalty-rate setting for future years (where the issues of Hard to Value Intangibles must also be considered), may be another area.

**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?**

PwC agrees it is helpful to make the point that sequential integration is not a basis for use of the PSM. An industry supply chain of independent parties may well be sequentially integrated (for example suppliers of parts to original equipment manufacturers which may co-operate extensively) without inhibiting them from setting prices or giving rise to a split of profits.

However, the concept of parallel integration is more difficult. If the reference to parallel integration is simply for the purposes of inserting a description of circumstances which are not sequential, then it is straightforward. If such is not the case, parallel integration is not, of itself, a reason to apply the PSM and it is not clear that a separate discussion thereon is strictly necessary.

If, as it seems, it is intended to mean something specific, this should be clarified. For example, two group companies may make different parts which are included in a product at a later stage of production by a third group company. They operate in parallel in the supply chain, perform similar functions and are exposed to (and assume) the same or similar risks (the Discussion Draft refers to commonality in functions and risks) but there is no reason why this fact pattern would lend itself to the use of PSM as most appropriate method. They may not even transact with each other. The 'commonality' the draft refers to must mean more than 'similar and at the same time'.

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

When read together with the text in the Discussion Draft on the sharing of risk, the meaning the OECD appears to intend for parallel integration in a situation where two or more parties are extensively co-operating in a specific business process. For example, in a global financial trading business where the 'book' is passed from location to location as exchanges in one country close and others open, it is easier to see how this applies. Outside the financial services sector it is harder to envisage what this entails and instances where it applies are likely to be less common. Nevertheless, this may be a good example to use. However, PwC understands that work on financial transactions is currently under preparation.

If the OECD intends that parallel integration of this sort should be a determinative factor i.e., that where it is found the PSM is likely to be the most appropriate method then it will be necessary to provide much more explanatory detail and examples (including exceptions) because PSM is unlikely to be appropriate in all such cases unless the definition provided is specific and tightly drawn. This would also mean a move away from the nine-step approach under paragraph 3.4 OECD TPG and the case-by-case analysis.

**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 sharing of economically significant risk is one, and only one, factor that should be considered in determining whether unique and valuable contributions are or have been made. The control over risk, as identified in the new Section D.1.2.1. of Chapter I, shared between the parties may be a relevant factor. The key lies in the functional analysis and the correct delineation of the actual transaction.

**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?**

Perhaps the best examples of situations where parties may make such contributions and not 'share' risk is already covered by the treatment of sequential integration (see above responses to Q 8). For example, components suppliers may be entirely independent of the original equipment manufacturer they supply without 'sharing' profits despite the fact that the parties co-operate extensively, often for the long term, and are therefore exposed to many of the same business risks.

With regard to the term 'unique and valuable contribution', it should be noted that the broader the interpretation of this term, the less likely it becomes that what is mentioned in the Discussion Draft is appropriate. There is a concern that some tax authorities may interpret the concept much more broadly than others.

Another example relates to the joint development of intellectual property ('IP') which may be one of the biggest risks involved in a business. In practice both the development of the IP and the risk related to such development (and assets that result from that activity) may be 'shared'. Yet a perfectly adequate way of reflecting this in the transfer price would be through cost sharing and would not require the use of PSM.

PwC considers that the guidance which should be provided is to reiterate the importance of the accurate delineation of the actual transaction between the parties including the functional analysis (functions performed taking account of assets used in risks assumed), and, where available, evidence on the behaviour of independent parties.



**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.**

PwC agrees that the use of a PSM should be based on the accurate delineation of the actual transaction. Further it should remain very clear (and may perhaps be emphasised in this section) that a PSM is used at a transactional level and it is not a 'split' of aggregate system profit.

However, we do not believe that a discussion of 'synergies' is in any way useful in determining whether a profit split is the most appropriate transfer pricing method. The Final BEPS Report on Actions 8-10 makes no attempt to provide an objective definition of the term 'synergy'. Synergies can exist any time one organisation interacts with another (even among unrelated parties). It would be hard to think of a situation when synergies would not be present in some form (especially since paragraph 1.157 notes that synergies can be either positive or negative).

Consequently, if the presence of synergies could be asserted as the basis for determining that a profit split was the most appropriate transfer pricing method we are concerned that the profit split could become a default transfer pricing method. Further, there is no guidance provided on measuring synergies, which would be necessary if they are to be somehow shared by members of the group in proportion to their contribution to the creation of synergies. With no practical definition of the term synergies and no guidance as how purported synergies should be measured and priced, it is difficult to see the usefulness of this concept in determining whether profit split is the best 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?**

The OECD should be clear that VCA should not be required as a part of any transfer pricing analysis. Transactional PSMs are not inherently any more useful for dealing with particular aspects of value chains. We are concerned that the approach may be used to treat an MNE as a 'single firm', and that too much reliance on transactional PSMs in complex factual scenarios will lead to an inappropriate 'rebuttable presumption' that a transactional profit split is the best method in such circumstances.

The term 'value chain analysis' should be defined. It should also be distinguished from a functional analysis on the one hand and the PSM itself on the other. It is not clear from the Discussion Draft whether value chain analysis and functional analysis are intended to be used interchangeably. Value chain analysis seems to be focused on "consideration of the economically significant functions, assets and risks" - the same items considered in a traditional functional analysis. In its original form, 'value chain analysis' means little more than identifying the different processes that are involved in delivering a product or service to a customer. In many transfer pricing cases the functional analysis (including risks and assets) will be sufficient. VCA can be quite detailed, for example going well beyond the 'supply chain' referred to in the requirements for a Master file, from which it should also be distinguished. However, the minutiae of individual processes and sub-processes may add little or



nothing to any transfer pricing analysis. The original purpose of VCA, in a commercial context, was to provide a framework to identify those processes that can be improved (e.g., to add more customer value) or made more efficient (e.g., to reduce costs). Thus VCA does not divide up the profits of a business between individual processes and there is no reason to expect that it would do so when used for transfer pricing purposes. In other words, the name ‘value chain analysis’ does not mean that it reveals per se where all the value added (i.e., profit) lies and it is important that any discussion of this term makes that clear. We would also welcome clarification as to whether value chain analysis is intended to be relevant only to PSM, as its placement in Section C of Chapter II might imply.

There is a welcome distinction between a PSM, as a specific transfer pricing method, and a VCA, which is better construed as a useful way to evaluate the business. Thus, VCA may help determine what an appropriate transfer pricing method is, but, it is not, itself, such a method. We believe that it would be helpful to stress the fact that VCA does not replace functional analysis, industry analysis or comparables analysis any more than it replaces the need to choose an appropriate method. It supplements or helps interpret these elements, but is certainly not a substitute.

We also believe that the OECD has reason to be cautious about recommending the use of VCA, which is not a precisely defined set of processes: it can take different forms and be applied to a greater or lesser level of detail. In common usage it is likely to be internally focused – looking at the relative contribution of different business processes – but may not, in those circumstances, help answer questions, such as whether there are, in fact, unique and valuable contributions being made.

Taking the example of unique and valuable contributions, to address this question any internally focussed VCA would often need to be supplemented by third party data or interpreted in conjunction with the industry or a comparability analysis.

**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.**

It is implicit in the Discussion Draft that the transactional PSM is not simply a high-level split of a group’s entire aggregate profit (this is also implicit in the word ‘transactional’ at the beginning of the name). VCA is not a proper application of the arm’s length principle nor is it an appropriate application of the PSM. What it can do is provide supporting evidence for the selection of method and results obtained (which may be true of any method, not just PSM) and, when PSM is the most appropriate method, it can assist with the question of which parts of the overall business might properly be included in a PSM and, if third party data is used, provide corroborative evidence for the calculation of the relevant profits for this purpose.

We note that the TPG has always stated that once the relevant profit has been determined, it should be split as independent parties would do. This has always been a particular challenge in relation to the use of this method. A VCA which does not use independent party data does not therefore assist with resolving this problem.

Where appropriate use of independent company data is used in performing VCA, it can provide valuable evidence of how profits are, in practice, divided by independent companies even where they use traditional methods of pricing (as almost all will do). This will usually involve looking at the value chains of other participants in an industry for the purposes of comparison.

For example, by looking at the relative profitability of businesses operating in different parts of the value chain, it will often be possible to identify both value drivers and the level of profits associated with each part. A specific example would be for a vertically integrated taxpayer with some competitors that are not so integrated. Those competitors may themselves be successful multinational groups having intellectual property and/ or significant risks. As such, they are unlikely to be used as traditional comparables in the normal way. But they may provide very valuable evidence in determining two things: first, whether one part of the industry supply chain is more or less profitable than another; second, and if independent parties can transact at market prices while owning different types of IP or where both parties carry significant business risks, delineating the relevant transactions and providing an indication that a more transactional TP method may be appropriate.

Similarly, looking horizontally rather than vertically across an industry will often help identify whether apparently valuable IP or other contributions meet the definition of 'unique and valuable' and, if so, provide useful evidence of just how 'unique' or how 'valuable' they may be. For example, in an industry where several successful competitors have equivalent products, similar kinds of IP, including brand names, and assume similar risks then a comparison of their profitability should identify whether one (or more) has (have) anything unique and valuable. Again, such companies are unlikely to be used as traditional comparables in the normal way if only because they have such IP or assume such risk.

**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 mentioned in the opening comments, there is a sense in the draft that seems to convey at times that what is intended is simply a general splitting of profits rather than an exercise in setting a price. The PSM as discussed in the TPG is a price-setting method rather than the sharing or allocation of non-transactional aggregate profit.

**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 47 – based upon para 2.13 of the 2010 OECD TPG – indicates also the following potential split factors besides the ones listed in section C.4.5.1: incremental sales and headcounts. It would be useful to add illustrations on these split factors. With regard to headcounts, the reference relates to actual full-time employees ('FTE'), whereas the importance of the contribution may also be found in the actual payroll, or in a combination of the two.

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

Further guidance on identifying and measuring splitting factors would be welcomed. A list of splitting factors may be useful, but the guidance would need to recognise that not all splitting factors will be appropriate under all circumstances. Rather it would be useful that the guidance indicates and stresses that actual splitting factors should be rooted, or find its basis, in the functional, industry and/ or value chain analysis.

It is also appropriate to re-emphasise that a functional analysis must be performed. A thorough functional analysis may lead to the conclusion that the PSM is the most appropriate transfer pricing methodology. In addition, the functional analysis will indicate what factors are the value drivers and what factors can be used – and how they can be used – as the splitting factors. For example, the functional, industry and/ or value chain analysis may identify R&D, marketing or the sharing of risk as the main element generating the result of the transaction.

It can be usefully repeated that the risk sharing factor – appropriately addressed in the functional analysis – is an important element, but not the only element, that should be addressed in the guidance and should be part of the transfer pricing analysis. For example, an entity that has no control over risk in a certain transaction should not be awarded a higher profit than its functional profile effectively allows, because tax authorities might wrongly consider under certain circumstances that various economically significant risks are automatically shared between the parties.

**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.**

As the current draft seems to show, it is easier to conceive of examples where PSM is not appropriate than examples of where it is. Our experience is that selection of PSM as the most appropriate method is usually highly specific as to the facts and circumstances of a particular case and may actually be inappropriate in the circumstances of an equivalent business which operates in a different way.

One further example the OECD should consider illustrates the fact that two businesses may be highly dependent on each other without being ‘integrated’ (in the sense of sharing or needing to share profits). This example below<sup>1</sup> is widely cited in economic literature and is of the dependency created by asset specificity i.e., when one (or both) parties to a transaction invest in assets (and therefore assume risks) that are highly specific to the business of the other.

Assume Company A is engaged in the extraction industry and is contemplating a coal mine. Further assume Company B operates in the power industry and is contemplating an electricity plant nearby. If there are not many competing coal mines close to the plant or several plants close to the mine then each is dependent on the other and, without some solution, involves a significant and very risky investment. The economics, developed by Oliver Williamson<sup>2</sup> as part of the work for which he was awarded his Nobel prize, is that the solution will often be a long term contract determining the volumes of coal to be sold but specifying a basis for setting a coal price (e.g. annually) without fixing such a price. This is, in fact, what was observed in the real world.

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<sup>1</sup> The Coal Mine example is inspired by the article: Contract Duration and Relationship Specific Investments: Empirical Evidence from Coal Markets, Paul L. Joskow – The American Economic Review, Vol. 77, No. 1 (March 1987). This approach is not necessarily isolated to coal-mines and power stations.

<sup>2</sup> See Transaction-Costs Economics: The Governance of Contractual Relations, Oliver E Williamson – Journal of Law and Economics, Vol 22, No. 2 (October 1979) – p 233 – 261.

An alternative identified in the same work is vertical integration (i.e., the power company builds the mine or the mining company builds the power plant). This, of course, becomes the related party situation to which the arm's length principle then applies. The proper application of that principle does not need to be a PSM but, depending on the circumstances, is more likely to be a long term contract with terms similar to those described above. This has the effect of allocating the profits (and risks) associated with the coal business to the mine and those associated with the power business to the plant.

In other words, the high degree of dependency between the two businesses does not imply a sharing of the relevant profits or risks, it creates an additional risk (that Williamson called 'asset specificity') which can be managed by both parties either by executing a long term contract or by taking joint ownership under common control.

PwC believes that this is another reason why the accurate delineation of the transaction is important.

### **Comments on individual paragraphs**

Paragraph 9 makes a reference to a single, cohesive business. PwC points out that such reference could be useful to indicate that 'single cohesive businesses' in the sense there is only one profit pool are very rare. Further PwC wonders whether such reference is useful in light of the application of the arm's length principle and the separate entity approach.

Paragraph 11: Is it useful to refer to the AOA in the OECD TPG as the AOA applies the OECD TPG by analogy (making the referencing a circular reasoning)?

Paragraph 22: Example at the end of the paragraph: The emphasis of the example should lie on the uniqueness of the contribution of both parties (in this case the development of the key component and the development of the rest of the product); the actual production can be outsourced, depending on the facts and circumstances, and may not constitute a unique contribution.

Paragraph 23: Please explain 'negative costs' – it is clear the synergies sought may not always be realised and may lead, under certain circumstances, to additional costs or other negative effects, rather than those intended under the deliberate concerted group action.

Paragraph 35: In using the term 'pool of profit,' it should be made clear that it does not envisage the use of aggregate group profit (except in some very limited circumstances) but the combined profits arising from the specific activities for which the conditions for applying a profit split exist. By using the term 'pool of profits' there also seems to be an inconsistency with the term 'combined profits to be split' in the following paragraphs. It is therefore suggested to change paragraph 35 as follows – words to be removed ~~struck through~~ and additions **in bold** – "35. Irrespective of the type of transactional profit split approach that might be applied in a given case, the first step in performing any transactional profit split is to determine the ~~pool of~~ **combined** profits to be divided amongst the parties of the transaction."



For any clarification of this response, please contact the undersigned or any of the contacts below. We look forward to discussing any questions you have on the points we raise above or on other specific matters raised by respondents to the Discussion Draft and would welcome the opportunity to contribute to the discussion as part of the public consultation meeting in October.

Yours faithfully,

Stef van Weeghel, Global Tax Policy Leader

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**COMMENTS TO QUESTION 8 AND 9 OF THE PUBLIC DISCUSSION  
DRAFT, BEPS ACTIONS 8-10, REVISED GUIDANCE ON PROFIT SPLITS**

Dear Sirs

Date 15/08/2016

Together with most other international engineering consultancy businesses, Ramboll warmly welcomes the OECD's proposed introduction of the concept of *parallel integration*, and in particular the adoption of the transactional profit split as the most appropriate method in such cases. This clarification is highly needed by all consultancy businesses whose business model is similar to that of the engineering consultancy business, with the main profit driver being hours worked.

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Ramboll is a major international engineering consultancy business with its headquarters located in Copenhagen, Denmark. In the course of a normal business year, Ramboll renders engineering consultancy services on construction projects in more than 100 different states. Since Ramboll has subsidiaries only in 35 states, many of these projects imply that engineers based in one state and working for a Ramboll company there have to travel to and stay in another state in order to perform work for Ramboll there. Depending on the length, regularity and overall period of such stays, they can give rise to a taxable permanent establishment (PE) in the other state.

In most cases, the work performed in the two locations is highly interlinked, and it is often the same persons who perform the work in the two locations, travelling back and forth. Therefore, it has been a longstanding practice for Ramboll as well as most other international engineering consultancy businesses to use the transactional profit split-method as the most appropriate method for the allocation of income to PEs. This is justified by the fact that the character of the work performed when the engineers stay in the PE-state does not deviate from the character of the work they perform when working on the same project at their offices in the headquarters-state. Moreover, Ramboll charges its client the same hourly rate for the work performed by its engineers, regardless of where the engineers perform the work. The main driver of profit within the engineering consultancy business is hours worked (fees are charged on the

basis of hours spent multiplied by hourly rates). Accordingly, we have applied the proportion of hours spent by staff members in the home state versus the PE state as the most appropriate splitting factor.

In 2010, the OECD introduced the so-called Authorized OECD Approach for the allocation of income to PEs.<sup>1</sup> Unfortunately, as a consequence of this, Ramboll has seen examples of tax authorities in some states deeming a PE to constitute a risk-free service provider for the Company's headquarters. This in turn has led to an inappropriate allocation of income between headquarters and the PE as the tax authorities insisted (and ruled) on the cost plus-method as the most appropriate method for the allocation of income to the PE, in spite of the facts set out above.

We consider the PE-case set out above a clear example of parallel integration as the parties (here the headquarters in one state and a PE in another state) are clearly involved in the same stage of the value chain. This could therefore make a good example for the OECD's final report and for purposes of further defining and illustrating the concept of parallel integration, cf. question 9.

Yours sincerely



**Henrik Meldgaard**

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<sup>1</sup> 2010 REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

5 September 2016

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

Dear Sir / Madam

**BEPS Actions 8-10: Revised Guidance on Profit Splits**

We are writing in response to the OECD's request for comments in relation to the Discussion Draft on the Revised Guidance on Profit Splits released on 4 July 2016.

RELX Group is a world leading provider of information and analytics for professional and business customers across industries. We operate in four major market segments; Scientific Technical & Medical, Risk & Business Analytics, Legal and Exhibitions. RELX Group has offices in around 40 countries and employs approximately 30,000 people worldwide.

We set out below our representations on the discussion draft. Our representations are focussed on the key issues for our business in relation to the discussion draft as follows:

1. We welcome the release of the additional guidance and we agree that profit splits can be useful as one of the various transfer pricing methods that can be applied to determine the arm's length price of a particular transaction. We note that there is no implication in the discussion draft that the profit split should have any preference over the other TP methods and agree with the wording in the guidance that a profit split should only be applied where it is considered to be the most appropriate TP method.
2. The discussion draft refers to a number of potential indicators where profit splits would be relevant, which include the following:



- a. Where multiple parties to the transaction make unique and valuable contributions, such as unique and valuable intangibles.
- b. Where there is a high degree of integration of functions between the parties.
- c. Where economically significant risks are shared by the parties to the transaction.

While we consider that the above can all potentially be indicators that a profit split would be appropriate, we do not necessarily consider that all of these indicators need to be present in order for a profit split to apply. It is generally accepted under the existing OECD transfer pricing guidelines that profit splits are appropriate where both parties to the transaction make unique and valuable contributions to a transaction. In most cases where this happens, we would also expect there to be a sharing of economic risks between the parties. We do not necessarily consider however that a high degree of integration of functions would always be best approached with a profit split. For example, each party could be rewarded for its respective functions carried out using a TNMM method or a cost contribution arrangement for services, particularly where the functions carried out are considered to be routine in nature. We would therefore consider that the most important factor for indicating a profit split as the most appropriate method would be the making of unique and valuable contributions, as is currently the case under the existing guidelines.

3. The discussion draft focuses on the difference between anticipated and actual profit splits. Actual profit splits can be difficult for multinational enterprises to implement and monitor. Not all data is tracked within a company at a product or transactional level and therefore when carrying out financial analysis for the purpose of profit splits, additional information may be required that is not part of the businesses standard reporting processes. This specific analysis may include apportionments of operating expenses to particular products or transactions. It can be resource intensive to complete this analysis on an ongoing basis. It can therefore sometimes be a more practical solution for a business to apply a profit split approach on an anticipated profits basis and convert this into a royalty payment. It is our view that this should be an acceptable approach under the profit split methodology.
4. Question 4 of the discussion draft specifically asks for comments on the strengths and weaknesses of profit splits. Some additional weaknesses of profit splits from a business perspective include the following:
  - a. It can be difficult to calculate the profit for particular transactions, as certain data required for the calculation may not typically be prepared in the general day to day operation of the business. This can therefore require certain judgements to be made, such as the apportionment

of operating expenses to particular transactions / products in order to calculate the profit to be split between the parties to the transaction. These judgements could be challenged by tax administrations.

- b. The allocation keys used to determine the allocation of the profits between the parties are typically dependent on where the value is created. This can also be subjective and could potentially be open to challenge from tax authorities.
5. Paragraph 1 of section C1 states that “References to “profits” should be taken as applying equally to losses”. While we agree with this concept in principle, we are concerned that some tax administrations will be more reluctant to agree to the sharing of losses than profits. If some jurisdiction do not accept the sharing of losses, this could lead to situations where there is a mismatch in the treatment between jurisdictions.
6. Paragraph 23 of section C.3.3 states that “the benefits of important group synergies attributable to deliberate concerted group actions should be shared by members of the group in proportion to their contribution to the creation of the synergy”. The benefits of group synergies may be difficult to value and additionally it may also be difficult to determine each party’s relative contribution to the overall benefit. This type of analysis may therefore be open to challenge by tax administrations.
7. Q13 indicates that the primary purpose of a value chain analysis is as a “tool in helping delineate the actual transaction and in identifying features in determining whether the transactional profit split method is appropriate”. Q14 asks for comments as to whether a value chain analysis serves a greater purpose in relation to profit splits. It is our view that the value chain analysis is also relevant in allocating the profits to the respective parties to the transaction to ensure that the profit for a particular transaction is split in accordance with where the value creation takes place in accordance with OECD guidelines. This is discussed later on in the discussion draft at Paragraph 48 of Section C.4.5.
8. Section C.4.2 discusses how to determine the profits to be split. In many cases profit split calculations involve particular transactions within a business which may relate to specific product lines / business areas. Companies don’t always track expenditure down to the operating profit level across specific product lines or business areas. Therefore in order to determine the profit of a particular transaction, certain judgements may need to be made, for example apportionments of operating expenditure between product lines. Some additional guidance on how to apportion such expenses in these situations would be welcome.

We look forward to being included in the ongoing discussion process.

Yours faithfully



Paul Morton

Catherine Harlow

Paul Hewitt

Kia Hejlskov

**Profit Split Transfer Pricing Under Challenge**  
Robert Feinschreiber, TransferPricingConsortium.com  
Margaret Kent, TransferPricingConsortium.com

The profit split transfer pricing method has become especially contentious. The detractors have garnered strength after the OECD issued Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration on July 22, 2010, elevated the viability of the transactional profit split method.<sup>i</sup> Quite to the contrary, Competition Commissioner Margrethe Vestager supported the profit split method rather than applying the TNMM. She argued that the TNMM does not even try to split a company's profits between the countries that might have a claim to tax them.

Vestager, in a speech at the High Level Forum on State Aid Modernisation: The EU State Aid and Tax rules: working together for fair competition (June 3, 2016) criticized the TNMM in contradistinction to the profit split method. She argued that "in some cases, it seems that this choice of operating expenses as a performance indicator is made systematically, without necessarily represented the commercial value of the functions of the company." Vestager argued further that the TNMM numbers "can be a poor profit indicator of how successful a company is." Her view is that applying the TNMM "to set taxable profit is only appropriate in a limited number of cases."<sup>ii</sup>

The OECD issued a July 4, 2016 discussion draft said to address the "clarification and strengthening" of transactional profit split method guidance. The Base Erosion and Profit Shifting Provisions, Action 8-10, precipitated this analysis. The underlying transfer pricing purpose should be to align transfer pricing outcomes with value creation. The OECD encouraged multinational enterprises and tax administrations to develop asset-based or cost-based allocation keys where such strong correlation exists. The July 4, 2016 discussion draft should have provided profit split "clarifications." Instead, the OECD sacrificed the scarce resource of multinational enterprise and tax administration expertise to achieve arcane profit split "strengthening."<sup>iii</sup>

### **Contentious Profit Split Transfer Pricing Issues**

The OECD, through its transfer pricing transactional profit split guidance, directly or indirectly, raised a number of contentious profit split concerns. We've selected eight issues:

*1. Economically valid basis*

The OECD presupposes, throughout the revised guidance, that the multinational enterprise or the tax administration would employ characteristics or factors creating economic validity. Such participants would split combined profits between associated enterprises on an "economically valid basis." Paragraph 1 and paragraph 4 reflect this approach. The OECD, however, fails to define the scope and parameters enunciating such economic validity. It might be that OECD is referring to causality as a basis for determining the economic validity of these operations or practices. Nevertheless, the OECD fails to define these definitional provisions more specifically.

*2. Actual profits v. anticipated profits*

The OECD acknowledges in paragraph 3 and paragraph 30 that the multinational enterprise or the tax administration can ascertain pre-split profits in two ways:

- by applying actual profits for the tax year or

- by applying anticipated future profits.

The OECD permits the multinational enterprise or the tax administration to choose between these two transfer pricing approaches. Nevertheless the OECD's commentary focuses primarily on actual profits. It is our view that, within the transfer pricing dispute context, tax administrations are under more pressure than are multinational enterprises from "results" basis. It is unlikely for the tax administration to determine both the mandatory actual transfer pricing determinations and then apply an anticipated profits analysis. Giving this choice favors the multinational enterprise against the tax administration.

The OECD favors the question of risk in the profit split context. The OECD takes the position that the multinational enterprise or the tax administration must determine the basis of the profit split in advance, before the parties know the outcome of the results. Otherwise, the OECD then asserts that in fact there is no longer any risk. The OECD's view toward risk analysis appears to be misplaced. The OECD has not come to grips with the fact that both parties, the multinational enterprise and the tax administration, have different profit approaches. For example, the multinational enterprise might apply the anticipated profits approach, but the tax administration might favor the actual profits approach.

### *3. Avoiding hindsight*

The OECD takes a strong stand against hindsight in paragraph 3 and paragraph 30. The OECD is concerned that one party, most often the multinational enterprise, can develop a rationale for its transfer pricing behavior after the fact. It is our view that a party should be entitled to address rationales that the courts might or might not treat as hindsight. The courts are better able to address this claim through ascertaining the burden of proof rather than enunciating a "hindsight" prohibition. It is our view that hindsight rationales are "worth less" than contemporaneous documentation, but hindsight rationales are far from being "worthless."

### *4. Integration activity levels*

The OECD presupposes in paragraphs 6 and in 19-21 that the multinational enterprise and its affiliates would apply a split of actual profits the enterprise would require "a high level of integration" of its economic activities.<sup>iv</sup> Such draft regulations nowhere define the parameters in ascertaining the level of integration activities. Presence of these criteria would make these integration standards high or low. Economists seek to apply integration measures based on the extent of capital flows and price differences, for example. The OECD's analysis is deficient in ignoring these qualitative and quantitative integration measures. Paragraph 21 introduces a new concept, "parallel integration," but the OECD fails to define this new term.

### *5. Database considerations*

Paragraph 14 views the transactional profit split as having a database weakness. Specifically, the tax administrations might have "difficulty accessing information from foreign affiliates." It is our view that paragraph 14 is out of step with the Action 13 process, which would include the Masterfile, the local file, and the CbyC documentation.

### *6. Accounting issues*

The OECD expresses that valid concern in paragraph 14 that the parties, in ascertaining the profit split, will need to identify and separate “combined profits for the products manufactured by the global manufacturer to be identified, and then separated from other activities.”<sup>v</sup> The parties will need to apply cost accounting techniques. The OECD fails to address the fact governments engaged in transfer pricing disputes have different levels of expertise as to these cost accounting and allocation and apportionment issues. True to form, the United States developed its allocation and apportionment analysis nearly 40 years ago,<sup>vi</sup> added to these basic allocation and apportionment rules, and then the United States failed to apply these rules in the transfer pricing context.<sup>vii</sup> U.S. Case law in this area goes back to 1925.<sup>viii</sup>

#### *7. When comparables are scarce*

The OECD in paragraph 18 takes the position that a lack of comparables alone is insufficient for the multinational enterprise or the tax administration to warrant the use of the transactional profit split method. Instead, the OECD suggests that the parties make comparability adjustments. It is our view that the parties are unlikely to find an acceptable transfer pricing adjustment. Further, this adjustment process is innately cumbersome. It is our view the shortness of comparables data should lead the parties to apply the transactional profit split method.

#### *8. Transfer pricing splitting approaches*

The OECD permits the international enterprise or the tax administration to apply either of two transfer pricing splitting approaches:

- the contribution analysis approach (paragraph 32) or
- the residual analysis (paragraphs 33 and 34).

The OECD recognizes that the residual analysis might be appropriate when the parties can separate the contributions of these parties into two categories. The first of these categories reflects contributions that the parties can directly value; with the second category reflecting contributions the parties cannot directly value. It is our view that multinational enterprises and tax administrations find the delineation between direct value items and indirect value items difficult to make. We suggest that the OECD should favor the profit splitting contribution analysis instead.

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<sup>i</sup> Feinschreiber, R., and Kent, M, “What You Need to Know about the Transactional Profit Split Methods.” CCH Corporate Business Taxation Monthly” February 2011, p.29; Feinschreiber, R. and Kent, M., Transfer Pricing Handbook: Guidance for the OECD Regulations (Vol.5) John Wiley & Sons, Inc. Chapter 7, 2012

<sup>ii</sup> See DG COMP Working Paper , *supra*, notes 77 parag. 22.

<sup>iii</sup> Feinschreiber, R., and Kent, M, Featured Perspective: A Critical Look at the OECD’s Profit Split Transfer Pricing Revisions, Tax Notes International, August 29, 2016.

<sup>iv</sup> Proposed Guidance on Transactional Profit Splits, #6

<sup>v</sup> Proposed Guidance on Transactional Profit Splits, #15

<sup>vi</sup> 1.861-8, T.D. 7456, January 3, 1977;

<sup>vii</sup> Feinschreiber, R., Final Regulations for Allocating and Apportioning Deductions 3 Int’l Tax J. 278, 1977;

Feinschreiber, R. Allocation and Apportionment of Deductions, Panel Publishers, 1978.

<sup>viii</sup> *Louis Roessel &co. Ltd.* 2 BTA 1141 (1925) acq. IV-2 CB 4

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Mr. Jefferson VanderWolk  
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division  
OECD Centre for Tax Policy and Administration

Submitted by email: [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

5 September, 2016

**SUBJECT: DISCUSSION DRAFT ON THE REVISED GUIDANCE ON PROFIT SPLITS**

Dear Mr. VanderWolk,

RSM Netherlands Belastingadviseurs N.V. ("RSM Netherlands") appreciates the opportunity to provide comments on BEPS Actions 8-10: "Discussion Draft on the Revised Guidelines on Profit Splits" as released by the OECD on July 4, 2016 ("the Discussion Draft"). This letter encompasses the view of RSM Netherlands' transfer pricing team. Our comments does not represent the view of RSM International but of RSM Netherlands alone.

Yours sincerely,

On behalf of RSM Netherlands

Juan Dosal / Jordi van der Struis

## EXECUTIVE SUMMARY

Although the profit split method may be viewed as being at the other side of the spectrum of acceptable transfer pricing methodologies (due to its reliance to a large extent on internal data), in practice, its application is necessary for associated enterprises whose operations are highly integrated (i.e. that they cannot reliably be evaluated separately) or when they make unique or valuable contributions, such as unique and valuable intangibles.

However, it is often the case that the application of the profit split method requires the conclusion of an Advance Pricing Agreement, most particularly in cases where the profit split method is applied following a contribution analysis or in cases where the profit split method covers the assessment of the arm's length return for Hard-To-Value Intangibles. Due to the practical challenges that multinational enterprises ("MNEs") and tax administrations may face when applying this method, it is of utmost importance to develop a concrete framework (specific steps) for its application to ensure that no controversy and uncertainty would arise when the profit split method is applied.

RSM Netherlands shares the position of the OECD on the relevance of conducting a value chain analysis to assist in delineating controlled transactions and thereby determining the most appropriate transfer pricing methodology. In this respect, the purpose of the value chain analysis should be to identify the features of the commercial or financial relations between the associated enterprises, which could indicate that the profit split method is the most appropriate transfer pricing method.

Moreover RSM Netherlands welcomes the OECD's efforts in clarifying the distinction between the application of the profit split method of actual profits on one hand and of the profit split methods of anticipated profits on the other hand. However, the Discussion Draft provides limited guidance on the situations where the profit split method of anticipated profits should be considered as the most appropriate methodology. Therefore, to avoid potential controversies and uncertainties for applying this method, it would be useful that the Discussion Draft would have emphasized the specific situations when the profit split of anticipated profits should be considered the most appropriate method, most particularly in cases of Hard-To-Value Intangibles.

RSM Netherlands shares the position that the profit split of actual profits, is appropriate where the accurate delineation of the actual transaction evidences that the operations of the parties are highly integrated and that both parties share the outcomes of the business activities and risks associated with those outcomes. In this respect, the basis upon which the combined profits are to be calculated and split should be first determined *ex ante* (before risk outcomes are known) and thereafter profits should be shared based on actual profits when the outcomes of risks are known.



With regard to the choice of the measure of profits to be split, RSM Netherlands considers that the choice of the measure of profits to be split should depend on the nature of transactions and the extent to which the associated enterprises are integrated and the nature of significant risks that they share. Thus the assessment of the most appropriate measure of profits to split can be made once the actual transaction is delineated.

Finally, RSM Netherlands is of the opinion that adopting an uniform measurement for the factors to be used to divide the combined profits under the profits split method is not the most appropriate approach. Instead, the determination of appropriate profit split factors should reflect the key value drivers in relation to the transaction. Therefore, the value chain analysis should be the departing point to assess the relevant factors to use in splitting profits, including determining the weighting of applicable profit splitting factors, most particularly in cases where more than one factor is used.

## **SPECIFIC ANSWERS TO RELEVANT QUESTIONS**

### **Question 1**

The distinction between the profit split of anticipated profits and actual profits is useful, however it could have been more clearly delimited by the Discussion Draft, by describing the concrete situations for applying each of both approaches, more particularly in case of the profit split of anticipated profits, as from the existing wording of the Discussion Draft it is inferred that the profit split of anticipated profits should be applied only when the profit split of actual profits cannot be applied.

### **Question 2**

Historically, financial markets have been limited by the national boundaries within which they operated. However, the world's financial markets and multinationals that operate in those markets are becoming more integrated because of technological developments, financial innovation and regulatory changes. This trend can be illustrated by observing the operating model of many financial intermediaries that trade commodities and derivative financial products around the clock, by maintaining traders in offices across the world following a fully integrated model. This circumstance requires the application of the profit split method to reliably allocate income in a way that it reflects the contribution of each trading location to the profitability of the global book (and as the operations of the parties are so interrelated that does not enable the application of other transfer pricing methods).

RSM Netherlands shares the position that the profits split of actual profits is appropriate where the accurate delineation of the actual transaction evidences that the operations of the parties engaged in the scrutinized transaction are highly integrated (i.e. that they could not reliably be tested separately) and that the parties share the outcomes of the business activities and risks associated with those outcomes. In this respect, RSM Netherlands agrees that the basis upon which the combined profits are to be calculated and split should be first determined *ex ante* (before risk outcomes are known) and then after profits should be shared based on actual profits when the outcomes of risks are known.

### **Question 3**

RSM Netherlands welcomes the guidance in paragraph 10, for assessing whether both of the parties exercise any degree of control over the risks associated with the outcomes of the business activities, so that it can be concluded whether the profit split of actual profits is the most appropriate. However, it could be useful that the OECD Transfer Pricing Guidelines clarify if when this criteria is not met, the profit split of actual profits should not be applied. This additional clarification would help to ensure a consistent application of the profit split of actual and of anticipated profits by MNEs and tax authorities.

To provide a specific illustrative example, one can assume two associated enterprises that are part of the same MNE, Company A and Company B where both have brought unique and valuable contributions to the development of an intangible (software). Both companies operations are highly integrated and are engaged in software development activities and on licensing the software to third parties. However, Company A incurs more operating expenses and achieves less revenues than forecasted under the allocated budget, whereas Company B decreased its level of costs and exceeded the revenues forecasted under the allocated budget.

In this situation, the profit split of actual profits would reasonably produce an arm's length result, if from the value chain analysis and the accurate delineation of the transaction, it can be evidenced that the operations of both, Company A and Company B, are highly integrated and that the parties share the outcomes of the business activities and risks associated with those outcomes.

### **Question 4**

The strengths and weaknesses of the profit split method are up to an extent illustrated in the Discussion Draft. In this respect, the profit split method is characterized by flexibility which entails the ability to make a case-by-case analysis for associated enterprises that are engaged in highly integrated operations (i.e. that they cannot reliably be evaluated separately) or when they make unique or valuable contributions. However, at the same time its application is not straightforward,

and in some cases, most particularly when applying the profit split method using a contribution analysis, it can be considered subjective (thus it has the potential of creating divergences between taxpayers and tax administrations). Due to the practical challenges that MNEs and tax administrations may face when applying this method, it is of utmost importance to develop a concrete framework (with specific steps of application). Most particularly when applying the profit split method following a contribution analysis approach, or when the application of the profit split method covers Hard-to-Value Intangibles, to ensure that no controversy and uncertainty arise when the profit split method is applied.

## Question 5

RSM Netherlands is of the opinion that the profit split of anticipated and of actual profits have their own advantages and shortcomings. The profit split of anticipated profits may be an effective method in cases where for instance only one of the parties exercise a degree of control over risks in relation to a Hard-To-Value Intangible. However, if this approach is used in conjunction with valuation techniques (e.g. discounted cash flow analyses), the suitability of this approach would largely depend on: the reliability of the financial projections used; the appropriate estimation of the useful life of the intangible; and the accurate selection of the discount rate applied. Therefore, it would have been useful if the Discussion Draft could have clarified the cases where the profit split of anticipated profits is the most appropriate method, and that it could have provided guidance for its application. In this respect, it is desired that this clarification is included in the OECD Transfer Pricing Guidelines and that it is consistent with the proposed guidance in *the BEPS Action 8: Discussion draft on arm's length pricing of intangibles when valuation is highly uncertain at the time of the transaction and special considerations for Hard-to-Value Intangibles*", regarding the appropriateness of using *ex ante* projections.

Concerning the second category, the profit split of actual profits, it has the strength of providing a pricing solution when the associated enterprises are sharing economically significant risks. Furthermore it is specified that it is less likely to produce an arbitrary result due to its ability to assess the unique and valuable contributions of each party. Nonetheless, the concern arises as to the lack of a concrete framework (i.e. specific steps) for its application, most particularly in cases where the profit split requires to be applied following a contribution analysis approach.

## Question 6, sub-question 1

Pursuant to the changes to Chapter 1 of the OECD Transfer Pricing Guidelines, a revised interpretation of the arm's length principle has been provided which is based on an expanded analysis to determine the economic substance of a controlled transaction. This is also referred to

as “accurately delineating the actual transaction” and brings the analysis of control over risks by the parties engaged in the transaction in the forefront of the functional analysis.

The concept of “accurate delineation of a transaction” entails assessing the actual conduct of the parties involved in the transaction, which should prevail over the terms of the transaction as found in legal agreements. RSM Netherlands shares the opinion of keeping a consistent notion of risk sharing in the context assessing “the sharing of economically significant risks”, as a factor that may indicate that the profit split of actual profits is the most appropriate transfer pricing method.

### **Question 6, sub-question 2**

With regard to the circumstances where the profit split method is the most appropriate method, the understanding of RSM Netherlands is that the Discussion Draft clarifies the cases where the use of the profit split is appropriate. However such clarification is mostly focused to the cases when the profit split of actual profits should be applied. Therefore it would be useful that the OECD Transfer Pricing Guidelines provide a more detailed clarification of the specific cases where the profit split of anticipated profits should be considered as the most appropriate transfer pricing method and provide a concrete framework of application, most particularly in case of Hard-To-Value Intangibles.

### **Question 7**

In general, the acceptable methods for the valuation of intangibles can fall into three broad categories: (i) market based; (ii) cost based; and (iii) based on estimates of past and future economic benefits. Special attention is provided to the last category, as this category includes valuation techniques that are commonly applied in conjunction with the profit split of anticipated profits. Commonly used techniques falling on the lastly mentioned category include: 1) the relief from royalty method; and 2) discounted cash flow (DCF) analysis. A brief description of each of these valuation techniques is provided below:

1. Relief from royalty considers what the purchaser could afford, or would be willing to pay, for a license of similar intangible. The royalty stream is then capitalized reflecting the risk and return relationship of investing in the asset.
2. The DCF analysis is probably the most comprehensive of appraisal techniques. Potential profits and cash flows need to be assessed carefully and then restated to present value through use of a discount rate, or rates.

The selection of the most reliable valuation technique for applying the profit split of anticipated profits should depend on the specific facts and circumstances of the transaction. However, it is

important to take into account that not necessarily all valuation methods applied in corporate finance or under International Financial Reporting Standards can be reliably be applied in conjunction with the profit split of anticipated profits. Most particularly as transfer pricing valuations frequently involve bundling intangibles not ordinarily covered in uncontrolled transactions and as transfer pricing valuations inherently compare two states: the “as is” to the after. We recommend that the OECD Transfer Pricing Guidelines clarifies this notion.

Furthermore, it is suggested that a practical framework is provided regarding valuation techniques widely used by taxpayers in cases involving Hard-To-Value Intangibles (i.e. discounted cash flow analysis) and that it is in alignment with the proposed guidance in *“the BEPS Action 8: Discussion draft on arm’s length pricing of intangibles when valuation is highly uncertain at the time of the transaction and special considerations for Hard-to-Value Intangibles”*. Such practical framework could provide guidance for the determination of the appropriate discount rates (adjusted for risk) to be applied and the terminal value computation (considering the economically useful life of the assets), identifying the key parameters that influence the overall valuation result.

## **Questions 8 and 9**

RSM Netherlands shares the view that the distinction between parallel and sequential integration of business operations is useful to determine whether the profit split method is likely to be the most appropriate method. Most particularly as in the case of sequential integration, in which the parties perform discrete functions in an integrated value chain it is often the case that it is possible to find reliable comparables. However, such distinction should not be considered as definitive criteria for rejecting the application of the profit split method, as it could be the case that although there is sequential integration of business operations, one of the parties could make unique and valuable contributions.

## **Questions 10 and 11**

RSM Netherlands agrees that another situation in which the 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.

For those cases when all of the parties are involved in making unique and valuable contributions (after accurately delineating the actual transaction), the profit split method following a contribution analysis approach could be a reliable method for allocating profits. In this respect, a Business Process Analysis, supported by a RACI analysis (and integrated with a bargaining analysis) can be a useful framework to:



1. assess whether the parties share the economically significant risks associated with the outcomes of the scrutinized transaction
2. identify the contribution to these activities of each party to the transaction, so that:
  - the contributions made by each of the parties to the transaction is quantified
  - the profits can be divided accordingly between the parties.

Furthermore a bargaining analysis<sup>1</sup> can be a powerful tool for assessing the contribution of the parties engaged in the intercompany transaction, as it allows the evaluation of the role and so the contribution, of each of the parties collaborating and creating a gain or an added value. Hence, should the value chain analysis supplemented with a Business Process Analysis (supported by a RACI analysis integrated with a bargaining analysis), identifies that only one of the parties has control over the economically significant risks associated with the outcomes of the scrutinized transaction, then the profit split of actual profits may not be the most appropriate method.

## Questions 13 and 14

RSM Netherlands welcomes the inclusion in the Discussion Draft that the value chain analysis is the starting point to identify when the profit split method may be appropriate.

The guidance provided is useful to delineate the actual transaction and the features relevant for determining whether the profit split is appropriate. However such value chain analysis could serve a greater purpose in relation to profit splits, particularly in cases where the profit split requires to be applied due to the highly integrated operations (that they cannot be evaluated separately) of the parties engaged in an intercompany transaction. For those cases, a Business Process Analysis, supported by a RACI analysis (and integrated with a bargaining analysis) could be a useful tool to further evaluate the contributions of the parties engaged in the scrutinized transaction.

## Question 15

In practice any of the following measures of profits to split are commonly used when applying the profit split method:

1. Sharing of revenues (when both parties are responsible for controlling their costs).
2. A gross profit (when both parties are responsible for managing their overheads).
3. Operating profit.

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<sup>1</sup> Bargaining theory was formalized by Lloyd Shapley and derived from the game theory, further developed (and popularized) by John Nash. Game theory proposes a modelling of strategic interactions between agents trying to maximize their return by cooperating or not. Following the work based on game theory, Shapley developed a theory providing an assessment of the bargaining power of each agent playing in a game. Shapley theory aims at evaluating the role of each player and at defining a quantitative tool to measure this role. It describes one approach to the fair allocation of gains obtained by cooperation among several actors.

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RSM Netherlands recommends that the OECD Transfer Pricing Guidelines do not provide a rigid criteria on the cases where a measure of profit to be split should be applied. Rather we propose that the OECD Transfer Pricing Guidelines emphasizes that the choice of the measure of profits to be split should: depend on the nature of the transactions; the extent to which the associated enterprises are integrated; and, the nature of the significant risks that they share (as the assessment of the most appropriate measure of profits to split can be made once the actual transaction is delineated).

### **Questions 16-18**

RSM Netherlands is of the opinion that the value chain analysis should be used as a departure point in determining the appropriate split factors, as based on this analysis it is possible to identify the drivers of profit to split.

Adopting a uniform measurement for the factor(s) to be used to divide the combined profits under the profits split method is not the most appropriate approach, but that the determination of the appropriate profit split factor(s), should reflect the key value drivers in relation to the transaction and that the value chain analysis should be the departing point to assess the relevant factor(s) to use in splitting profits, including determining the weighting of applicable profit splitting factors, in cases where more than one factor is used. Moreover, the selection of the most appropriate splitting factor should take into account the taxpayer's management structure and management information. Hence we recommend that the OECD Transfer Pricing Guidelines clearly state that the selection of the most appropriate profit split factor should reflect the taxpayer's particular facts and circumstances as closely as possible.



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September 5, 2016

**VIA ELECTRONIC TRANSMISSION**

Tax Treaties  
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**Re: Comments on July 4, 2016 OECD Public Discussion Draft on BEPS Actions 8–10  
*Revised Guidance on Profit Splits***

Dear Sirs or Madams,

The Silicon Valley Tax Directors Group (“**SVTDG**”) hereby submits these comments on the above-referenced Public Discussion Draft (“**PDD**”). SVTDG members are listed in the Appendix of this letter.

Sincerely,

A handwritten signature in blue ink that reads "Robert F. Johnson". The signature is written in a cursive, flowing style.

Robert F. Johnson  
Co-Chair, Silicon Valley Tax Directors Group



## **I. INTRODUCTION AND SUMMARY**

### **A. Background on the Silicon Valley Tax Directors Group**

The SVTDG represents U.S. high technology companies with a significant presence in Silicon Valley, that are dependent on R&D and worldwide sales to remain competitive. The SVTDG promotes sound, long-term tax policies that allow the U.S. high tech technology industry to continue to be innovative and successful in the global marketplace.

### **B. Summary of comments**

In this letter, we comment on the alternative approaches proposed by the PDD for implementing the transactional profit split method and the guidance provided by the PDD regarding the conditions under which these alternative approaches are appropriate. We believe the conditions under which the two types of profit split methods are applicable have not adequately been defined in the PDD. In particular, the choice between these methods is unclear in transactions where parties are exposed to some, but not all, risks of the transaction and where their activities are either partially integrated or focus on different steps in the value chain for end-products. Concepts critical to the choice of an appropriate method, such as “highly integrated” activities, “closely related” risks, and “parallel” versus “sequential” integration remain ill-defined, leaving considerable latitude for arbitrarily exposing taxpayers to the risk of retrospective disputes with tax authorities over the interpretation of these terms and the choice of intercompany payment terms. The “value chain” analysis proposed by the PDD as a guide to the choice of methods addresses relevant economic questions regarding the economic contributions of affiliated parties in the transaction. However, it is unclear how this value chain analysis differs from a rigorous application of the functional analysis already required by the OECD’s transfer pricing guidelines.

## **II. SPECIFIC CONCERNS WITH THE *PDD***

### **A. An overview of the proposed transactional profit split methods**

The PDD proposes that the transactional profit split method (“*TPSM*”) can be applied under two alternative approaches. The first approach involves combining and splitting the actual profits arising from a transaction on the basis of certain factors determined *ex ante* at the time the transaction is entered into (“*TPSM Actual*”). The second approach involves identifying the anticipated profits associated with the transaction at the time it is entered into and splitting these

anticipated profits on the basis of factors identified at the time of the transaction (or “*TPSM Anticipated*”).<sup>1</sup>

The PDD notes that under a *TPSM Actual*, risks associated with the business activities undertaken within a transaction are shared by the participants of the transaction. Following the guidance in Section D of Chapter I of the 2016 *Transfer Pricing Guidelines*, the PDD states that such a sharing of risks requires a “high level of integration of activities” between participants in the transaction, with economically significant risks associated with the transaction being controlled, either separately or collectively, by the parties sharing the actual profits.<sup>2</sup> The PDD adds that it would be “contrary to the guidance in Section D of Chapter I” to apply a *TPSM Actual* when one party “does not exercise any degree of control” over the risks associated with the business activities undertaken in the transaction.<sup>3</sup>

The applicability of *TPSM Anticipated* appears to have been defined only by contrast to the conditions under which the alternative *TPSM Actual* is applicable. The PDD notes that “a transactional profit split of anticipated profits does not require the same level of integration or risk sharing required for a transactional profit split of actual profits.”<sup>4</sup> In a similar vein, the PDD says “a further difference between the two approaches is that there is a greater sharing of uncertain outcomes resulting from the risks associated with the transaction under a transactional profit split of actual profits, than under a transactional profit split of anticipated profits.”<sup>5</sup>

## **B. The conditions under which the two forms of *TPSM* are applicable are ill-defined**

The PDD explains how the *TPSM* should be applied in polar extreme cases of risk-bearing and integration. When one party “does not exercise any degree of control” over the risks inherent in the transaction, the *TPSM Actual* may not be applied.<sup>6</sup> At the opposite end of the spectrum, when all parties to the transaction are highly integrated and exercise control over economically substantial risks, the *TPSM Actual* is appropriate.

However, most intercompany transactions—like most third-party transactions—lie between these two extremes on the spectrum of integration and risk-taking. For such transactions, the PDD is unclear on the objective criteria by which taxpayers and tax authorities

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<sup>1</sup> PDD, Section C, ¶ 2–4.

<sup>2</sup> PDD, Section C, ¶ 6, 9.

<sup>3</sup> PDD, Section C, ¶ 10.

<sup>4</sup> PDD, Section C, ¶ 20 (emphasis added).

<sup>5</sup> PDD, Section C, ¶ 6 (emphasis added).

<sup>6</sup> PDD, Section C, ¶ 10 (emphasis added).

can gauge the degree of integration and risk-taking that would be considered sufficient to support the application of a TPSM Actual. Consider the example of Company A that owns certain technology and bears the expense of continuing research and development (“*R&D*”) on this technology. The failure of products incorporating these intangibles would place Company A’s investments in R&D at risk. Suppose Company A licenses its technology to an affiliated Company B, which manufactures the product and markets it in a certain territory. Company A bears the risk its technology will prove commercially unviable and its R&D expenditures wasted if the product fails in the market. However, Company A does not participate in, or control, the manufacturing and marketing activities that bring the product to market. Will Company A’s risk-bearing on R&D activity be considered sufficiently significant in the aggregate risks of this business activity that a TPSM Actual can be used to determine the Company’s arm’s length profits from this transaction? If the answer depends upon the facts of the transaction, by what objective criteria can taxpayers or tax authorities evaluate whether the facts of a particular transaction merit the application of a TPSM Actual? It is important for the OECD to articulate these criteria to eliminate regulatory and compliance uncertainties in the structuring of intercompany transactions.

The PDD allows a TPSM Actual to be applied in cases where parties do not share the same economically significant risks, provided they share “closely related” risks associated with the business opportunity.<sup>7</sup> At the same time, however, the PDD states that applications of the TPSM Actual should be governed by the principle articulated in Section D of Chapter I that parties cannot be assigned the impact of risks they do not control.<sup>8</sup> In a transaction where Company A contributes technology and an affiliated Company B contributes marketing intangibles towards a common product, each company bears risk that the other will fall short in its area of activity. Each company is exposed to risks it does not control; therefore, under the principles of Section D in Chapter I, this transaction may be deemed inappropriate for a TPSM Actual. Yet, the risks borne by each may be “closely related” since their intangibles are being commercialized through the same product and the quality of each intangible affects the value of the other. Therefore, the same transaction might be deemed appropriate for a TPSM Actual under the “closely related risks” criterion. Without further guidance on what constitutes “closely related” risks, taxpayers face the risk that conflicting guidance could cause their transactions to be challenged or re-characterized.

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<sup>7</sup> PDD, Section C, ¶ 16.

<sup>8</sup> PDD, Section C, ¶ 10 (“It would be contrary to the guidance in Section D of Chapter 1 to apply a transactional profit split of actual profits where the functional analysis demonstrates that one party does not exercise any degree of control over those risks, since to do so would assign to that party the impact of risks it does not control.” (Emphasis added)).

Ambiguities regarding the definition of “close” risks can also affect the choice between a TPSM Actual and methods other than a TPSM. When a company performs routine functions for an affiliated enterprise, it is customary for the terms of the transaction to be determined with reference to the profit margins earned by unaffiliated companies performing similar functions at arm’s length. However, it is possible that the company performing routine functions also bears certain risks under this transaction, in keeping with allocations of risk observed at arm’s length. For example, the company performing distribution services may also bear a part of the cost created by product failure through losses on inventories of the product or by bearing product warranty risks for the product. To the extent similar risks are borne at arm’s length by unaffiliated distributors, a transactional benchmarking analysis may be used to establish the arm’s length profit margin of the company. However, the language of the current PDD may leave room for a tax authority to require that the distributing entity enter into a profit split with the affiliated enterprise whose product it distributes, on the grounds that product warranty risks are “closely related” to product quality, which in turn is related to the development and marketing activities of the affiliated enterprise.

The PDD could be improved by including a more focused and balanced discussion of the circumstances under which the TPSM is the most appropriate method. The PDD’s statement of the strengths and weaknesses of the TPSM is over-weighted towards strengths and fails to mention a number of important weaknesses (e.g., the subjectivity involved in attempting to hypothesize transactional or segmented profit from consolidated profit statements, the need for a tax system and administration to have achieved a certain level of sophistication before applying a TPSM, the reluctance of some administrations to apply the method to both profit and loss situations, etc.). The PDD is overly focused on integration of activities (which occurs to varying extents within all multinational groups) as an indication of sharing of risks and as a potential trigger for the TPSM, when a better indicator of whether the TPSM is a more appropriate method than a one-sided method is whether each of the parties to the transaction contributes unique or valuable intangibles or assumes risks that are not comparable to risks assumed by uncontrolled parties in comparable circumstances and are a key source of actual or potential profits. The PDD should be revised to ensure that the TPSM does not, in effect, become a default method whenever comparables are scarce or integration exceeds some subjectively determined “high” threshold.

**C. The concepts of “parallel” and “sequential” integration are not sufficient to identify transactions with highly integrated business activities**

In an attempt to give greater clarity to the concept of “highly integrated” business activity between the participants of an intercompany transaction, the PDD draws a distinction between “parallel” and “sequential” integration. A “parallel” integration is said to occur when multiple parties to the transaction are involved in each step of the value chain, sharing exposures to the risks inherent in that step. By contrast, a “sequential” integration is said to occur when each

party performs a discrete function in an integrated value chain, as would occur, for example, when one party is responsible for technology development, another for manufacturing, and a third for marketing, all of the same product. The PDD claims that the commonality of functions and risks that mark highly integrated activity between the affiliated parties is more likely to occur with parallel integration than with sequential integration.

It is important to note that in the rapidly evolving markets faced by technology firms, a close integration between different steps in the value chain is essential for a firm to produce commercially valuable innovation. Therefore, the activities of affiliated enterprises may be highly integrated even though each focuses on a separate step of the value chain such as R&D, manufacturing, or marketing. For example, effective new product development is driven not only by the technological considerations provided by R&D teams but by intelligence from marketing teams regarding the attributes most valuable to customers. In turn, once new products are developed, engineers help marketing teams sell the product by conveying the technical attributes of the innovation more effectively to consumers. For firms that manufacture their products internally, the R&D function has to coordinate closely with manufacturing operations to develop design processes that incorporate considerations of reliable manufacturability into the design of the product itself. Given the interdependence of activity across these steps of the value chain, affiliated enterprises focusing on particular steps in the chain may nonetheless be significantly integrated with enterprises focusing on other steps.

Therefore, the mere fact that affiliated enterprises focus on different steps of the value chain does not necessarily indicate that they are less likely to be highly integrated.

**D. The PDD is unclear about the conditions under which intermediate forms of risk-bearing such as contingent royalties are appropriate**

The PDD describes the TPSM Anticipated as a pricing arrangement based on splitting the anticipated profits from a transaction between its participants. Given that the profits anticipated at the time of the transaction do not, by definition, change subsequently, one form of payment that can arise from a TPSM Anticipated is a lump-sum payment computed to ensure each participant realizes a specified percentage of the known and fixed anticipated profit. This lump-sum can be converted into a series of equivalent installment payments without changing their fundamental character as payments independent of actual outcomes.

Thus, under a straightforward construction, a TPSM Anticipated can produce outcome-independent payments that contrast with the outcome-dependent payments generated by a TPSM Actual. However, the PDD recognizes that one variant of the TPSM Anticipated can produce payments with outcome-dependence. Specifically, the PDD describes a royalty contingent on

sales as a specific example of a TPSM Anticipated, in which the royalty rate is determined on the basis of anticipated future profits but is applied to actual sales to determine annual royalty payments.<sup>9</sup>

On the central issue of when a TPSM Anticipated (including variants with contingent royalties) is appropriate, the PDD notes merely that a TPSM Anticipated does not require “the same level of integration or risk sharing” as a TPSM Actual.<sup>10</sup> This guidance is insufficient for determining when a TPSM Anticipated would be appropriate relative to a TPSM Actual, and when an intermediate form of the TPSM Anticipated would be preferable to a purely non-contingent form such as lump-sum payments. A royalty contingent on sales exposes the payor of the royalty to risks associated with the business’s sales, but not to risks associated with fluctuations in costs. Would a TPSM Anticipated with contingent royalty be considered appropriate if the payor of the royalty had some measure of control over the risks of sales, even if the recipient had no control over cost fluctuations? Is such control necessary or would this contingent royalty method be applicable even if the payor controlled only “related risks”? As before, articulating the concepts of “related risks” and the degree of integration in business activity remain important for taxpayers and tax authorities to have clear guidance on the choice of transfer pricing method.

**E. It is unclear whether a “delineation of the transaction” involving affiliated enterprises includes the payment terms associated with the transaction**

The PDD states that when evaluating the applicability of a TPSM Actual, taxpayers should perform an “accurate delineation of the transaction” and evaluate whether this delineation shows the relevant affiliated enterprises undertaking activities that involve the sharing of economically significant risks.<sup>11</sup> To the extent that an “accurate delineation of the transaction” involves a detailed analysis of the functions performed and assets contributed by each entity, we agree that such an analysis is helpful in evaluating alternative methods for determining intercompany payments.

However, it is unclear whether an “accurate delineation of the transaction” can be independent of the payment form under which the affiliated enterprises are being compensated under the intercompany transaction. As an economic matter, whether or not a party bears economically significant risks under a transaction depends on how the party is compensated. If the chosen form of intercompany payment is a royalty contingent on sales or a TPSM Actual,

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<sup>9</sup> PDD, Section C, ¶ 6 (emphasis added).

<sup>10</sup> PDD, Section C, ¶ 20 (emphasis added).

<sup>11</sup> PDD, Section C, ¶ 11.

both the payor and the payee are exposed to the risks of actual outcomes. Conversely, regardless of the activities performed by a party, it can be immunized from risk simply by selecting a form of payment under which the party receives a fixed (or more generally, an outcome-independent) payment, such as a TPSM Anticipated under which the payee receives a lump-sum payment. Thus, the proposed guidance that taxpayers should consider the sharing of economically substantive risks when selecting the a method for evaluating intercompany payments is potentially circular; the sharing of risks is itself a function of the form of payment

The circularity embedded in a “delineation of risks” is evident in certain statements in the PDD. The PDD states that “a key indicator for the appropriateness of a profit split of actual profits is that the parties continue to share in the outcome of the business activities and the risks associated with those subsequent outcomes.”<sup>12</sup> Yet, a TPSM Actual, if chosen, would ensure that parties “share in the outcome of the business activities.” Thus, the condition that is taken to indicate the appropriateness of a TPSM Actual is ensured by the implementation of the TPSM Actual itself—a circularity.

It is important for guidelines on profit splits to recognize that affiliated parties, acting at arm’s length, may choose between alternative forms of payment for a given transaction. As the PDD notes, an enterprise acting in a market-mediated transaction can choose to offer its assets or services either for a fee that is independent of market outcomes or for a share of the income realized by the other party.<sup>13</sup> Well-accepted economic principles can be used to compute the payment terms associated with each form of payment, given the degree of risk the enterprise will bear under the chosen payment form. The chosen payment form will affect the risks to which the enterprise is exposed at arm’s length under this transaction.

To provide clear guidance to taxpayers and tax authorities on how to evaluate the appropriateness of profit split methods, it would be helpful for the OECD to articulate the precise considerations that should enter an “accurate delineation of a transaction” and, to the extent these considerations include the terms of the intercompany payment for the transaction at issue, clarify how such an analysis can be used to choose the method for determining these payments.

**F. It is unclear how the value chain analysis described by the PDD is different from a careful functional analysis, or what role it is supposed to play**

The PDD indicates that a “value chain analysis” (or “VCA”), undertaken as part of an overall analysis of a taxpayer’s economic activities, may help to identify circumstances where a TPSM (either in Actual or Anticipated form) is appropriate. This VCA is described as including

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<sup>12</sup> PDD, Section C, ¶ 10.

<sup>13</sup> PDD, Section C, ¶ 10.

a review of the economically significant functions, assets, and risks associated with each affiliated entity and the economic circumstances under which these functions are performed, assets deployed, and risks borne. The VCA would also have to consider whether these economic circumstances allow opportunities for profits in excess of the levels typically associated with the activity because of factors such as first-mover advantages or unique intangibles.<sup>14</sup>

We agree that an analysis of the economic activities of affiliated enterprises is useful in determining arm's length terms for intercompany transactions. However, it is not clear how such a VCA is different from a careful implementation of a functional analysis, as described by the OECD's *Transfer Pricing Guidelines*. A functional analysis also examines the functions performed, risks borne and assets deployed by affiliated parties in connection with intercompany transactions.<sup>15</sup> A functional analysis should also consider factors affecting the economic values of these contributions, such as the uniqueness of an asset, the profit margins on products generated through these contributions and factors that may sustain these profit margins over time, which would include considerations such as the uniqueness of the asset or the sustainability of competitive advantage.

In light of the considerations that already fall within the ambit of a rigorous functional analysis, it would be helpful for the OECD to clarify if the VCA proposed in this discussion draft is different in scope or detail from such a functional analysis, and if so, in what respects. The PDD provides no definition of a VCA nor any guidance on best practices for how a VCA should be carried out or how it should be used or interpreted. The PDD likewise provides no guidance on whether its inclusion of the discussion of the VCA is intended to suggest that this will be a new and potentially onerous and poorly formulated compliance burden on taxpayers or merely that it may be an optional analysis some taxpayers may wish to prepare. Unless and until the PDD can clearly describe the added value (if any) of a VCA, articulate the elements and process of conducting and interpreting such an analysis, and address the significance of including a reference to the VCA in the *Transfer Pricing Guidelines*, we strongly recommend eliminating it from the final guidance.

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<sup>14</sup> PDD, Section C, ¶ 26.

<sup>15</sup> 2016 *Transfer Pricing Guidelines*, ¶¶ 1.51–1.106.



## Appendix—SVTDG Membership

Accenture	Integrated Device Technology, Inc.
Activision Blizzard	Intel Corporation
Acxiom Corporation	Intuit, Inc.
Adobe Systems, Inc.	Intuitive Surgical
Advanced Micro Devices, Inc.	KLA-Tencor Corporation
Agilent Technologies, Inc.	Lam Research Corporation
Amazon.com	LinkedIn Corporation
Apple Inc.	Marvell Semiconductor, Inc.
Applied Materials, Inc.	Maxim Integrated
Autodesk	Mentor Graphics
Bio-Rad Laboratories, Inc.	Microsemi Corporation
BMC Software	Microsoft Corporation
Broadcom Limited	NetApp, Inc.
Brocade Communications Systems, Inc.	Netflix, Inc.
Cadence Design Systems, Inc.	Oracle Corporation
Chegg, Inc.	Palo Alto Networks, Inc.
Cisco Systems, Inc.	Pandora Media, Inc.
Dolby Laboratories, Inc.	PayPal Holdings, Inc.
Dropbox Inc.	Pivotal Software, Inc.
eBay, Inc.	Plantronics, Inc.
Electronic Arts	Pure Storage, Inc.
EMC Corporation	Qualcomm, Inc.
Expedia, Inc.	Rovi Corporation
Facebook, Inc.	salesforce.com
FireEye, Inc.	SanDisk Corporation
Fitbit, Inc.	Sanmina-SCI Corporation
Flextronics	SAP
Fortinet	Seagate Technology
GE Digital	ServiceNow, Inc.
Genentech, Inc.	Snapchat, Inc.
Genesys	Symantec Corporation
Genomic Health, Inc.	Synopsys, Inc.
Gilead Sciences, Inc.	Tesla Motors, Inc.
GitHub	The Cooper Companies
GLOBALFOUNDRIES	The Walt Disney Company
GlobalLogic, Inc.	Trimble Navigation Ltd.
Google, Inc.	Twitter, Inc.
GoPro, Inc.	Uber Technologies
Groupon	VMware Corporation
Harmonic	Xilinx, Inc.
Hewlett-Packard Enterprise	Yahoo!
Hewlett-Packard Company	Yelp, Inc.
Ingram Micro, Inc.	

Ref  
Submission File

6 September 2016

**Organization for Economic Co-operation and Development (OECD)**  
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BY E-MAIL: [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

Dear Sir/Madam

**SUBMISSION: DRAFT DISCUSSIONS ON BEPS ACTION 7 AND BEPS ACTIONS 8 to 10**

1. We herewith present the South African Institute of Chartered Accountants (SAICA) written submissions on the Draft Discussions on BEPS ACTION 7 relating to Additional Guidance on the Attribution of Profits to Permanent Establishments and BEPS ACTIONS 8 to 10 relating to the Revised Guidance on Profit Splits on behalf of the SAICA Transfer Pricing Subcommittee (a subcommittee of the SAICA National Tax Committee).
2. Our submissions include comments on the questions specifically raised in the discussion papers, as well as further input to simplify and clarify examples. We have deliberately tried to keep the discussion of our submissions as concise as possible, which does mean that you might require further clarification. In this respect, you are more than welcome to contact us in this regard.

**BEPS ACTION 7**

Question 1:

3. We are of the view that the result will be the same irrespective of the order that article 7 and article 9 of the Model Tax Convention (MTC) are applied.
4. The guidance should suffice, provided that the entity operating in its own capacity and creating the Dependent Agent Permanent Establishment (DAPE) for the offshore entity is rewarded with an arm's length return for the undertaking of its activities.



Questions 2 and 3:

5. In principle yes. However, the functional analysis is simplistic. It may occur that the selling DAPE also takes some risk associated with logistics, depending on the nature of the product sold.

Question 4:

6. The key difference is that under the old interpretation of Article 7, cognisance of the overall profit situations is considered.
7. For example, a commission rate which provides for a reasonable allocation of a portion of the profit to SellCo may differ from an amount determined in pricing a notional transaction.

Question 5:

8. Not necessarily. The people function is not the only factor that needs to be considered when performing the functional and factual analyses.
9. Consideration should also be provided to the level of risk, and furthermore how and where such risk is managed.

Question 6:

10. It is submitted that if SellCo bears credit and stock risk, it may be more likely be classified as a buy/sell entity. In such instance a commission based approach may not always be the most appropriate.

Question 7:

11. Please refer to paragraph 6 and 7 above for an answer to the question raised.

Question 8:

12. The consequences in the example and the question to which party inventory and credit risk should be allocated depend on how the term “financial capacity” is determined.

Question 9:

13. We concur with the conclusion reached in example 2.

Question 10:

14. The construction of the profits or losses of the DAPE in Example 3 is dependent on whether the employee remains employed by Prima or is seconded to SellCo.
15. Furthermore, an analysis of the customer relationships should be undertaken to determine whether the employee has marketing intangibles as a result of these relationships.

Question 12 and 13:

16. We agree with the construction of the profits/losses of the DAPE in Example 4, as well as the conclusion reached regarding the difference that arises due to the allocation of risk between different enterprises and attribution of risk within the same enterprise.

Question 14 to 20:

17. While we agree with the conclusions, the various scenarios of the Example are simplistic. For example, the outcome can be impacted if the goods are stored in bond and the answer to the question regarding which entity is responsible for raising this may change the outcome.
18. The nature of the example suggests that some people need to be in the warehouse location, but these need not necessarily result in a significant people function (SPF).
19. For example, these people in the warehouse may be operating under the guidance of the offshore entity.
20. It should be considered if a cost plus method is not appropriate for this Example.

**BEPS ACTIONS 8 TO 10**

Question 1 to 3:

21. The distinction between transactional profits splits of anticipated profits and actual profits seems to be clear.
22. Practical examples and guidance on how entities would share risks would also be useful.
23. It is furthermore our understanding that often one entity typically takes certain risks associated with a transaction, while the other entity takes different risks. Where the parties to a transaction arguably share risks (for example the market risk) one may be able to separate these based on how the risks are managed. For example reputational risk and brand related risk versus customer relationship risk.

Question 4 and 5:

- 24. Yes, strengths and weaknesses appear to be captured clearly. One of the key strengths of the transactional profit-split-method (PSM) is that it aligns more to business practicalities than some of the other methods.
- 25. Accordingly, if a business operates in a way which makes the PSM a natural fit, then this would support the application of this method.
- 26. For instance in a retailing environment where there is a gradual shift from heavy support to a more autonomous operation over a period. A retailer may therefore have a number of markets in different stages of maturity.
- 27. As retailers operate internally in a similar manner to franchise arrangements, providing a combination of know-how, the brand, support services, centralised purchasing etc., a PSM often makes sense.

Question 6:

- 28. It is submitted that the sharing of economically significant risks does exist. It may be useful to clarify how the relevant risk is managed and by which entity it is managed.

Question 7:

- 29. No examples showing the application of a transactional profit split of anticipated profits have been observed.

Question 8 and 9:

- 30. The distinction between parallel and sequential integration of business operations is a useful refinement, but it should be noted that there may be instances where lines are close and difficult to differentiate. More detailed guidance would be appreciated.

Questions 10 and 11:

- 31. No responses.

Question 12:

- 32. The question to be put forward in this regard is how the group synergies came about. It may be argued that if one entity incurred costs in development, it should be rewarded over and above the marginal sharing.

Question 13:

- 33. The undertaking of a value chain analysis is effectively a more detailed functional analysis. However, a value chain analysis involves an in-depth assessment of value

drivers in an industry or organisation along the chain of primary and support activities of a multinational group that lead to the delivery of a product or service to end customers. Thus, the value chain analysis relies on more than just a functional analysis, it uses a value focused, end-to-end, functional analysis.

34. The more detailed analysis may however give rise to instances where the level of contribution is misunderstood as being more valuable than it really is, leading to a greater risk of default to a PSM. Thus, clear guidance is required.

Questions 14 and 15:

35. No responses.

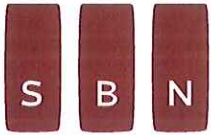
Questions 16 to 18:

36. It is submitted that in reality profit splitting is mostly subjective, and a quantifiable basis for profit splitting can result in distorted outcomes.
37. Guidance regarding the application of the profit split method should therefore only point into a direction, but it should not be exhaustive, as there will need to be a degree of subjectivity.
38. The key area where additional guidance would be helpful is around the different measures for allocating and splitting profits between functions, risks and assets.

We would like to thank the OECD for the opportunity to participate in the development of the Base Erosion and Profit Shifting regime.

Yours sincerely

**Pieter Faber**  
**SENIOR EXECUTIVE: TAX LEGISLATION AND**  
**PRACTITIONERS**  
*The South African Institute of Chartered Accountants*



**STUDIO  
BISCOZZI NOBILI**

legale - tributario

September 5, 2016

Sent via email to: [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

To Tax Treaties, Transfer Pricing and Financial  
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## **Re: Comments on “BEPS ACTION 8 – 10: REVISED GUIDANCE ON PROFIT SPLITS”**

Studio Biscozzi Nobili (SBN) is pleased to provide comments on the public discussion draft “*BEPS ACTION 8 – 10: REVISED GUIDANCE ON PROFIT SPLITS*” (the “*Draft*”).

SBN commends the work that the OECD has undertaken to date in relation to the BEPS Project and offers its assistance in support of its further efforts.

SBN appreciates the opportunity to further invest in the process and further assist the WP6 by presenting or clarifying our views and comments, if necessary, on the proposed changes to the Transfer Pricing Guidelines (the “*Guidelines*”).

### *Preliminary remarks*

The Draft addresses the issues deriving from the application of the transactional Profit Split Method (PSM) and the review of the 2010 Guidelines in respect thereof after the *Discussion Draft on the use of profit splits in the context of the global value chain*, aimed at identifying criteria for the PSM application assuring that transfer pricing outcomes are in line with value creation.

In our practical experience, the application of the PSM has become a key issue of Italian tax practice over the last couple of years not only from a transfer pricing perspective, but also in relation to the introduction of a Patent Box regime (on election basis) in the Italian Tax system; therefore, views and



proposals included in the Discussion Draft are welcome and a final consensus of the 2010 Guidelines is appreciated in the due course.

Before dealing in detail with the Draft and questions to commentators from WP6, it is worth noting that, our feeling about the proposed changes to PSM Guidelines is positive considering that:

- the Draft includes various new paragraphs aimed at coordinating PSM with already approved BEPS Actions 8 – 10;
- moreover, various paragraphs of the Draft address in detail the key issue of the “*most appropriate method to apply to controlled transactions*”, clarifying that a lack of comparables alone is not sufficient to justify the application of the transactional PSM. We agree with the conclusion that adjustments of inexact comparables data, where possible, could result more appropriate in order to establish a reasonable transfer pricing range than the application of the PSM, that should always require transactions among two or more associated enterprises involved in activities where they share economical significant functions and risks;
- the Draft attempt to clarify different scenarios where PSM of anticipated profit is preferable to PSM of actual profit and *viceversa*, notwithstanding the uncertainties described here below.

Thus, the revised Guidelines should include additional and more detailed examples<sup>1</sup>, as the 2010 Guidelines and the Draft are mainly based on a theoretical approach that could trigger subjective interpretations.

In other words, the revision of Chapter II of the Guidelines should include specific sector guidance, where applicable, notwithstanding the fact that each controlled transaction will maintain its specific characteristics and a correct transfer pricing analysis cannot take place without a detailed examinations of the integrated functions and value chain, risks shared, unique and valuable contributions of the associated enterprises (with reference to the “*Group synergies*” please see our further comments in the following).

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<sup>1</sup> A starting point could be represented by examples included in *Discussion Draft on the use of profit splits in the context of the global value chain* and comments received in respect thereof.



### Answers and Comments

For your convenience, the answers and comments below are numbered in accordance to the Draft.

1. In our opinion, the guidance contained in par. 2.127 of 2010 Guidelines did not clearly outline the distinction between the approach based on actual profits and anticipated profits.

Please consider that we appreciate the (new) clear distinction proposed by the Draft. In particular, we find it very useful since it explains the substantial difference between the two approaches: *“under a transactional profit split of actual profits there is a greater sharing of the effect of uncertainty resulting from risks”* (par. 6). Paragraphs 8 and 9 deeply examine such substantial difference.

Notwithstanding, we consider that in practice the PSM based on anticipated profits should have limited application depending on the industry involved, since it seems to trigger an uncertain way to determine compensation in a related party transaction. As explained in the above mentioned paragraphs 8 and 9 of the Draft, uncontrolled parties may try to mitigate their individual risks through, for example, variations in prices, but this generally does not result in sharing the outcomes of the business controlled by another party.

In case an entity does not agree to participate to the future outcome of a whole business, probably the required remuneration would be a non contingent payment, which can be determined through the use of one-sided method (see par. 17 of the Draft).

In our opinion, then, the distinction is considered useful, but the use of the PSM in the majority of cases should be based on actual profits, while anticipated profits could find application in limited cases.

Finally we would appreciate further clarification from WP6 about the practical way of application of PSM based on actual profits: in particular, since the transfer pricing method should be applied on actual results of the controlled transaction(s), revised Guidelines should clearly state whether PSM would bring to year-end adjustments or it would imply timing differences between the collection of final data concerning the profits to be split and the final remuneration of the related parties involved in the transaction.

2. In our view, in case of high integration of functions (for which PSM may be assessed to be the most appropriate method) and continuing involvement in the business key risks of all the parties involved in the controlled transaction, the approach to be used should be based on actual profits, since it is the only way through which each party involved in the transaction can participate to the future outcome of the common business.
3. The below examples show the practical use of actual profits:
  - new brand development: brand owner and licensee would both perform marketing, advertising and promotion activities, take the strategic decisions and bear the related risks; consequently, both of them are supposed to participate to future outcomes of the brand. Under this scenario the use of anticipated profit to determine the compensation of brand owner would lead to results not in line with the arm's length principle;
  - software development: different parts of a potentially successful and innovative software are developed by different parties. Related entities are strategically linked and they cannot work without the other parties; in this case all the parties are expected to participate to the outcomes of the whole business on actual basis.

The example below shows a practical use of anticipated profits:

- in our opinion the PSM based on anticipated profits may have limited application. Notwithstanding, we can consider R&D activities concerning a new product where at first stage (research) is remunerated with non-contingent payments, based on anticipated profits of the business. Since a party involved in the first stage research will not bear the risks related to the subsequent development of the product (and cannot control the related risks), it does not seem appropriate that it participates to the (positive or negative) uncertainty of the future economic and financial outcomes of the final product. At the same time, the selection of PSM as the most appropriate method could be justified by the fact that the contribution is unique and valuable: the party that performed the first scientific discovery could be reasonably compensated through a payment based on the expected results of the whole business, but it would not accept a compensation based on risks



subsequently controlled by other parties. In such situation, PSM on anticipated profit could represent the appropriate way to determine arm's length remuneration.

4. In our opinion, strengths and weaknesses of the PSM are well outlined and they are substantially in line with the 2010 Guidelines. Moreover, the Draft, better clarifies situations in which PSM would not be appropriate, in order to prevent "*profit-split abuse*".
5. The two different approaches in principle share the same strengths and weaknesses. Thus, PSM based on anticipated profits is more discretionary since it requires projections of future flows (income or cash flows) related to an integrated business; in our opinion, the use of such approach would be recommended only in presence of the following conditions:
  - consolidated and stable market trends;
  - consolidated performance of the entities/business under analysis;
  - reliable projections of future trends and results (sales, working capital changes, etc ..);
  - no start-up phase and stable investments (we suppose this additional condition is consistent with the Draft, since par. 2.123 of 2010 Guidelines has been deleted).

Consequently, one additional weakness of anticipated profits approach is that it could lead to misleading and not accurate results (unless the above conditions are met) and – therefore – it might be inconsistent with the strengths outlined in par. 13 of the Draft (par. 2.113 of 2010 Guidelines).

6. In our opinion, it should be clarified and stressed the fact that risk sharing means the possibility to exercise control over the relevant business risks, decision making and financial capacity of controlling the relevant risks. The valuation of PSM as the most appropriate method cannot be limited only to the presence of integrated functions or unique and valuable contributions; the level of risk sharing can be broadly based on the possibility – and capacity – of affecting / influencing / controlling the relevant key / strategic drivers of the business. Consequently, PSM should be applied only in cases where two or more related parties actually share relevant continuing risks of a common business.

The Draft is also helpful to clarify the circumstances where PSM is considered the most appropriate method, in particular it is very helpful in clarifying that the use of profit split cannot be justified by the mere lack of exact comparables. In this regard, Par. 18 seems very reasonable as it formalised a concept long discussed.

As an example, we can refer to Scenario 3 included in the Discussion Draft on the use of profit splits in the context of the global value chain<sup>2</sup>: it would be useful to clarify if in such a case WP6 and / or commentators consider PSM or adjustments to a one-sided method as the most appropriate transfer pricing approach.

7. In our opinion the anticipated profits approach necessarily requires the use of financial valuation techniques, since future outcomes of a combined business must be estimated. In other words, business plans or projections of financial data are required; consequently, such approach should only be used in presence of: (i) reliable provisions of future flows; (ii) market stability; (iii) consolidated industry trends; (iv) no start-up businesses (see also above answer no. 5 about weaknesses of anticipated profits approach). In case reliable consolidated entities' trends and reasonable assumptions for future trends are not available, different valuation techniques might be used (e.g. sectors / industry multiples).

In our opinion the most useful valuation technique is the "Discounted Flow" model, either based on economic profits or on cash flows. We hold that a profit split based on anticipated profits with the use of future cash flows

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<sup>2</sup> A party (Company S) is responsible for selling the equipment produced within the group and carrying out marketing activities. Scenario 3 recognises Company S not merely as a "routine" distributor, but as a source of competitive advantages derived from the customer services and after sales activities which entails developing close relationships with customers.

As high value-added activities/services usually incorporate know-how intangibles, which are reflected in the compensation of the individuals performing those functions, the level of interdependence between group profitability and sales force know-how should be fully examined. In this context, the analysis should focus on examining to what extent, the significant people functions (the sales force), rather than the risks assumed by the parties, represents a source of competitive advantage therefore giving scope for the application of a PSM.



projections would be appropriate only in the case the entity being compensated with anticipated profit accept to share the financial risks of the business.

8. Yes, the distinction is useful and it is consistent with par. 18 of the Draft (no use of PSM for the mere absence of exact comparables).
9. In our opinion, the concept of parallel integration is sufficiently clear; however, additional examples could be useful to further clarify the definition.
10. In our opinion, Guidelines should better clarify the fact that in order to use the PSM as most appropriate method the risk sharing must exist over the whole life of a product.

In this respect, a substantial statement is included in par. 10 of the Draft: *“However, 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”*.

In our opinion, then, in a deal between independent parties, no one would enter in an agreement where the remuneration would be based on risks that are controlled by another party.

On the other side, if one of the party bears significant risks, but related to one stage only of the value chain, it would probably require to be compensated through a non-contingent payment and would not accept to bear risks of subsequent stages. In such situations, even though the contribution of the party asking a non-contingent compensation is unique and valuable, PSM may not be the most appropriate method, or it could be used through the anticipated profits approach. This seems to be consistent with the scenario described in paragraph 17 of the Draft.

11. As already anticipated, in our opinion if one of the party involved bears risks related to only one stage of the value chain, it would not accept a compensation based on future outcome of the whole business, even though

its contribution is unique and valuable. In this regard, more guidance should be provided to clarify when the contribution of a party is unique and valuable, but the risks borne it is limited to one stage of development of the business, and as a consequence other methods could be applied. For example, depending on the industry under consideration, when the value chain can be split in a number of subsequent steps that lead to a finished product, they can also be seen as independent from the others; therefore, the party which has completed its work would not accept to be exposed to uncertainty of future stages.

12. Our understanding of the Draft is that the WP6 intends to avoid the use of PSM for the mere presence of group synergies. In other words, group synergies are factors to be allocated to the MNE group parties in a manner similar to the allocation of costs of share services.

The first step is to determine the incremental / marginal benefit of group synergies, and the subsequent step is to identify proper allocation keys. We appreciate the intention to simplify the analysis (a different approach would lead to a wider use of profit split), but it seems difficult and very discretionary to calculate the incremental or marginal advantage / disadvantage deriving from group synergies. In addition, we are not in the condition to understand the real effect of such approach. We are not sure that group synergies should be compensated in any case. We think a very useful distinction is the one proposed in paragraph D.8 of BEPS Actions 8-10 Final Report between incidental benefits and deliberated group actions. We think that only in this latter case (deliberated actions) synergies could be reliably measured and consequently compensated.

13. We hold the section properly describes the use of value chain analysis as a tool for delineating the actual transaction and its key features and consequently in determining the most appropriate transfer pricing method.
14. We agree about the fact that value chain analysis is a useful tool in determining the most appropriate transfer pricing method. However, in our opinion, value chain analysis must be a substantial part of functional analysis, since the identification of the key drivers of value is an important step in order to assure that prices are in line with value creation.

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Some final comments are requested in respect to paragraph C.4. of the Draft in respect to the “*Guidance for application*” of the PSM.

Paragraph 31 and following of the Draft seem not to be materially different from the 2010 Guidelines and clarification set forth in paragraph 40 about the measure of profits to be split (gross or operative profit) sounds reasonable and consistent with practice already adopted in the past, since PSM shall trigger transfer pricing outcomes aligned with value creation and risk borne by the various entities of the MNE.

Moreover, as already stressed in our comments to the Discussion Draft on the use of profit splits in the context of the global value chain, material issues arise when the allocation factors utilised are not objectively perceived and, therefore, it is uncertain what third parties would have agreed upon. Again, we recommend that a possible guidance should identify a (non-exhaustive and non binding) list of key factors divided per industry or sector.

The following list identifies examples of allocation keys per industry:

- Luxury: Sales promotion; Marketing and Advertising;
- Automotive: Production capacity; Value of production; Headcount;
- Pharmaceutical: R&D;
- Software development: Direct cost of employees and external counsels
- Consumer product: Marketing and Advertising; Digital investment (e-commerce), if any.

The list of allocation factors to be included in the Guidelines, should be non-exhaustive in nature so that the taxpayer should be able to select allocation keys not listed therein, if properly justified, that better fit each particular case.

\*

Finally, we also suggest that WP6 explicitly addresses in the revision of the 2010 Guidelines situations where associated enterprises consistently realizes losses while the MNE group as a whole is profitable (i.e. situations dealt with in Chapter I of the revised Guidelines, par. 1.129 – 1.131). More in detail, we recommend that further clarification are included in the revised Guidelines in cases dealt with paragraphs mentioned above, where a loss making business (to

be identified in different ways, products, geographical areas, etc ...) should be allocated among the entities that could (indirectly) benefit through the application of PSM, notwithstanding the fact that one sided method could be the preferable criteria for the identification of the ordinary compensation of the related entities.


Moreover, it is worth noting that in the “*Discussion Draft on the use of profit splits in the context of the global value chain*” it has been described a scenario involving a banking group carry on trading activities and discussions whether profit split methods may be applied in a different way when there are losses to split instead of profits. We are of the opinion that there are circumstances under which it might be appropriate to vary the application of splitting factors depending on whether a profit or loss has incurred (see additional detail in our comments of February 5, 2015).

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Truly yours,

Franco Pozzi

Lisa Vascellari Dal Fiol



# Memo

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**To:** Tax treaties, Transfer Pricing and Financial transactions division      **Company:** OECD/CTPA

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**From:** Julien Pellefigue

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**Date:** September 5, 2016

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**Subject:** Taj comments on the discussion draft on the revised guidance on profit split

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Dear all,

We are pleased to send you our comments regarding the discussion draft on profit split that was posted on the OECD site on July 4<sup>th</sup>.

We would be happy to discuss these topics into more details at your best convenience.

Yours sincerely,

For the Taj transfer pricing team (Eric Lesprit, Aymeric Nouaille-Degorce, Julien Pellefigue, Grégoire de Vogüé)



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Dr. Julien Pellefigue  
Transfer Pricing Partner

## Introduction

- The BEPS objective of aligning taxable income with “economic substance” or “value creation” has been understood by many as leading to favouring the use of double sided methods, such as profit split, against one-sided methods such as TNMM.
- In particular, the notion that the taxable income of a multinational enterprise (“MNE”) should be split according to the value of the contribution of each subsidiary has made its way in certain National Tax Administrations. An increasing number of notifications of reassessment are based on the idea that if the audited subsidiary is a key part of the MNE, it deserves a portion of the consolidated group profit rather than a certain profit level set up by reference to comparable companies.
- This new and rising interest in the profit split method combined with the fact that its principles of implementation are rather vague (both concerning the situation where profit split is the most appropriate method and how to implement it when it is the case) creates a very significant risk for MNEs. Indeed, it is very difficult to comply with a rule that is not perfectly clear. In addition, the high probability that two different Tax Administrations have different opinions on what is “key” within a MNE creates a risk of multiple taxation in a world where MAPs are not a trustful solution as they are more and more difficult to apply.
- Within that framework, guidelines for the application of the profit split are eagerly awaited by all the transfer pricing community and this request for comments by the OECD is a great opportunity to contribute to that effort, which we are very happy to seize.
- This note is structured as follows:
  - > Chapter 1 makes very general economic comments on profit splits and underlines the key ideas that are developed further in this note.
  - > Chapter 2 presents our comments to the 18 questions asked by the OECD

## I. General Economic comments

The issues that are at the core of the profit split have been already extensively studied by economists. In what circumstances would two independent firms enter into a profit split agreement vs. a standard spot market transaction? How would two independent firms bargain for their respective share of profit in such an agreement? Why do multinational firms exist? What makes them generally more efficient than national firms? What determines the level of profit that is generated by a firm?

All these questions have given way to an enormous amount of work, and certain general – and reasonably non-technical – conclusions have been derived. We believe that it would be extremely beneficial for all parties that the guidelines refer to these well understood economic notions because it would create an objective common ground for discussion with, and between, Tax Administrations and it would reduce the possibility of arbitrary reassessment.

The guidelines for the application of certain articles of the EC treaty concerning competition law<sup>1</sup> are a good example of how economics can be fruitfully used to precise the meaning of a rule and therefore give more legal security to firms.

Three examples of economics-based conclusions concerning profit splits can be underlined here:

<sup>1</sup> See for instance the Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings (2009/C 45/02) that defines market power, foreclosure or predatory pricing with elements that are directly taken from the economic theory.

### **I.1 The exclusive reference to third party behavior might not be fully relevant for profit split**

In the revised guidance on profit split, §1, it is mentioned that “the transactional profit split method seeks to (...) determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction”. Thus, according to the arm’s length principle, an arm’s length profit split would exactly replicate the kind of arrangement that would be set up by two independent firms in the same circumstances. Therefore, the best way of setting up a profit split between two subsidiaries of a MNE should be to find “comparable” profit splits arrangements between comparable third parties.

Unfortunately, this approach might prove very difficult in practice:

- Commissions based on sales or royalty rates increasing with overall sales or volume are reasonably frequent, however there are very few occurrences of profit split agreements between third parties *per se*. Several reasons explain this fact, notably that “profit” is rather difficult and costly to measure, particularly in multiproduct firms. Since common costs can be split between several product lines, each party to a profit split might have an incentive to allocate more common costs to the product line which profit should be split, so as to reduce the profit pool to be shared with the other party. Profit splits between third parties are therefore difficult to set up and to enforce and they are very rarely used. As a matter of fact, in the economic circumstances where a profit split would be the best possible agreement between third parties, they would most likely choose to merge instead (or one would acquire the other) and become a MNE<sup>2</sup>.
- The closest to a profit split agreement is certainly a joint venture or a cooperative / partnership (where transparency on the accounts is guaranteed to all parties). However, in the most general circumstances, it will be impossible to use JVs or cooperatives as good benchmarks to determine a profit split allocation key. Indeed, the way the profit is split between JVs shareholders or between partners has a very strong impact on the incentives given to them. Therefore, between third parties, the profit allocation key is set up not only to evaluate and compensate each party’s real contribution to the success of the venture but also to give strong incentives to perform to all of them. A good example is given by law firms<sup>3</sup>. In certain of them a mechanism of “lockstep” is used to share the residual profit between equity partners, whereby each partner of the same experience bracket will earn the same amount, independently of his real direct contribution to the business. This profit allocation mechanism might seem unfair, as it does not tie the profit share of each partner and their contribution to “value creation”, however it is very widely used because it has some properties that can make the whole firm more efficient (in particular, it gives incentives for strong cooperation between partners). The same kind of reasoning can be used for JVs, and explains why a large number of JVs are 50% / 50% even though each partner does not necessarily contribute evenly<sup>4</sup>, which makes a lot of them not a good benchmark for related party profit split.

### **I.2 Profit split might be the best method each time a transaction between two subsidiaries could not take place in the market**

The guidance currently identifies several types of situations where a profit split might be the most appropriate method between two subsidiaries: (i) when their activities are deeply integrated, (ii) when they each contribute something unique and valuable or (iii) when they share risks (or the control over risk).

<sup>2</sup> Hart O., 1995. *Firms, Contracts, and Financial Structure*. Oxford University Press

<sup>3</sup> See Gilson R. and Mnookin R., 1985. “Sharing among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits”. *Stanford Law Review*, Vol. 37, No. 2: 313-392

<sup>4</sup> Other consideration unrelated to the contribution of each partner, like different risk aversion, liquidity constraints or tax consideration might also impact the profit split within a JV. See Sercu P., 2009. *International Finance: Theory into Practice*. Princeton University Press

However, an analysis of the behavior of firms shows that these criteria are not perfectly accurate, as it is possible to identify situations where a simple fixed price spot market transaction is made between firms that are very much integrated, contributing valuable and unique intangible to each other and sharing control over risk. If independent firms in these situations can simply transact in the market, it means that for comparable subsidiaries, the CUP method or the TNMM would be more appropriate than profit split.

On the other hand, economic theory shows that specific contracts, such as profit sharing agreements or JVs, would only appear when standard contracting across a spot market is not efficient. Therefore, as a first line of analysis, it is possible to assume that each time a transaction with a subsidiary can be outsourced to a third party in the market without any significant loss of efficiency, the TNMM would be appropriate. On the other hand, if strong economic reasons make it impossible for the group to outsource this transaction and create a case to internalizing it within the group, chances are, a profit split might be the best TP method.

There are several classical circumstances in which independent firms would not transact over a spot market, they generally involve: (i) the necessity for one or both parties to make specific investment (i.e. investment that would not be usable with another party), (ii) incentives issues (for instance when one party requires that the other perform some actions which are hard to monitor, for instance when a producer needs a distributor to ask clients feedbacks on the products) and (iii) when the transaction covers a good that can hardly be sold over a market (corporate culture for instance, know how embodied in human capital, etc.).<sup>5</sup>

This criteria, of whether or not the transaction between two subsidiaries could take place over a market without a significant loss of efficiency, is different but closely related to the unique and valuable contribution, risk sharing and business integration criteria (as it will be described in the examples below). Its main advantage is to give a robust analytical framework that ties together these different criteria and allows decisions to be made on an objective basis. It could be considered to mention explicitly that criteria in the guidance.

### **I.3 The best profit split mechanism should be determined on a case by case basis**

Following the arm's length principle, the correct way of devising a profit split mechanism between two (or several) subsidiaries is to assess how they would bargain over the share of profit they are entitled to in the hypothetical scenario where they would become suddenly independent from one another.

This exercise is however extremely complicated because of the vast number of parameters that would enter into such a bargain: relative market power, existing opportunities to make business with other entities, relative risk aversion of the entities, asymmetry of information, industry specific parameters, etc. Therefore, faced with the concrete problem of designing a profit split, taxpayers and Tax Administrations have to make a tradeoff between accuracy and tractability of the calculation.

We believe that this trade-off should be situation specific (large and complicated cases should warrant the use of a model as accurate as possible vs. smaller cases where a simple model should give a reasonable second best solution). Depending on where on the accuracy/simplicity matrix we are, different methodologies could be used, which will be described later in this document.

## **II. OECD questions**

### **Question 1**

- Question 1.1: the distinction between profit split of anticipated profit and profit split of actual profit is clear.

<sup>5</sup> The criteria determining whether a transaction is more efficiently performed within a firm or over a market have been studied thoroughly for the past 40 years, for an introduction see for instance Lafontaine F. and Slade M., 2007. « Vertical Integration and Firm Boundaries: The Evidence ». Journal of Economic Literature, vol. 45: 629-685

- Question 1.2: this distinction is also useful. We believe it could be further explained whether the Profit split (PS) on anticipated profit should only be used in the framework of the transaction of an intangible or if it can be used to set up a recurrent policy between two entities - for instance, a fixed royalty rate (% of turnover) could be set up based on the splitting of anticipated profit. In our opinion, the PS on anticipated profit should be mostly limited to intangible transactions. Indeed, it is difficult to identify clearly a set of circumstances where the best method to price a recurrent transaction of goods/services would be a profit split on anticipated profit rather than a profit split on actual profits.

## Question 2

The question raised here is whether PS is the best TP method for two related parties with integrated activities. In order to answer that question following the arm's length principle, we should assess whether two independent firms with integrated activities would (or would have an incentive to) enter into some kind of profit sharing system.

The answer seems to be rather no, as there are numerous examples of third parties having their business very much integrated and however not entering into profit sharing agreements. The automotive sector gives very good examples of such situations, as it is very customary to have independent OEM install their equipment on the production line of an automotive manufacturer, working in a perfectly integrated fashion. However, profit sharing is hardly used in that industry and other types of agreements (cost + type) are customarily used. Conversely, some of the best examples of profit split contracts between third parties are to be found in the biotech/pharma sector where a small biotech firm licenses an innovative molecule to a big pharmaceutical company that will try to turn it into a successful drug. In this kind of setting, we sometimes observe a royalty scheme where the rate depends upon the overall profitability of the drug (coming therefore close to a profit split). Nonetheless, in this situation the activities of the biotech and of the pharma are far from being integrated.

Integration *per se* does not seem to lead to profit split in real life. Additionally, integration does not necessarily either imply a sharing of the (control over the) risks. In the automotive sector for instance, it is reasonably easy for the automotive manufacturer to control the quality of the work of its integrated OEM, therefore even though an OEM responsible for the production of a critical equipment makes a critical input, the automotive manufacturer can generally easily monitor the quality of the product and therefore control all risks.

Instead of using purely the "integration of business" criterion, coming back to the analytical framework described in the introduction (whether a transaction could be performed over a spot market or not), we can identify certain circumstances where two firm activities are very much integrated and where it would be impossible for them to transact over a spot market. The usual case is when one, or both parties have to make specific investment. For example, an aluminium producer can source its bauxite from a spot market, where the suppliers are mining companies. The aluminium producer can also invest in a specific set of equipment, tailored to the mineral composition of one particular bauxite mine, which would significantly reduce production cost. However, no independent aluminium producer would perform such a relationship specific investment for fear of a *hold up*<sup>6</sup>. The investment is costly and specific in the sense that it does not have any value outside the relationship (tools are set up for the specific mineral produced by one specific bauxite mine). By doing this investment, the aluminium company gets tied to one particular bauxite producer. It would be unreasonable to make that investment without first entering into some kind of long term pricing agreement with the bauxite miner (otherwise, he would appropriate all gains from production cost reduction by raising its price). Even with a long term agreement, in case of a future unforeseen event that would require a renegotiation of the contract between the parties, the producer would be in a very weak position because of the investment it had realized. Indeed, no "complete" contract could be drafted *ex ante* to take care of all possible situations and protect the producer. This is the reason why aluminium producers are generally vertically integrated, to benefit from the efficiency gain allowed by specialization of the equipment while protecting themselves against the threat of a hold-up.

<sup>6</sup> Williamson O., 1985. *The Economic Institutions of Capitalism*. The Free Press

For transfer pricing purposes, this example shows that it is not the integration of activities per se that makes it impossible to transact on?? a market but rather the existence of specific investment. Following that line of reasoning, the existence of specific investment would be a sign that a PS might be the best TP method.

### Question 3

The aluminum producer / bauxite miner example described above would be a good example of a situation where the profit split of current profit would be the best method. With a residual profit split, both the bauxite miner and the aluminum producer would obtain a market compensation rate as the routine return, and the extra return related to the cost reduction allowed for by the specific investment would be shared between both parties.

An example of profit split of anticipated profit would be the situation where two subsidiaries of a MNE were involved in the creation and marketing of a new IP intensive consumer electronic product by joining their specific and hardly transferable know-how. The circumstances were such that the best TP method chosen was the profit split. In case of a reorganization of the MNE, if one party to the profit split is to be acquired by a foreign subsidiary, the value of the total IP and goodwill to be transferred should be calculated for a capital gain tax purpose. In that context, using the profit split methodology based on reasonable business plan detailing the expected future income stream would be the best method to value the intangible.

### Question 4

We believe that the strengths and weaknesses described in §12 (flexibility), §13 (balanced result), §14 (difficulty of implementation) and §15 (access to data) are very accurate.

Specifically concerning item §12, it should be worth noting that a “balanced” split of profit is not necessarily the economically correct result. Indeed, certain very centralized MNEs have a wide network of related party distributors or service providers even though they could rely on third parties with a reduced loss of efficiency. For such MNEs, if their total consolidated profit is much higher than the sum of the routine returns of all subsidiaries, the correct application of transfer pricing rules would come up with a very unbalanced split of profit (all residual would be in the center, all subsidiaries would have just a routine return) – this result would however be perfectly reasonable.

### Question 5

The implementation of a Profit Split of anticipated profit will rely on the production of a business plan covering revenues and costs for a reasonably long time horizon. This part is obviously very challenging due to the asymmetry of information between the taxpayer (who knows its business environment, market trends and cost structure) and the Tax Administration, which will have a hard time discussing growth assumptions made by an industry experts based on her experience. For that reason, the profit split of anticipated profit is likely to be less secure for the taxpayer, as the underlying assumptions can be more easily challenged by Tax Administrations. This is obviously a problem, since, in many circumstances, the only way to value an asset is based on future earnings and there is no way around uncertainty.

### Question 6

- Question 6.1.: The notion of “risk sharing” should indeed be very precisely defined in the new guidance. In the context of profit split, risk can be roughly defined as the variability of the profit generated by the collaborative action of two firms<sup>7</sup>. Two definitions of “risk sharing” can therefore be proposed:

<sup>7</sup> A project that yields a cash flow of 100\$ with certainty is not risky, whereas a project that will produce a cash flow between -100 and +200 with a uniform distribution (the project can yield a cash flow of any value between -100 and 200 with equal probability) would be considered risky, and a project producing a cash flow between -200 and +200 would be considered even riskier.



- > Definition 1: risk sharing may simply mean that both firms' profit will be at risk. For instance if each firm obtain 50% of the risky consolidated profit stream generated by their activity (as opposed to giving a fixed return to one party and therefore concentrating all the risk on the other party).
- > Definition 2: from a BEPS perspective, risk sharing might also mean that both parties can make certain key decisions that will have an impact on the profit. For instance if the commercial success of a widget depends upon its shape and colour, and if two subsidiaries of a MNE jointly produce that widget, one party choosing the colour and the other the shape, we could conclude that both parties are risk sharing in the BEPS sense.

Third parties have different risk aversion, meaning that they value differently the uncertainty of the profit they will get. For instance a very large firm might be willing to pursue a venture with a very high expected profit and a high risk, because it can afford to lose money, whereas a smaller firm, close to financial distress, might not be able to afford the loss and would rather choose a project with a lower expected payoff but a reduced risk. In the real world where insurance and financial markets are not perfect, differences in risk aversion sometimes explain the choice of the pricing arrangement between third parties – for instance a small biotech firm with financing issues might want to sell an IP for a certain lump sum rather than setting up a profit split with the pharma company. However, when it comes to transfer pricing, it can be generally assumed that all subsidiaries of a MNE have the same risk aversion<sup>8</sup>, so a difference of risk aversion should not be able to explain the choice between a TNMM and a profit split as a TP method. Therefore definition 1 of “risk sharing” would generally not be relevant for the choice of a TP methodology. As a matter of facts, within a MNE, it is rather the TP policy that determines the risk profile (under definition 1) of a subsidiary rather than the other way around.

Definition 2 on the other hand might be useful to select the most appropriate TP methodology. However a more precise definition of what it means to “control” risk would be very useful in this regard, particularly by describing how it is different from “making a unique and valuable contribution”. Using again the example of a MNE composed of two subsidiaries that produce a widget, suppose that one has an expertise in colour, and therefore chooses the colour, and the other has an expertise in shape and therefore chooses the shape. Here, the difference between “making unique contribution” and “controlling risk” is not totally clear, as it is the party with the knowledge and the skill to make a valuable contribution that will make the decision and control the risk.

- Question 6.2. Again, if we use the behaviour of independent firms as a benchmark, it does not immediately appear that independent firms that share a risk (under definition 2) would necessarily choose a profit split scheme. In many circumstances they would instead resort to a spot market transaction with a fixed market price. The example described in question 10 will be helpful to understand that point.

## Question 8 and 9

Again, to answer these questions following the arm's length principle, we would have to assess whether firms in a sequential setting (operating on contiguous steps of a value chain) would be less likely to depart from spot market transaction and enter into a profit split agreement than independent firms in a parallel setting (operating on the same steps of a value chain).

<sup>8</sup> This is also true for specific risks, it could be argued that all subsidiaries have the same level of risk aversion of foreign exchange risk, bad debt risk, etc.

Even though it is difficult to make a quantitative assessment, numerous studies<sup>9</sup> show that independent firms in a vertical setting can depart from spot market transactions to long term contracts or vertical integration. As a matter of facts, modern MNEs are more likely “vertical” (i.e. grouping subsidiaries in a sequential order), whereas the original MNEs from the 1920s were more likely “horizontal” (grouping subsidiaries in a parallel setting), which shows that in today's global economy, firms in a sequential setting are more likely to depart from market transaction than firms in an horizontal setting. For this reason, we do not believe that the sequential / parallel distinction is helpful for the profit split question.

### Question 10 and 11

We believe that between third parties, there does not seem to be a systematic relationship between making a valuable and unique contribution and sharing the risks (using definition 1 from question 6). Neither does it exist a systematic relationship between making a unique and valuable contribution and entering into a profit split agreement.

An example for that is given by the relationship between a supplier of handset and a telecom operator to sell subscriptions based on mobile internet. For a long time, handset design was key to develop mobile internet consumption, and this was a differentiating factors for the offer along with the quality of network and the quality of the retail network. In this example, each party (the handset company and the telecom operator) was making a unique and valuable contribution to the success of the new products sold by the telecom company (mobile subscriptions with a lot of data), because both the handset and the network were strong differentiation factors. In spite of this circumstances, it was very customary for both parties to enter into a normal supply contract where handset were sold at a market price (possibly with a volume discount) instead of a profit split (which would be very difficult to measure anyway, since the “profit” generated by a marginal user in a high fixed cost industry such as telecom is very hard to calculate unambiguously)..

In this case, an innovative handset producer would undoubtedly be making a unique (in the sense that none of its competitors had a comparable product) and valuable (since the handset was a key element of the offer) contribution. However, this contribution could be easily and very profitably sold over a market, so there was no need to enter into a profit sharing agreement.

Unlike this case, certain unique and valuable contributions could not easily be sold over a spot market and require a different type of contracting, notably when specific investments are made. If the telecom operator had asked the handset company to produce over a period of time a mobile phone that would only work on its network and which had very specific characteristics, it is very likely that both parties would have agreed on a different type of agreement. Therefore, to determine if a profit split is appropriate, rather than looking at the existence of a valuable contribution, it might be worth analyzing whether that valuable contribution could be sold over a market.

### Question 12

The idea of calculating group synergies on a marginal basis and splitting them between parties using an *ad hoc* allocation key is very interesting. Several comments can however be made:

<sup>9</sup> See Barba Navaretti G. and Venables A., 2004. *Multinational Firms in the World Economy*. Princeton University Press



- This seems easily applicable when group synergies only bring a marginal benefit (e.g. economies of scale in the production of management services that result in lower cost) because it is then easy to separate “core business” profit and “group synergies benefit”. On the contrary, when the group synergies are strongly connected with the core business, things might become more complicated. For instance, luxury goods producers are usually vertically integrated in the distribution. Their goods are only sold in outlets that are owned by the company and not through third party dealers. The difference between the two distribution models lies in the protection of the brand value. If a luxury handbag is sold to a third party distributor, this distributor could very well display the handbag next to a much cheaper brand, or make very high discounts, which would reduce the value of the brands in the eyes of potential buyers. To avoid this, luxury producers generally own the distribution outlets to make sure that no such thing would happen<sup>10</sup>. In that example, integrating production and distribution in the same MNE creates some kind of group synergy since it allows to maintain the value of the brand. However, the calculation of the value of this specific group synergy on a marginal basis, independently from the core business of the luxury group would be very difficult.
- In order to calculate the value of group synergies to be split between parties, it is necessary to establish a counterfactual scenario without the group synergies. For instance, to assess the value of the economies of scale in the production of management services, it would be necessary to determine how much the production of the same services would cost if all subsidiaries of the group were independent. This is not necessarily easy and might require some guidance.
- The splitting methodology itself can become tricky if many subsidiaries are involved. For instance suppose that three subsidiaries want to create a common IT infrastructure to handle payments. Subsidiary A can build a system for a price of 10, Subsidiary B, which is bigger, would have to pay 20 and subsidiary C also 20. Altogether, A, B and C can build a system that would serve their consolidated needs for 40. The group synergy here is 10 (20+20+10-40). The question of how these 10 should be equitably split between the three parties is more complicated than it seems and many methodologies have been devised for that purpose, that could be fruitfully used in that context<sup>11</sup>.

### Question 13 and 14

We believe that the original value chain framework described in Michael Porter's work<sup>12</sup> can very well be used for transfer pricing purposes. Indeed, a value chain analysis is a very useful tool to describe the strategy of the firm (how it can consistently price its output higher than production cost in spite of the competitive pressure) and relate it to the key capabilities of the firm.

Porter first identifies a set of generic strategies that can be followed by a firm (cost leadership, differentiation, focus). In a second step, the value chain is used to depict what are the key capabilities that allow the company to pursue and maintain this strategy in spite of competing firms trying to replicate the same offer at a slightly lower price.

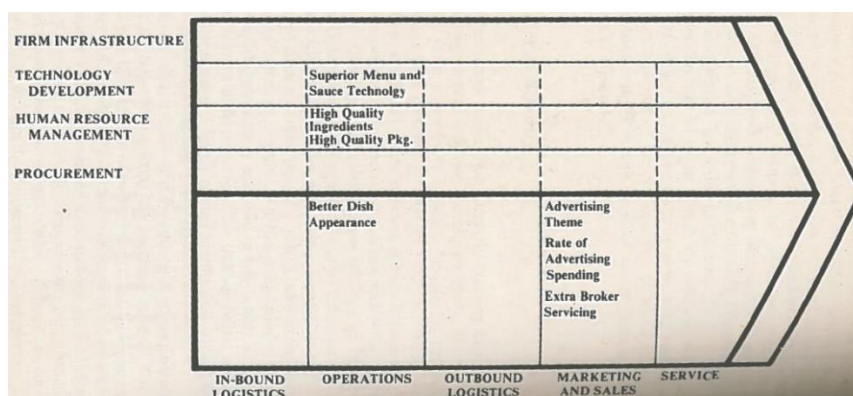
An example of this approach is given by Porter himself illustrating the case of a frozen food producer. The analysis shows that this company follows a differentiation strategy, according to which it can price its product higher than the competitors (and higher than its own production costs) because its products have a higher value for the customers. The value chain is then used as a systematic tool to identify and picture the key capabilities that the firm uses to follow that strategy. The diagram below<sup>13</sup> show how that analysis is performed, and underlines the key elements of the company's strategy (a capacity to prepare meals with better appearance, superior ingredients sourcing capabilities, strong advertising skills, etc.)

<sup>10</sup> An alternative solution would be to use selective distribution contracts, which impose certain rules to the distributors. However they can be very costly to enforce, as it requires to monitoring the behavior of a lot of different distributors on a regular basis. In that case, vertical integration is generally preferred.

<sup>11</sup> See for instance Moulin H., 2004. *Fair Division and Collective Welfare*. The MIT Press

<sup>12</sup> Porter M., 1985. *Competitive Advantage*. Free Press

<sup>13</sup> Porter, Ibid, p.152



This kind of strategy analysis could be very useful in a transfer pricing context. Indeed it gives a common ground to present a firm's strategy and its key enablers, and discuss these elements with Tax Administrations, which is very useful. In a further step, it should be possible to see in which subsidiaries the key capabilities are located and whether these capabilities could be sold over a market or if it requires a different institutional setting. All these elements should prove very useful to determining whether a profit split is the most appropriate method.

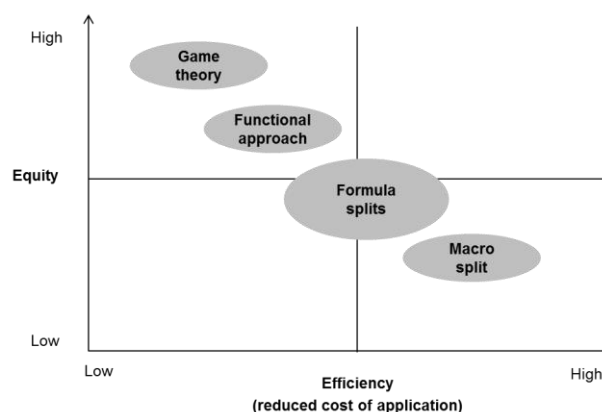
## Question 16

We can first underline that the splitting methods that are described in the guidance (cost based or asset based) would not be used by independent third parties trying to negotiate a profit split agreement (cost based methods would for instance give an incentive for each party to increase its cost base to obtain more profit, which is inefficient). Thus, the splitting methodologies already in use and those which are described in the guidance already depart from the pure application of the arm's length principle, which is normal considering the complexity (most often impossibility) of identifying relevant comparable agreements between third parties. It might be useful to acknowledge this and to propose a new clear standard that would be applicable to the definition of an appropriate profit splitting mechanism (which could for instance be "the split should yield a result where the share of each party is proportional to its contribution to the consolidated profit of the group")

If we extend our search of profit splitting mechanism outside of what independent parties would do, a literature review allows to identify a rather large number of methods that can be sorted across two axis: (i) an "equity" axis, such that the more equitable method ties perfectly the share of profit of a subsidiary with the value of its contribution to the group and (ii) an efficiency axis that represents the complexity and cost of implementation of the method, simpler methods being more efficient.

The table below shows 4 groups of methods that are based on different equity/efficiency trade-offs:

Matrix of potential splitting methodologies



- Macro splits are profit split formulas based on macroeconomic indicators (e.g. the GDP of the country where the subsidiary is located). They are very easy to implement but very inequitable since it is unlikely that the performance of a subsidiary should be correlated to any macro variable of the country where it is located.
- Formula splits are splitting the cost pool using an allocation key based on quantitative accounting information. Costs or assets method would fit within that category.
- “Functional” approaches are using allocation based on a “qualitative” assessment of the contribution of various subsidiaries. This kind of methods usually rely on some kind of expert assessment, where, for instance a weight is attributed to certain activities, proportionally to their importance in the value creation process (e.g. marketing accounts for 50% of the success, manufacturing 30% and project management 20%), then the responsibility of each subsidiary for the performance of these key functions is also assessed (e.g. subsidiary A is responsible for 50% of manufacturing, and subsidiary B is responsible for all the rest). Then, the importance of a subsidiary in the value creation process (and hence the allocation key) is calculated by multiplying its share of responsibility in the various functions by the relative importance of these functions (e.g. Subsidiary A makes 50% of manufacturing that is worth 50% of the total value, so 25% of the profit should be allowed to A and 75% to B).
- Game theoretical methods are based on a branch of economics that studies how economic agents can interact. More specifically, there exists a class of games, called fair division games, where the problem consists of dividing a set of goods between several people, such that each person receives his/her due share. This problem arises in various real-world settings like auctions, electronic spectrum and frequency allocation, etc. Several quantitative methods have been designed to solve this kind of problems<sup>14</sup>, they would be very adapted to the profit split problem but their main drawback is that they are generally rather complicated and difficult to implement.

Unfortunately, there do not seem to exist a perfect splitting mechanism that would be both easy to implement and that would split the profit proportionally to the real value of the contribution of each party to the split. In our opinion, macro splits should not be considered for TP purposes and formula splits (which we see more and more in TP documentations prepared by taxpayers) are also risky as they are based on qualitative and therefore debatable grounds. Formula splits and game theoretical methods seem to be the best possible solutions, but they might not be usable in the same sets of circumstances: formula splits do not necessarily measure accurately the contribution of each party but they are rather easy to implement and would be the best possible methods for smaller sized cases. On the other hand, the recourse to game theoretic solutions would only be a reasonable way for very large cases where accuracy of split is critical and a significant investment can be made.

We believe that the question of the “best” splitting methodology is still rather open and that more work devoted to it (possibly in an academic context) could help bring new and valuable ideas.

### Question 17

A few comments can be made on the costs and asset based methodologies:

- Costs based PS are easy to perform but their main drawback is that they do not necessarily give a good proxy of each party's contribution to the overall profit. An example would be the case of a profit split between a manufacturer and a R&D entity. The lower the cost base of the manufacturer, the more competitive and profitable the whole firm will be. Hence, reducing the manufacturer's cost base will increase the value of its contribution to the group, however with a cost based PS, reducing the cost base of the manufacturer will reduce its profit share, which is hard to defend. Additionally, in an international setting, the question of the difference in standards of living in different countries can raise some issues. If two R&D entities, one in Europe and one in India, are party to a cost based PS, differences in average wages will push a lot of profit in Europe, which might not be considered acceptable by the Indian Tax Authority on the basis that cost is not necessarily a good proxy for value.

<sup>14</sup> Driessen, T., 1988. *Cooperative Games, Solutions and Applications*. Kluwer Academic Publishers

- Asset based methods raise the problem of intangible asset valuation. If we take the example of two subsidiaries A and B using an asset based PS, the profit allocable to A will be related to the value of the intangible assets it owns. However, the value of an intangible asset is generally calculated based on the stream of future profit it can generate, and the stream of future profit that will be generated by A are determined by the TP policy. There is a circular reference that is likely to create a problem. Alternatively, intangible asset value can be calculated based on the cost of creating these assets, but we would then come back to the previous remarks regarding potential discrepancies between cost and value.



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4 September 2016

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## RE: Revised Guidance on Profit Splits

To Whom It May Concern:

The Organisation for Economic Co-Operation and Development (OECD) published final reports pursuant to its base erosion and profit shifting (BEPS) project on 5 October 2015. The reports were the culmination of the OECD's *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Plan) published in 2013. The Plan set forth 15 actions the OECD would undertake to address a series of issues that contribute to the perception of tax bases being eroded or profits shifted improperly. Included in the October 2015 final reports was a report under Actions 8-10 of the Plan, *Aligning Transfer Pricing Outcomes with Value Creation*. Subsequently, the OECD issued a public discussion draft under those actions on 4 July 2016 (the Discussion Draft), requesting comments regarding revised guidance in Chapter II of the OECD Transfer Pricing Guidelines (the Guidelines).

I am pleased to respond to the OECD's request for comments on behalf of Tax Executives Institute, Inc. (TEI). TEI also requests the opportunity to speak in support of these comments at the public consultation to be held on 11-12 October 2016 in Paris.

### TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organization has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all



levels of government. Our nearly 7,000 individual members represent over 2,800 of the leading companies in the world.<sup>1</sup>

### **General Comments**

TEI commends the OECD for its continued work on issues regarding base erosion and profit shifting, even as the “final” reports under the Plan were issued more than ten months ago. Issues and controversy surrounding transfer pricing, including the use of the transactional profit split method, continue to be of significant concern to multinational enterprises (MNEs) as well as tax authorities around the world. TEI particularly appreciates the confirmation in the Discussion Draft that not only should profits be shared among associated enterprises under the transactional profit split method, but that losses among associated enterprises must be shared as well.

Overall, the Discussion Draft depicts two approaches to splitting profits. The first approach splits anticipated profits from a transaction and the second splits actual profits. The content of the Draft focuses in great measure on splitting actual profits based upon a very detailed economic analysis and transaction monitoring. This is a difficult approach to administer. In light of this difficulty, in TEI’s view, more guidance is needed on how to properly perform a profit split analysis. In general, one-sided methods are easier to apply in practice and are less subjective. On the other hand, the profit split method has historically not been used as frequently because of its subjective element, although it does provide for greater flexibility in application. Moreover, developed markets tend to prefer one-sided methods while developing countries – which tend to have no or significantly fewer comparables – view profit splits as an attractive option. To avoid this natural bias, additional guidance would be helpful to assist tax administrators in applying the profit split method properly. In that regard, TEI recommends that splits of actual profits, as opposed to anticipated profits and excluding those contractually provided for between the parties, be limited to cases of abuse.

Finally, TEI is concerned that in the current economic environment there is a substantial risk that the first jurisdiction to audit a taxpayer will use the profit split method, or even formulary apportionment, to propose significant adjustments in an attempt to obtain the largest share of an MNE’s profits as possible. This would lead to increased controversy and litigation as other countries propose their own adjustments. Such an aggressive approach, if especially punitive and non-economic, will eventually cause MNEs to outsource their local operations, which likely would lead to a lower net profit in the outsourced jurisdiction. Thus, the final

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<sup>1</sup> TEI is a corporation organized in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).



guidance should continue the strong emphasis on the limited circumstances in which the transaction profit split method is the most appropriate method for setting transfer prices.

### **Responses to Specific Questions in the Discussion Draft**

This section sets forth TEI's responses to the specific questions posed by the OECD in the Discussion Draft. The lack of a response to a question should not be taken as agreement with the analysis in the Discussion Draft.

*Q1. 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?*

TEI agrees that the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits is clear. In TEI's view, however, concrete numerical examples are needed to differentiate between transactional anticipated profits and transactional actual profits. For example, it is not clear under what circumstances a purchase price adjustment is needed if anticipated profits are used.

Moreover, while it is useful to acknowledge the distinction between anticipated and actual profits, the Discussion Draft is unclear on the preferred approach. For example, in certain cases the Draft makes comments in the context of actual profits that could also be applicable to anticipated profits. More broadly, and other things being equal, parties might prefer to split actual profits because it better fits the general approach of the parties to share in the risks and outcomes of a transaction. Nevertheless, in practice other things are rarely equal, and, in particular, the subsequent determination of prices in the case of a split of actual profits faces significant administrative obstacles. These include the need to adjust retroactively the price of units already sold, as well as changes in VAT returns and customs clearance documents. Overcoming these obstacles requires additional costs, which do not add value to the business. In such a case, splitting actual profits would only be prudent if the achieved precision of the transfer pricing determination is worth additional administrative efforts. This is a rather simple and practical test which would benefit the guidelines if included.

Finally, paragraph 20 notes "However, 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."<sup>2</sup> The Discussion Draft does not provide any support for this statement in paragraph 20 (nor does paragraph 6) and thus it is not clear why split of anticipated profits requires less integration than splits of actual profits. TEI recommends that the OECD substantiate this assertion or remove it.

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<sup>2</sup> *Id.* at 9.



*Q2. 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 unclear why the comments on integration of business activities were made solely in the context of profit split of actual profits. These comments would also be valid for splits of anticipated profits.

*Q3. 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.*

Splitting actual profits may be more appropriate where there is a high degree of uncertainty involved (e.g., research and development of a product is not complete or a market has not yet developed). In contrast, splitting anticipated profits may be more appropriate where research development is complete or in a developed market. In any event, TEI recommends the OECD acknowledge that both approaches have merit, especially where MNEs apply one of the methods consistently from year to year.

An example of the appropriate use of anticipated profits is when an MNE determines its transfer pricing during the budgeting process for recurring transactions, and the use of anticipated profits is applied consistently from year to year. Profit splits using anticipated profits is also appropriate in the context of a complex supply chain, where there are several different legal entities to the profit split, and the financial information to apply an actual profit split is not readily available. In these situations, there are practical obstacles when attempting to perform complex “true-up” calculations.

Another example when anticipated profits could be appropriate would be when a profit split is performed near year-end, using actual data for 10 or 11 months and forecasted “anticipated profits” for 1 or 2 months. In this case, any variation between anticipated profits and actuals may not be significant. Again, this assumes that the same methodology is applied from year-to-year to maintain consistency and to ensure the taxpayer is not “cherry-picking” favorable results.

Conversely, actual profits might be most appropriate in supply chains that have less complexity; for example, where there are few participants and reliable and readily available financial information is available to easily perform true-up calculations.

In addition, it should be kept in mind that the data on actually achieved profits is usually available after the end of the year in which the profit was earned. Thus, it may be that additional payments to reflect the profits earned in fiscal 2016 may appear in the books of one of the parties only in fiscal 2017. This is a typical situation for related and unrelated party transactions, and thus the tax administrators should not consider such situations as a breach of the arm’s length principle.





*Q4. Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarised?*

At a high-level, the main strengths and weaknesses of transactional profit splits are appropriately captured and summarized in the Discussion Draft. We note that the strength described in paragraph 13 of profit splits (it is “less likely that either party to the controlled transaction will be left with an extreme and improbable profit result”) would also apply to splits of anticipated profits (*i.e.*, this is a strength of profits splits in general).

In addition, paragraph 15 states that one of the disadvantages of the profit split method is that “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.” TEI agrees with this statement, which helpfully warns tax administrators that they will rarely, if ever, have enough data to perform a completely accurate profit split analysis. Thus, administrators should not propose a profit split as an alternative to the taxpayer’s method when the latter is properly applied under the Guidelines.

TEI also recommends, that the final guidance state that the transaction profit split method – as opposed to a residual profit split – does not necessarily require benchmarking studies. Such studies are expensive and complex to produce and thus, if required, are a significant compliance burden.

*Q5. Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses? If so, what are they?*

Transactional anticipated profit splits may require purchase price adjustments especially if the profit projection is materially different than actual profit. An additional weakness of profit split methods is that they often requires a degree of subjectivity and professional judgement. This results in an increased risk of controversy and compliance costs, for both taxpayers and tax administrators, even when there is full cooperation from taxpayer.

*Q6. 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.*

TEI recommends that the Discussion Draft make clear that for the profit split method to apply it is not necessary that the parties share or control approximately equal risks. One of the parties may control less risks than another party, but still control some of them and share profits or losses.

*Q7. 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.*

This question assumes that anticipated profits would be used when valuing intangibles, hence the reference to valuation techniques. However, the anticipated profits approach could also be valuable in pricing “day-to-day” transactions. For example, in practice, transfer prices are often determined during the budgeting process using anticipated profits consistently from year to year. For practical purposes, the compliance costs and complexity of performing true-up calculations may not be worth the effort if all parties end up with reasonable profit allocations given their relative functions, risks, and assets.

*Q8. 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 Discussion Draft can be read to imply, although it does not state explicitly, that in the case of parallel integration the OECD favors the profit split method, and in the case of sequential integration, the OECD favors one-sided methods. This is particularly helpful because the distinction between methods of integration can be used to determine when the profit split method is not the most appropriate method. Nevertheless, this is an oversimplified portrait of the operational environment faced by MNEs. Different functions are more and more often split into different legal entities and different locations. Workforce and hence significant people functions become more and more mobile and cross-functional project teams become more and more common. Such a distinction between parallel and sequential integration may have been a useful tool a few decades ago but it does not fit well with the current business environment and the prevailing business organization trends show further blurring of such a distinction for the foreseeable future.

*Q9. If so, how should the concept of parallel integration be further defined?*

No response.

*Q10. 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 important not to confuse making unique and valuable contributions by both parties at different stages of the value chain with making unique and valuable contributions to the overall transaction. For example, one party may make unique and valuable contributions to the marketing stage and another at the manufacturing stage. The distinction between the two situations should be noted in the final guidance as it would impact the analysis.

*Q11. 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?*

Parties may make unique and valuable contributions but they may not share economically significant risks. For example, manufacturing, marketing, or research and development contributions may all be unique and valuable but the level of risks may be quite different.

*Q12. 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.*

TEI agrees that the use of the profit split method is not appropriate based on the presence of group synergies alone.

*Q13. 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?*

In certain ways the “value chain analysis,” described in paragraphs 24 to 27, is similar to the functional analysis that taxpayers and tax administrations currently prepare and apply. The additional guidance on the use of a value chain analysis is helpful to explain the concept, since it coincides with the analysis taxpayers currently prepare. TEI recommends that the OECD make clear it is not creating a new documentation requirement in addition to the existing one.

TEI agrees with the Discussion Draft in paragraphs 25 and 26, which notes that the existence of a supply chain is not conclusive proof that the profit split method is the most appropriate method.

*Q14. 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 response.

*Q15. What further guidance or clarification of existing guidance would be helpful in these sections? Please provide practical examples in support of the response.*

No response.

*Q16. 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.*

When unrelated parties create a partnership or joint venture, they take into account a wide range of factors when determining how to split future profits. As described in section C.4.5.1. of the Discussion Draft, the asset based factors and cost-based factors are useful examples, but attention should also be paid to future contributions of the parties. In unrelated party negotiations, difficult-to-value contributions often play important roles, and such contributions are based upon, and documented using, expert estimations. Such contributions are not always carefully reflected by asset-based or cost-based factors. For example, a contribution of a highly qualified scientist may be much more valuable than reflected by the underlying cost factor (e.g., his/her salary). Such estimates are usually documented in advance by the parties and it would also be reasonable if the related parties used this method of determining the profit splitting factors. The Discussion Draft would be improved by including considerations on determining the profits splitting factors by expert estimates.

*Q17. What further guidance would be useful in this section relating to identifying and measuring profit splitting factors? Please illustrate your response with examples.*

No response.

*Q18. 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.*

In practice, the application of a profit split works well in a collaborative environment between tax authorities and taxpayers, such as an advanced pricing agreement situation, regardless of whether the actual profits or anticipated profits method is used.

### **Conclusion**

TEI appreciates the opportunity to comment on the Discussion Draft regarding the revised guidance on profit splits. As noted above, TEI requests the opportunity to speak in support of these comments at the Public Consultation on the Discussion Draft scheduled for 11-12 October 2016 in Paris.

These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission,

please contact Mr. Hasenoehrl at +41 786 88 3772, [nickhasen@sbcglobal.net](mailto:nickhasen@sbcglobal.net), or Benjamin R. Shreck of the Institute's legal staff, at +1 202 464 8353, [bshreck@tei.org](mailto:bshreck@tei.org).

Sincerely yours,  
TAX EXECUTIVES INSTITUTE, INC.



Janice L. Lucchesi  
*International President*

Brussels, 5 September 2016

**Subject: Public review comments on OECD Public Discussion Draft “Revised Guidance on Profit Splits” (BEPS Actions 8-10), dated 4 July 2016**

Sent by e-mail to [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

Dear Sirs,

We are pleased to have been invited to review the document “Revised Guidance on Profit Splits”, published by the OECD on 4 July 2016 (hereafter, “the Document”), and provide you with our comments. We first start with an upfront note, followed by a more detailed discussion on some selected themes, grouped in aspects in relation to new guidance and aspects that were deleted from existing guidance. In appendix we will address the specific questions raised in the Document.

## **1. Upfront note**

We do appreciate that the OECD has made the efforts to make reference in brackets where the guidance constitutes “new guidance”, and where it involves a derivation of the 2010 Guidelines. Nevertheless, unfortunately, after having reviewed the document we noticed that the paragraphs that were derived from the 2010 Guidelines also contained a considerable amount of new, additional guidance, or at least contained significant rewording. Also, we noticed that certain guidance of the 2010 Guidelines has been deleted from the Document. We would like to suggest that discussion drafts that aim to replace complete section of existing guidelines would be published in track changes, for the benefit of all users of such documents.

## 2. Comments in respect of new guidance: Critical conceptual concerns

We have selected to comment on the following three points, that in our view are critical to a good understanding of the new guidance and that have raised concerns with us in view of conceptual appropriateness in view of the arm's length principle and its application.

### A. The new guidance contains the explicit reference of the splitting of actual profits as the most appropriate method (new paragraph 2)

The 2010 Guidelines deal with the use of actual vs projected profits in section C.3.3.1 (paragraphs 2.127 through 2.130). In contrast to the new guidance in the Document, the 2010 Guidelines do not contain an explicit preference, but rather refer to the choice of using either to be dependent on the facts and circumstances of the case. Furthermore, it has been acknowledged that both profit splits on the basis of actual profits and projected profits are observed in practice.

We are of the view, that the decisive factor indeed should be retained to be found in the facts and circumstances for the case at hand. An explicit preference for the use of actual profits in our view is unnecessary, and may lead taxpayers to make a choice for a profit split method that risks not to be consistent with the arm's length principle, solely on the basis of this expressed preference. Notwithstanding the Document in our understanding leaves the option still open to base the profit split on projected figures (however, it is further made de facto unavailable through several examples, most notably in respect of the transfer of intangibles, as we will discuss further below), in our experience it may be reasonably expected that deviating from this preference results into significant disputes, whereas the critical governing principle remains the arm's length principle, which potentially – depending on the facts and circumstances – is best attained through the use of projected figures.

If the OECD decides to pursue with retaining the expression as if for any case there would be one most appropriate method, we find it necessary that the OECD explicitly refers to the “new guidance” being effectively “new”, and that therefore this preference cannot be invoked on taxpayers that have been applying the profit split on the basis of projected figures. Post-BEPS transfer pricing guidelines in a broader perspective, in many important cases, go beyond the arm's length principle as can reasonably understood under the 2010 Guidelines. This is a real life issue since we are experiencing transfer pricing audits using post-BEPS principles on pre-BEPS controlled transactions. In our view, not every post-BEPS guidance is a mere clarification. Aforementioned choice to include a “most appropriate profit split” method is an example that could lead to significant disputes (and undesired results).

**B. The new guidance contains the explicit reference that the basis of the profit split, including the splitting factors “must” be determined ex ante (derived paragraph 3, yet containing substantial new guidance)**

First of all, we do note that we consider the first 3 chapters of the Guidelines as the key guidance of the application of the arm’s length principle in general terms. We do understand that aforementioned requirement is in line with the logic of the earlier BEPS publications whereas there are 9 explicit references to “ex ante” in those post-BEPS chapters. We do note, however, that the 2010 Guidelines only refer to the notion of “ex ante” only five times, and sometimes in a manner that is equivalent to an ex-post application (most notably in paragraph 2.116 of the 2010 Guidelines on profit splits, which has been retained in the Document (paragraph 29), but without reference to the use of “ex post” approaches).

Whereas the use of “ex ante” approaches could indeed be more consistent with current views on how transfer pricing policies are to be determined, we strongly suggest to rephrase the new guidance to not make this an absolute requirement, but rather that of a general preference (yet to be assessed in view of the facts and circumstances for the case at hand). We do find an absolute “ex ante” requirement, for the obvious reason that the arm’s length principle is formulated in the past tense (“... *have not so accrued...*”). The arm’s length principle therefore essentially in our view is the standard to test whether profits have accrued in an appropriate manner, potentially – albeit probably not showcasing best practice – on a policy basis that does not directly translates into one of the five OECD transfer pricing “testing” methods (cf. paragraph 1 of chapter 2: “... *used to establish whether the conditions imposed in the commercial or financial relations between associated enterprises are consistent with the arm’s length principle*”; and cf. paragraph 15 of the 2010 Guidelines: “... *methods for evaluating...*”).

In that same respect we cannot agree with the definition provided in new paragraph 4 of the Document, which states that a transaction profit split would be “a type of pricing arrangement”. We are of the view that a pricing arrangement has the potential to not coincide necessarily with a transfer pricing method (for evaluation). Indeed, post-BEPS guidance states (paragraph 81 of chapter I) that “*it should not be concluded that the pricing arrangements adopted in the contractual arrangements alone determine which party assumes risk*”. By introducing an absolute “ex ante” requirement in view of profit splits, the new guidance effectively does so, and in our view is also contradictory to the fact that a transfer pricing method cannot be the source of conclusion what risk environment the affected entities are navigating (cf. 2010 Guidelines, Chapter IX, paragraphs 44 onwards). For example, new paragraph 6 of the



Document seems to suggest that the choice for actual or projected figures to split would result in a different appreciation of how risks are effectively shared. Hence, as such, methodological choices would in accordance with this guidance lead to a certain risk assessment. We do not feel that this is neither in line with the earlier BEPS deliverables, nor with real life where independent parties actively make a business decision to assume a certain level of risk themselves (dealing with a certain degree of uncertainty, in line with one's ability to control the risk and with one's financial capacity), or to seek sharing risks (and potential upside) with others.

In conclusion, we can agree that it is more likely than not that, with reference to the behavior of independent parties, pricing arrangements at arm's length would consider an appropriate profit split mechanism on an ex ante basis. However, we do find to make this an absolute requirement ("must") to be (potentially) deviating from the arm's length principle itself, and moreover could be viewed as contradictory with other guidance. Rather, we would suggest formulating a preference, but dependent on facts and circumstances.

**C. The new guidance seems to suggest that a final valuation in case of transfer of intangibles is not in line with the "most appropriate method" (we refer a.o. to the example in new paragraph 4 of the Document)**

As mentioned earlier (section A), the new guidance includes an explicit choice for applying the profit split on an actual profit basis. The example in new paragraph 4 of the Document, however, includes an example of a profit split applying a projected profit basis. When the new guidance refers to the use of the "less than most appropriate method", consistently the transfer of intangibles are used a case study (also in paragraph 20 for instance).

In our reading, therefore, the editorial choice of this example is to say at least unfortunate, as we feel that the topic of "hard-to-value (not-impossible-to-value)" intangibles should not be the subject of the guidance in view of the application of the profit split method.

We suggest finding other examples that do not carry an additional – and in our view separate – connotation, or in this case a different point of important debate.

### 3. Comments in respect of deleted 2010 Guidelines

Based on our review of the Document and the 2010 Guidelines, we noted certain paragraphs have been deleted. Here below we provide an overview of selected items for which we express a concern.

**A. The deletion that the criteria for the choice of the profit split method as most appropriate transfer pricing method includes the availability of comparable data**

Amongst others, paragraph 2.109 of the 2010 Guidelines, refers to the fact that the *“reliable comparables information might be insufficient to apply another method”*. Notwithstanding paragraph 2 of post-BEPS chapter II mentions the availability of reliable information as one of the criteria for selecting an appropriate transfer pricing method, the Document seems to deliberately omit (derived paragraphs on the subject have been altered) such criteria to assess whether the profit split method is the most appropriate for the case at hand.

We suggest acknowledging that this is part of the selection procedure, reaffirming guidance of chapter II.

**B. The deletion of “ex post” as valid option**

We refer to our earlier comments above, but repeat it here (paragraph 2.116 2010 Guidelines).

**C. The deletion of alternative approaches to apply a residual profit split**

The Document does not make any reference anymore to two alternative approaches which in our view have the potential to satisfy the arm’s length principle in a more appropriate manner than either the contribution or residual analysis (depending on the facts and circumstances), as they explicitly refer to the concepts of “options realistically available”, respectively put “value creation” central to the discussion, namely the use of bargaining theory (paragraph 2.122 2010 Guidelines) and the use of discounted cash flows (paragraph 2.123 2010 Guidelines).

Notwithstanding these alternative approaches may represent more sophisticated methods that require expert usage, we are of the view that a tax payer should have the freedom to establish a transfer pricing policy and/or apply a transfer pricing evaluation method consistent with it accurately delineated controlled transaction, provided it is in accordance with the arm’s length principle.

As such, we suggest including these alternative approaches again in the new guidance, or at least make a statement that the contribution analysis and residual are not exhaustive approaches.

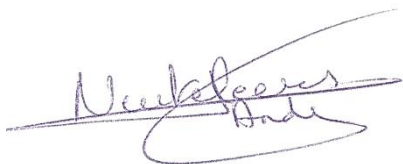
We refer to the appendix for our specific comments, to the questions raised in the document but would clearly like to ask you to focus your future work on dealing with aforementioned, broader concerns.

•

In case you would require further clarifications, please feel free to contact us. In the meantime, we sincerely wish to express our hope that the OECD will take into consideration the above comments, and those of business community in view of our joint effort to realize the BEPS objectives, yet with proportionate measures and the arm's length principle as prevailing standard for transfer pricing.

Best regards,

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## Appendix: Answers to questions raised in the Document

- Q.1:** 1. We find the distinction between the application of the profit split on an actual profit vs. anticipated profit basis overall clearly formulated. Nevertheless, we refer to our core letter for our conceptual concerns.
2. As can be derived from our referred to concerns, we do not find the new guidance to be very useful for the reasons mentioned. We do, however, feel that the guidance would benefit from keeping the distinction in, yet making the relative appreciation of both bases less restrictive, and more contingent on the facts and circumstances of the case at hand.
- Q.2:** No further specific comments at this stage as we find it more important with the broader conceptual concerns we raised.
- Q.3:** No further specific comments at this stage as we find it more important with the broader conceptual concerns we raised.
- Q.4:** In our view the strengths and weaknesses of the profit split method are not fully captured; As referred in our core letter, we suggest to (re-)introduce the availability of reliability as one of the assessment criteria to select a transfer pricing method in line with general guidance under chapter II – i.e. enabling the profit split method to be used as method of last resort, if needed.
- Q.5:** We do agree that profit splits applied on an actual or on an anticipated profit bases may have different strengths and weaknesses, although those would be linked to the specific case at hand, in our view, and not to be generalized.
- Q.6:** 1. The notion of risk sharing should not deviate from the general guidance on risk available in chapters I to III of the (post-BEPS) guidelines. Furthermore, it should be acknowledged – as referred to in our core letter – that the level of risk one party is willing to assume or to share follows from a business decision, and not from the use of one or another (profit split) method. Independent parties may agree to a certain profit split basis, but still have adjustment clauses available when one party's actual conduct would not be as intended, for instance, to name just one example for the fact that parties may deal with this in an alternative manner.
2. No further specific comments at this stage as we find it more important with the broader conceptual concerns we raised.

- Q.7:** As referred to in our core letter, we do have a concern that the new guidance may have a different, undesirable connotation in respect of the use of anticipated profits and valuation techniques (predominantly by referring to the profit split on an actual basis explicitly as “the most appropriate method”).
- Q.8:** No further specific comments at this stage as we find it more important with the broader conceptual concerns we raised.
- Q.9:** No further specific comments at this stage as we find it more important with the broader conceptual concerns we raised.
- Q.10:** No further specific comments at this stage as we find it more important with the broader conceptual concerns we raised.
- Q.11:** We tend to agree with the guidance provided in paragraph 23, but would suggest to elaborate further on this important topic.
- Q.13:** In our experience (and practice) a value chain analysis has the potential to be more informative than the features described in the new guidance. As such, we do not think that a proper value chain analysis is merely or simply a tool, but provides for the foundation of the accurately delineated controlled transaction as it provides for the appropriate context of the relevant comparability factors and other relevant features to identify the intragroup financial and commercial relations from which the controlled transactions are the result, irrespective of the choice of transfer pricing method. We suggest elaborating more on this topic in a broader context.
- Q.14:** As mentioned here directly above, we find a proper value chain analysis to serve an even wider purpose than merely within the framework of the profit split method. In relation to the profit split method, a value chain analysis would be a good starting point to identify the relevant process to perform a contribution analysis, when this would be deemed the most appropriate technique for the case at hand. We suggest to elaborate more on this aspect (from value chain to business processes) in the context of the new profit split guidance.
- Q.15:** No further specific comments at this stage as we find it more important with the broader conceptual concerns we raised.

- Q.16:** Please refer to our core letter, where we suggest to (re-)introduce the possibility of using bargaining theory and valuation techniques. Also, in certain cases, we do find (anticipated) return on capital employed could satisfy the arm's length principle in a more appropriate manner, and could be based on sound economic analyses (dealing with relative risk appreciation in greater detail).
- Q.17:** See answer here above
- Q.18:** No further specific comments at this stage as we find it more important with the broader conceptual concerns we raised.

• [end of document] •

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

Tremonti Romagnoli Piccardi e Associati appreciates the opportunity to submit these comments to the OECD on the Public Discussion Draft BEPS Action 8-10: Revised Guidance on Profit Splits, published on 4 July 2016.

We provide hereinafter our observations and comments in relation to the issues raised in the discussion draft. Our responses follow the numbering of the questions proposed to commentators as set out in the draft.

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**Executive Summary**

While we appreciate the effort made in the discussion draft to clarify the applicability of the transactional profit split method, identifying the two different approaches of anticipated profits and actual profits, we are concerned that the revised guidance leaves an excessively high level of uncertainty.

Indeed, the guidance does not seem to extensively describe in which circumstances (i.e., with respect to which level of business integration and risk sharing) it is advisable to apply the transactional profit splits of anticipated profits rather than of actual profits.

Furthermore, the guidance does not clearly indicate how to practically apply the transactional profit splits of anticipated profits (i.e., how to determine such profits, which/how accounting principles are to be applied, how to evaluate future risks and, consequently, future profits).

In light of the above, it would be our advice that some punctual guidance be provided to better specify the operative application of the transactional profit split method, especially of the profit split method of anticipated profits.

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?

The distinction between the transactional profit splits of anticipated profits and the transactional profit splits of actual profits described in the proposed revised guidance is clear in theory. Nevertheless, the guidance does not seem to clearly indicate in which circumstances or with respect to which business activities it is advisable to apply the transactional profit splits of anticipated profits or actual profits.

In addition to that, it has to be noted that the proposed revisions do not clarify how to apply the transactional profit splits of anticipated profits. It is clear that such a method takes into account the provisional profits of an enterprise; what is not clear is how to determine such profits, which/how accounting principles are to be applied, which level of certainty is to be considered as relevant in the identification of future risks and, consequently, of future profits.

This scenario will probably result in an excessively high level of uncertainty in the application of the transactional profit split methods, and therefore it could be a source of disputes between taxpayers and tax authorities.

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

The distinction between the two profit split approaches described is, again, in theory, useful to the enterprises in order to apply the most appropriate



transactional profit split method in each specific case.

Nevertheless, as described under comment 1.1., the distinction needs to be made clearer, especially with respect to the transactional profit splits of anticipated profits, for which it is necessary to better understand the application scenarios and the guidelines to be followed in order to correctly determine the anticipated profits.

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.

According to the proposed revised guidance, the transactional profit splits of actual profits - unlike the transactional profit splits of anticipated profits - requires a "*high level of integration of activities*" and a "*greater sharing of uncertain outcomes resulting from risks associated with transaction*".

Nevertheless, there is no specific indication in the text of what is meant by a highly integrated business or highly integrated organization.

It is therefore necessary to formulate restrictive/precise definitions - given the difficulty related to the creation of a peremptory list of requirements - of such concepts.

In the absence of specific clarification on the point - or references to other international sources - there is a risk that the choice between one approach or the other, could be arbitrary in practice. The resultant situation of uncertainty that could arise would increase the frequency of disputes between the tax authorities and taxpayers.

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 transactional profit splits of actual profits appears to be applicable in the telecommunications sector, in the digital sector and in internet based businesses given the presumed integration of the activities carried out. As a matter of fact, the business models that characterize these sectors are so complex that all companies involved in the particular business share all the risks with the result that it is not possible to identify who suffers or who controls the aforementioned risks.

With respect to different types of business activities, given the absence of clear guidelines or examples, it is difficult to choose which approach to apply, between a transactional profit split of anticipated profits or actual profits.

The transactional profit splits of anticipated profits seems to be applicable in relation to elementary and repetitive business (e.g., in the food or in the simple consumer goods sectors, in the utilities sector, etc.). In other words, it should be applicable where it is possible to foresee, with quite a high level of certainty, the future trend of risks and of profits or to isolate/identify the contribution made by each enterprise.

As stated above, a precise indication of the characteristics of businesses or a list of business activities with respect to which the transactional profit splits of anticipated profits is to be applied will give to practitioners, taxpayers and tax authorities a clear picture, thereby reducing the risk of disputes and increasing the correctness of the

determination of the transfer prices.

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

No, since the discussion draft is unable to provide a proper indication with respect to the strengths and weaknesses of the transactional profit split method and, moreover, it does not seem to have made significant strides compared to what is reported in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

In this regard, it should be noted that the discussion draft would seem to identify only a single strength (see paragraph 12.) and a single weakness (see paragraph 14.) with reference to the transactional profit split method. However in doing so it appears the focus is mainly kept on the transactional profit split of actual profits; given that no reference is made to the strengths and weaknesses of transactional profit split of anticipated profits.

Considering the above, it would probably be helpful that guidance be provided in order to address: (i) the strengths and weaknesses of the transactional profit split method in general (i.e., with regard to both the actual and the anticipated approaches); and (ii) the strengths and weaknesses which are peculiar to each of the two proposed approaches.

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?

Yes. Indeed, based on the aforementioned circumstances and on the conditions - as highlighted by Section C. of

the discussion draft - required for the proper implementation of the two different approaches, it should reasonably be expected that they have strengths and weaknesses that are not necessarily the same.

In more detail, one could note that the identification of different strengths and weaknesses in relation to the two transactional profit split approaches is closely linked to the proper delimitation of their respective scope of application.

In other words, the lack of examples which are suitable to define cases to which the transactional profit splits of anticipated profits should be applied, differently from those to which the transactional profit splits of actual profits should be applied, does not facilitate this kind of analysis.

6. The discussion draft introduces the sharing of economically significant risk 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?

Based on what has been reported in Section C.3 of the discussion draft, the notion of risk sharing seems directly linked to the existence of specific commercial relationships between the parties involved in the relevant transactions, which could be identified by means of a proper functional analysis.

It follows that, in order to clarify the notion of risk sharing and its measurement in the relevant transaction, it would seem essential to identify useful criteria at the outset in order to properly perform such an analysis.

In this regard, it could be helpful to put in place an

approach similar to the one utilized in Part II of the OECD 2010 Report on the Attribution of Profits to Permanent Establishments, where special considerations were made in relation to the functional analysis of a traditional banking business (through the punctual identification of the routine functions performed by banks and the risks assumed by them).

- 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.

Although the general application of the profit split method seems to be clear in theory, the fact that the draft introduces the two approaches (anticipated and actual) - according to the different level of the risk sharing (e.g., high or low degree of integration and unique and valuable contributions) - could generate some uncertainty.

In this regard, it would be helpful to provide detailed explanations in order to help operators to distinguish the different levels of risk sharing required for the (i) non-application of the transactional profit split method (i.e., no or "limited" risk sharing), (ii) application of the transactional profit splits of anticipated profits (i.e., "low-medium" risk sharing) and (iii) application of the transactional profit splits of actual profits (i.e., "high" risk sharing).

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.

Consider the hypothetical case of two different companies, A and B, both holders of an intangible asset, the value of which contributes to their

financial results as detailed in the example below.

	Company A	Company B
<b>Sales</b>	50	100
<b>Purchases</b>	(10)	(50)
<b>Manufacturing costs</b>	(15)	(20)
<b>Gross Profit</b>	25	30
<b>Operating expenses</b>	(10)	(10)
<b>Net Profit</b>	15	20

In this particular case, Company A transfers the semi-finished product to Company B, which in turn modifies the product prior to selling it to a third party. The net income of companies A and B is substantially influenced by the contribution made by the intangible assets.

The contribution made by intangible assets to companies A and B could be determined by calculating their value, applying the DCF method on the basis of anticipated financial values and expected risk components.

Therefore:

$$\text{Intangible asset value A} = \sum_{t=1...n} \frac{FCA_t}{(1+i)^t}$$

$$\text{Intangible asset value B} = \sum_{t=1...n} \frac{FCB_t}{(1+i)^t}$$

where:

FCA = cash flow related to the intangible

t = useful life of intangible

i = discount rate

The net profit relating to company A and B could be calculated in the following manner:

Net profit company A =

$$\text{Combined Net Profit} \times \frac{\text{Intangible asset value A}}{(\text{Intangible asset value A} + \text{Intangible asset value B})}$$

Net profit company B =

$$\text{Combined Net Profit} \times \frac{\text{Intangible asset value B}}{(\text{Intangible asset value A} + \text{Intangible asset value B})}$$

As in any valuation technique, the contribution of the intangibles to the combined net profit depends on three key variables: i) the financial projections, ii) the useful life of intangibles; iii) the discount rate. These variables should be determined according to the indications described in the section D.2.6.3 (p. 102, *Aligning Transfer Pricing Outcomes with Value Creation*, Action 8-10:2015 Final Reports).

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?

Relying on the content of paragraph 21., it can be argued that the transactional profit split of actual profits is the most appropriate approach in the case of highly integrated operations at the same level of the value chain.

It should be explained which is the most appropriate method to apply in the case of sequential integration. Transactional profit splits of anticipated profits or actual profits? Are there other alternative applicable methods?

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

In order to further define the concept of parallel integration it will be necessary to provide

- (i) some examples in different economic industries in order to clarify the concept of highly integrated operations at the same level of the value chain;
- (ii) an explanation as to whether this concept is applicable to the digital economy (*Addressing the Tax Challenges of the Digital Economy*, Action 1 - 2015 Final Report).

**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 sharing of the same risk dramatically strengthens (in theory) the need to have recourse to the transactional profit split method, considering that a one-sided method would not be in the condition to evaluate the impact of that same risk on one party (i.e. the non-tested party). However, taxpayers or tax authorities should not automatically consider the transactional profit split method the most suitable method if the comparability analysis shows that there are adequate tools to autonomously measure the individual contributions of the parties.

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

In the aforementioned situations, guidance should be provided in order to primarily attribute relevance to the determination of the so-called "routine profit" (assuming that a residual profit split is selected).



The accurate quantification of such "routine profit" could indeed mitigate the final outcome of the overall method, specifically with reference to subsequent splitting of the residual profit/loss among the parties, which could otherwise lead to unexpected/unpredictable results.

12. The Final BEPS Report on Action 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 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.

In principle, the accurate identification/determination of the single synergy should prevail on cumulative/forfeit methodologies to ascertain their value.

However, in the absence of "ad hoc" guidance - even by means of examples - on how to treat the most recurrent group synergies, also measurements based on the apportionment of aggregate (residual) results should be considered legitimate, being stated that any selected criteria should rely on sound allocation keys.

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?

In order to achieve the goal outlined by this section it would be helpful to improve it by providing (i) some examples of value chains implemented by companies in various industrial sectors and (ii) some information in relation to the concept of "virtual" value chains, in order to determine whether it is also possible to apply the transactional profit method as the most appropriate method in such case.

- 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.

In some industrial sectors (e.g. the digital economy) or for some types of company (e.g. start-up company) the value chain analysis should be used with functional analysis to better understand the different kinds of risk related to the function considered. The value chain analysis allows for the identification of the industry's value drivers and critical success factors for the company: these elements help to identify and split the risks better than the functional analysis.

- 15.** 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 or clarification on this topic does not seem to be necessary.

- 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.

In order to reach the goal outlined under paragraph 42., it is key to have comparable uncontrolled data available. However, this is not often frequent. Therefore, such profit splitting factors need to be replaced by something that is unbiased.

Generally in selecting the relevant factor, reference is made to parameters linked to the accounting/financial data of the parties. However one should acknowledge that there are also some additional (i.e., non-accounting) factors which could reliably be utilized to execute the splitting and therefore measure the arm's length conditions. To this end, figures such as the number of branches/lines of business, clients, computers, kilometers of cables, etc., could represent a sound profit splitting factor. Although it is clear that specific guidance in selecting these non-accounting factors amongst the various business sectors should be provided in order to reduce discretionary approaches.

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

Given that it is obviously impossible to provide a peremptory list of profit splitting factors to be utilized in each single case, and for the purpose of limiting an arbitrary selection, the identification of some sort of "safe harbor" percentages could under certain conditions mitigate the difficulties of adopting a profit split when comparables are scarce/absent.

18. More generally, examples are requested of scenarios where a transactional profit split of actual profits or 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.

If we refer solely to the profit split of anticipated profits, it is clearly stated in the discussion draft that such a method is to be chosen in those circumstances when there is not a high level of integration of the activities performed by the related parties.

Assuming the above can be ascertained, scenarios in which a transactional profit split of anticipated profits is applicable are therefore those envisaging - as we stated in our reply to question No. 3 - elementary and repetitive businesses (e.g., in food or simple consumer goods sectors, in the utilities sectors, etc.). In other words the aforementioned method should be applicable where it is possible to foresee, with quite a high level of certainty, the future trend of risks and of profits or to isolate/identify the contribution made by each enterprise.

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If you have questions or you would like further clarification, regarding any of the points discussed above, please contact [milano@virtax.it](mailto:milano@virtax.it).

Respectfully submitted,

Yours sincerely,

Tremonti Romagnoli Piccardi e Associati



UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

September 2, 2016

**VIA EMAIL**

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**Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Actions 8-10 – Revised Guidance on Profits Splits (“discussion draft”)**

Dear Mr. VanderWolk,

USCIB<sup>1</sup> appreciates the opportunity to comment on the Revised Guidance on Profits Splits Discussion Draft (“discussion draft”). We understand the importance of having a meaningful two-sided method such as the transactional profit split method to support the other transactional methods listed in the OECD Guidelines. We understand, per page 1, that this is not a consensus view of the CFA and hope our comments and the public consultation in October will help the OECD achieve guidance supporting cross-border investment and minimize double taxation by providing a consistent and administrable set of rules on this important topic.

**Executive Summary**

We agree with the overall tone and content of the discussion draft. In particular, we agree with the discussion draft:

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<sup>1</sup> USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

- On the need for the transactional profit split method (“TPSM”) to be consistent with arm’s length principles and reflect the arrangements that unrelated parties would likely enter into under similar circumstances;
- That a key indicator of the appropriateness of a profit split of actual profits is that the parties continue to share in the outcomes and manage the business activities and risks associated with those subsequent outcomes (they act more like partners);
- That lack of comparables alone is insufficient to warrant the use of a transactional profit split under the arm’s length principle;
- That group synergies alone are insufficient to warrant the use of a transactional profit split under the arm’s length principle;
- That the transactional profit split method may be the most appropriate method if unique and valuable intangibles are contributed by both parties to the transaction(s) under consideration;
- That the most appropriate method criteria requires significant integration of functions and risks among related parties, in addition to the presence of unique and valuable intangibles, before the TPSM would be considered the most appropriate method;
- That profit splits are more common and appropriate in some industries than in others;
- That defining the level of profits (or losses) to be split is often a complex and difficult exercise;
- That profit split factors should be measurable, verifiable, and related to the profits that are to be split; that is, there must be a causal relationship between the measure of the contributions that give rise to the economically significant risks (the profit split factor) and the definition of the profits to be split which must be the return on these economically significant risks; and
- That a value chain analysis can be useful as a diagnostic tool to assess the relative contributions of both parties to a transaction and identify potential split factors, but should not be required to support taxpayers’ determination of the most appropriate method.

USCIB believes that in most cases a transactional profit split method will not be the most appropriate method and the introduction to this section of the Transfer Pricing Guidelines should recognize that. In addition, it would be useful to include additional statements concerning what the transactional profit split method is not. USCIB is concerned that some countries use profit splits that are not based on the principles articulated in the discussion draft and set forth above. That is, for example, some countries rely on profits splits when they find it difficult to find comparables even though the transactional profit split is not otherwise appropriate. In some of these countries the profit split method looks more like formulary apportionment, which has been repeatedly rejected by the countries participating in the BEPS project. Despite recognizing that a value chain analysis can be a useful tool, USCIB is also concerned that countries that support a formulary type profit split intend to use the value chain analysis to justify profit splitting factors that achieve global formulary apportionment, rather than a transactional profit split of profits. In a transactional profit split, profits outside of the transaction between the two parties to transaction are not relevant. Therefore, the

information provided by the value chain analysis might be more relevant to risk assessment than actual splitting of the profit from the transaction at issue and therefore discussion of value chain analysis would more properly be included in Chapter I.

It is therefore important for the OECD – perhaps by adding an introduction that could remain a permanent part of the Transfer Pricing Guidelines -- to state that the transactional profit split method is not formulary apportionment, is not intended to achieve results consistent with formulary methods, and should not be used for this purpose. An executive summary should also highlight the complexities of the TPSM, and the difficulties in obtaining appropriate financial reporting information and other relevant data, as discussed in detail in the body of the discussion draft. We believe these issues are the most important factors to consider in evaluating the TPSM and will generally result in a conclusion that the transactional profit split method is not the most appropriate method.

While we understand that the discussion draft is meant to provide general guidance rather than specific instruction on the selection and application of the transactional profit split method, we do think greater clarity is required on a number of topics listed below. Greater clarity will help reduce confusion on evaluation, selection and application of the transactional profit split method by both taxpayers and tax authorities.

## Comments

### Section C.1 – In general

USCIB requests greater clarity on the differences between a split of anticipated profits and a split of actual profits. In particular, we are unclear if there are significant differences in risk profile or selection of method between anticipatory and actual. With respect to risk, we agree with paragraph 10 that “It would be contrary to the guidance of Section D of Chapter 1 to apply a transactional profit split of actual profits where the functional analysis demonstrates that one party does not exercise any degree of control over those risks, since to do so would assign to that party the impact of risks it does not control.” We think this standard applies to anticipated profit splits as well because if one party does not control any risks it should only be entitled to a routine return that should be determined under a one-sided method. The discussion draft should make clear that control of risk by both parties to the transaction is also necessary to the proper application of an anticipatory profit split.

While 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. Risk is real and is taken on anytime a company does business. 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 USCIB’s view, therefore, that in most cases risk can be priced accurately without resorting to the transactional profit split method unless both parties make unique and valuable contributions. The existence

of unique and valuable contributions, in virtually all cases implies the use of non-routine intangibles.

Paragraph 3 states that “profit splitting factors...must be determined ex ante on the basis of information known or reasonable foreseeable by the parties at the time the transactions were entered into.” USCIB agrees that the *framework* must be determined ex ante. However, USCIB would like to point out that profit split factors are often based on annual results, especially if the transaction is more of a service than an asset. An example of this could be barrels of oil pumped from a joint venture or billable hours by a service company. Additionally, in a transactional profit split of actual results, the profit splitting factors are often updated on an annual basis. An example would be a capitalized cost method that rolls forward the additional expense and amortization annually. So while the profit split framework may be established ex ante, the annual application will change as the taxpayer’s underlying business inputs change.

We note that the comment in paragraph 8 that distributors do not bear risk in underlying product price movements (e.g., chocolate bars) is at odds with the practice of many distributors of commodities who do pass along price increases. Gasoline stations, grocery stores (produce) are examples of such pricing behavior. The example might need to be narrowed, so that it is not misinterpreted.

#### C.1 - Commentator Questions

*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:*

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

As noted above, USCIB thinks greater clarity is needed on the differences between an actual vs. anticipatory profit split. In particular, how does the anticipatory profit split differ from a conventional CUP royalty analysis? That is, in order to apply a transactional profit split method to anticipated profits, the relative shares might have to be converted into royalty rates. Furthermore, anticipated profit cannot be split by assigning a royalty rate to both parties to a transaction, because the effect of such an assignment would be to split actual profits – for example as the actual base varies from the projected base. 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.



Although paragraph 2 of the discussion draft states that references to a transactional profit split method cover both applications of the method, it is sometimes not clear whether the discussion draft is referring to the transactional profit split generally or only the split of anticipated profits or only the split of actual profits. The discussion draft should be revised to make this clear throughout.

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

The distinction is useful but requires additional clarification. The guidelines also need to address the reliability of financial data on which the transactional profit split method is based. In the case of a profit split based on actual profits, the splitting factor is the key. In the case of a profit split based on anticipatory profits, both the allocation keys and the base to split are determined ex ante and therefore depend on financial data that must be reliable to achieve an appropriate answer. Clarification is required to define the appropriate level for the ex ante determination to be applied – while the framework may be determined ex ante it seems highly likely that the annual computations required will change as the underlying business inputs change. In addition, the role of risk should be clarified in an anticipatory profit split.

*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.*

USCIB agrees that close integration between both parties to the transaction is required if the transactional profit split method is to be considered the most appropriate method. We believe this integration includes both the sharing and the management of the risks in question. However, operations do not necessarily have to be integrated. In addition, highly integrated businesses (a baseline requirement to succeed in today's business world) may earn routine profits and comparables may be available to determine the appropriate price. So integration, without the presence of unique and valuable intangibles earning non-routine profits on both sides of the transaction, should not be a sufficient condition to support the use of the transactional profit split method as 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.*

See examples section below

Section C.2 – Summary of strengths and weaknesses

As detailed above, USCIB agrees that for highly integrated businesses with unique and valuable intangibles the transactional profit split method may provide a reliable method to determine the arm's length price. Similarly, we agree that it can provide flexibility and can mitigate extreme results. We also agree with the challenges in defining, implementing and administering the transactional profit split method. As noted later in this letter, we also agree that delineating the profit to be shared and the profit split factors are complex exercises that if performed incorrectly can greatly compromise the reliability of the pricing method.

## C.2 - Commentator Questions

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

USCIB generally agrees with the summary of the strengths and weaknesses in this section. We are concerned, however, that the difficulty of applying the transactional profit split method is not emphasized enough. 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 also likely that the creating the records for one year does 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".

### *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?*

A critical weakness of the transactional profit split method as formulated with the distinction between actual and anticipated profits, is that, in practice, it will be difficult to distinguish whether actual or anticipated profits ought to be used. USCIB is also concerned that tax authorities will be evaluating the results after-the-fact when outcomes are known and will use hindsight to determine which method produces better results and require the taxpayer to use that method.

Another weakness of an anticipatory profit split is that it requires the use of forecasts concerning the profitability of the transaction. Factors that determine the reliability of valuation techniques also apply to the anticipatory profit split. These include: reliability of forecasts, reliability of the estimated useful life of the product or service offering, and the reliability of the appropriate discount rate. Inability to accurately specify any of these variables would limit the use of an anticipatory profit split.

The transactional profit split of anticipated profits may, therefore, be most useful when there is a single contributing factor that is not expected to be volatile, which can be isolated and valued. For example, if one party to a transaction contributes a brand name and the other party contributes in-process R&D, the brand value might not be expected to vary significantly which might mean that it is relatively easy to convert to a royalty rate. In this case the role of the

transactional profit split would be to determine the relative value of the two intangibles. Determining the relative value of intangibles may be a complex and subjective exercise and may mean that the transactional profit split of anticipated profits is unreliable.

At a first glance, it appears that a strength of the transactional profit split of anticipated profits is that it would allow one to correctly capture the risk of each party: if A grows the market through own efforts, splitting the actual profit between A and B would allow B to free-ride on A's effort. But this assumes that the actual profit would necessarily have to be split based on pre-determined percentages. 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.

As mentioned above, the main weakness of the transactional profit split of actual profits is the difficulty of identifying the profit to be split, as well as quantifying the profit splitting factors, because the books and records of the companies are very unlikely to provide this information without substantial adjustments. This weakness should not be underestimated.

### Section C.3 – Most appropriate method

USCIB 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. Concerning the sharing of risks as discussed in paragraph 19, USCIB believes the criteria for control of risk as applied in Chapter IX is appropriate. For the transactional profit split method to be considered the most reliable method, both parties to the transaction must have management responsibility over their respective risks, not simply the bearing of the risks.

### C.3 - Commentator Questions

*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*

USCIB believes that, consistent with Chapter IX, that risks should only be included in a transfer pricing analysis if they are controlled by the relevant party. We are uncomfortable with the selection of the transactional profit split method in a fact pattern where one party bore risk but did not have a high level of integration in business activities with its transactional partner or where the transaction does not involve the contribution and use of unique and valuable intangibles by both parties to the transaction.

It would also be helpful to analyze which party bears the ex ante “common risk”. Suppose companies A and B engage in a project where the risks are sequential. A engages in R&D, B engages in marketing. Suppose the product is successfully marketed during year 1. In year 2 another company enters the marketplace with a competing product leading to a decline of combined profit of A and B. Which party should be responsible for the decline of profit? If the risk is shared, how should the relative exposure to this risk be evaluated?

### Section C.3.1 – Highly integrated operations

#### C.3.1 - Commentator Questions

*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 between parallel and sequential integration of business operations may be useful. It would appear that parallel integration lends itself more readily to a transactional profit split of actual profits, whereas a transactional profit split of anticipated profits would be more appropriate in the case of sequential profits. In both cases, however, the integrated business may only generate routine profits and comparables may exist, so another method may be the most appropriate method.

While the distinction between parallel integration and sequential integration may be useful, it may also be more useful conceptually than in practice because most companies will have both parallel and sequential integration. USCIB is concerned that attempting to define an activity as part of parallel versus sequential integration could become an area of dispute, if tax authorities believe that applying the label of “parallel integration” would permit them to apply the transactional profit split method, while labeling something “sequential integration” would not. This might be of particular concern in the area of intangibles. The tax authorities may argue that taken together development, enhancement, maintenance, protection and exploitation of an intangible are a unified activity that if done by different entities would result in the activities being considered parallel integration. While this might be the case, it also might not. In particular, exploitation of an intangible would frequently be a sequential step, rather than a parallel step to development, enhancement, maintenance and protection. Rather than depending on whether the label “parallel or sequential” is applied, the application of the transactional profit split method should depend on a careful functional analysis and the determination that the transactional profit split method is the most appropriate method.

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

USCIB agrees with the statement in paragraph 21 that “the parties may each contribute intangibles, share functions in jointly developing products, and exploit the marketing of those products together. 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.” With parallel integration it is clearer that the level of integration between the parties will limit the effectiveness of one-sided pricing methods. Additionally, parallel integration also makes deriving relative allocation keys easier. For instance, compare a company A performing similar R&D and marketing functions in both countries with company B performing R&D in one country and marketing in another. It is more reliable to create profit split factors based on attributes of R&D and marketing where they are performed in both countries. For company B, development of a reliable transactional profit split factor is more difficult.

However, even with the parallel integration, there is no explicit assumption of one party’s risk by another party. For example, if the parties are the same in all respects, but one party experiences supply disruption which leads to a decline in profit, should the parties split the actual profit based on ex ante-determined shares because there is parallel integration of business? In addition, the parallel integrated businesses may not involve unique and valuable intangibles, may generate routine profits, and comparables may exist such that transfer pricing methods are more appropriate than the transactional profit split method.

It would be helpful to discuss whether/how the risks are shared in the case of parallel integration. The reason is that, even with parallel integration, the risks may differ, for example, were the parties bring separate component IP into the supply chain.

#### Section C.3.2 – Unique and valuable contributions

##### C.3.2 - Commentator Questions

*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 cases of unique and valuable contributions, USCIB believes that the transactional profit split of actual profits may be more reliable. For example, consider a case where the two parties contribute separate patents, A and B, which together have to be used in the finished product. If the product performs as expected, the profit split would be based on the relative contributions of the parties which can be established ex-ante, and both parties would bear the risks to which they are jointly exposed, such as the market risks. If the product malfunctions because of one of the patented components does not perform correctly, the transactional profit split of actual profits may still be the most appropriate method, but the split, determined ex-ante, would have to provide for the probability of failure of one or both of the patented products or provide for ex post true-ups to the profit split based on actual results (e.g., differences outside of an agreed-upon range).

*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?*

Paragraph 22 recognizes that: “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.” Intangibles are important to the determination of the most appropriate method and selection of the transactional profit split and the creation of reliable profit split factors. However, 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 for splitting the intangible non-routine profit are the level of integration among the related parties, joint management of the unique and valuable contributions, and sharing of the economically significant risks.

*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.*

USCIB strongly agrees with the approach taken by the discussion draft that group synergies alone would not support the combining and splitting of “total system profits.” USCIB is especially concerned with the use of the phrase “total system profits” since that seems to be a reference to a global profit split. As discussed above, the discussion draft pertains to transactional profit splits, which is not “total system profits”. Even without this caveat, applying a transactional profit split method any time there are synergies would likely result in the transactional profit split method becoming the default method, which is fundamentally inconsistent with the Transfer Pricing Guidelines as a whole.

#### Section C.3.4 - Value Chain Analysis

USCIB believes a value chain analysis may be a valuable tool in the functional profile stage of the assessment of any intercompany transaction, although it is not clear to USCIB how a value chain analysis differs from a standard functional analysis. As discussed in paragraph 24, a value chain analysis can play an important role in assessing the contributions of both parties to a transaction and helping establish the most reliable method. USCIB agrees that the purpose of a value chain analysis is to “...assist in delineating the controlled transaction...and determining the most appropriate transfer pricing methodology.” As such, we agree with the discussion draft that a value chain analysis “alone does not imply that the transactional profit split method should be applied.” (Para. 25) As a diagnostic tool used in the functional profile, USCIB believes this section may be better placed in Chapter 1, Section D, where it would be clear that the value chain analysis, if relevant, should apply to all pricing methods.

USCIB also believes that it is important to recognize that the value chain analysis is merely a tool and use of a value chain analysis, if it somehow differs from a standard functional analysis, is not and should not be required. In many MNEs most of the entities are engaged in routine transactions that are amenable to one-sided pricing and therefore a value chain analysis is not required to determine the best method or the arm's length price. As noted above, USCIB is concerned that the routine use of value chain analysis and its use to determine profit splitting factors will result in profit split methods that are based on global formulary apportionment and are not consistent with the arm's length principle.

#### C.3.4 - Commentator Questions

*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?*

*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.*

USCIB 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.

#### C.4 Guidance for application

USCIB agrees with the tone of this section that the application of the transactional profit split method can be complex, and the method may be unreliable. In particular, the profit split method maybe unreliable if: the economically significant risks have not been specified; if the nature of the parties' contributions has not been accurately determined; if an evaluation of how those contributions drive profits has not been made; if the profits to be split have not been reliably identified, or if the basis for splitting profits has not been reliably determined. Failure to specify the economically significant risks, accurately delineate the level of profit or the profit split factor can render the method unreliable. (Para. 28) These restrictions on the use of the profit split should be emphasized. USCIB members have been subject to adjustments that do not consider these factors and simply assume that global profits should be split in a manner that attributes substantially all profits to a particular jurisdiction. Such use of the profit split method is inconsistent with the arm's length principle and will result in double taxation. It is important that the OECD guidance reject these sorts of approaches and specify all conditions necessary to support the transactional profit split method as the most appropriate method.

##### C.4.1.1 Contribution analysis

USCIB would point out that, as a practical matter, a contribution analysis (paragraph 32) is employed very rarely – most transactional profit splits are residual profit splits – as data on comparable profit splits is seldom available and the valuation analysis implied by a “relative value of the functions performed” is particularly difficult. If comparables are available, they should be used to price the transaction and profit split is less likely to be the most appropriate method. Use of this method is likely limited to a few industries.

#### C.4.2 Determining the profits to be split

USCIB strongly agrees with the statement that “the combined profits to be split in a transactional profit split method are the profits of the associated enterprises from the controlled transactions in which the associated enterprises are engaged.” (Para. 36) USCIB is concerned that some jurisdictions may ignore the transactional nature of the profit split method and instead apply a global profit split. It is very important that the OECD guidance clearly reject that approach.

USCIB agrees with paragraph 39 that determining the level and nature of profit to be split is often times complex and burdensome. Indeed, this is a major factor in limiting the broader use of the transactional profit split method. Often company financial systems do not allow the creation of transaction-specific financial profit and loss statements. If transaction specific financial profit and loss statements cannot be used, then attempting to apply the transactional profit split method might produce unreliable results. This would be the consequence of the use of unreliable cost allocations, identification of collateral income, difference in currencies and complex tax issues such as customs, duties and VAT.

#### C.4.2 Determining the profits to be split

#### C.4.3 Different measures of profits

Paragraph 40 correctly acknowledges that the measure of profit can vary by industry and by company-specific factors. Operating profit is the most common measure, both because the transactional profit split method is most naturally thought of in terms of operating profit, and because many value drivers that will create the profit split factors are focused on creating operating profit. Yet in some circumstances, a split of gross profit may be the method most likely to yield an arm’s length result. In particular, where each party controls the economically significant risks relevant to its own operating costs, a split of gross profit may be more appropriate than a split of operating profit because the latter would result in the sharing of risk outcomes with a party that does not control those risks.

On the use of operating profit vs. gross margin, the first example in paragraph 41 concerning the “two associated enterprises” is problematic. While this example is intended to show the benefits of gross margin as a measure of profit when sales and marketing functions are unintegrated, an alternative explanation can lead to the use of operating profit. The key



question is the reason for the differing sales and marketing expense between the two countries. If the higher level of sales and marketing is required to generate the forecast or actual revenue, then one should properly include both the level of revenue and the level of sales and marketing expense. By excluding marketing expense this example assumes the sales quantity or price is not enhanced by these additional expenses. In this case, use of operating profit, not gross margin, may be a more reliable measure of profits.

In contrast, the second example in paragraph 41, involving “associated enterprises that engage in highly integrated worldwide trading operations,” effectively illustrates when gross margin may be the more reliable measure of profits. In some industries, such as financial services, a business may be highly integrated for purposes of generating revenue and the direct costs incurred to produce that revenue (e.g., cost of goods sold), but each associated enterprise may independently control the economically significant risks relevant to its own operating costs. Further, unlike in the manufacturing context, forecast or actual revenue may not depend directly on the level of operating costs. In such a case, a gross profit split would avoid rewarding associated enterprises for risks they do not control, and gross margin would be the more reliable measure of profits.

#### C.4.3 - Commentator Questions

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

Gross margin should only be used if the excluded functions are separable and do not effect realized price, revenue, and cost of revenue. The standard should be that the level of profit must define the pool of jointly managed and controlled potential income, and must in turn be consistent with the profit split factor or factors.

Will the transactional profit split be a reliable method if the profit to be divided is generated in only one jurisdiction? This could be the case if both parties contribute valuable IP but the product is sold only in one party’s marketplace. The use of the CUT method might not be appropriate if both parties manage the intangibles and risks. But in this case, the profit to be split will be determined only in the market where the product is sold (taking into account the other party’s relevant costs).

A measure of profits to be split can be an intermediate measure between the gross profit and the operating profit. For example, the parties share all risks except R&D risks, and one party performs R while the other party performs D. In this case, all costs (except R&D) can be taken into account when arriving at the pre-R&D profit, and then the resulting amount will be split based on relative contributions of unique and valuable intangibles (which may not include routine development (D) services).

#### C.4.4 Splitting of profits

USCIB stresses that the ability to identify reliable and effective split factors is a key component of supporting the transactional profit split method as the most appropriate method.

The primary criteria for the selection of a profit split factor should be a direct relationship between the split factor and the profit being split. There must be a causal relationship between the measure of the contributions that give rise to the economically significant risks (the profit split factor) and the definition of the profits to be split which must be the return on these economically significant risks. That is, value drivers of routine profit should not be used to split residual income. We suggest the criterion described above be added to the list in paragraph 42.

USCIB generally agrees with the requirements of paragraph 42 [based on paragraph 2.132 of the existing transfer pricing guidelines] that the factors used to split profit be (1) reasonably independent of transfer pricing policy and based on objective data, (2) verifiable, and (3) supported by comparables data, internal data, or both. Moreover, USCIB agrees with the statement at paragraph 44 that “Thus, where there is no more direct evidence of how independent parties in comparable circumstances would have split the profits in comparable transactions, the allocation of profit may be based on the relative contributions of the parties, as measured by their functions, taking into account the assets used and risks assumed.” For example, the frequent use of relative capitalized development costs of two intangibles, as a residual profit split key, is meant to provide a reasonable measure of the relative contributions of the two parties. Indeed, it is well known that the ex-ante value of an intangible contribution is proportional to the level of fixed funding commitment required to develop the asset (because fixed costs commitments increase risk and increased risk means increased expected value). Therefore, measuring relative contributions of value by a relative measure of the capitalized development costs (as a proxy) is not only meaningful, it is grounded in a correct application of basic financial economics concepts.

‘Risk-weighting’ specified in paragraph 51 is not defined. The discussion draft should specify if this is the bearing of risk or the management of risk. In addition, a method to value risk for purposes of a transactional profit split method is both undeveloped in the discussion draft and complex as can be seen in the discussion of control in Chapter IX of the Transfer Pricing Guidelines.

USCIB wishes to point out that all of the issues and difficulties of using costs as a reliable estimate of an intangible asset value also apply to a profit split allocation key.

## Examples of use of transactional profit method

### Example A: Professional service firm

Example A: A professional services firm has operations in countries A and B. The firm delivers services based on jointly-staffed teams from both countries. A two-sided functional profile determines that the critical business activities of business development, service offering development, recruiting, training and development are all performed jointly by professionals from both country A and B. Additionally, senior management is also comprised of members of both countries. Here, the necessary criteria for functional integration are met and the profit split method may be the most appropriate method.

Example A1: Same as Example A above, except the firm also has operations in Country C that focused on project execution under the direction of professionals in Countries A and B. Here, it may be more appropriate to establish an arm's length price for Country C based on one-sided method. Therefore, Countries A and B would be included in the profit split but Country C would be excluded.

Example A2: In Example A above, if a profit split of the total operating profit of the firm is selected, then a profit split allocation key based on value driver of overall operating profit must be used. A potential allocation key might be total billable hours by staff. Conversely, if residual profit split is employed, the staff-based service delivery may be characterized as routine. Here residual income would exclude routine profit based on staff-based billable hours, and an allocation key more directly related to the driver of residual income would be more appropriate, such as business development, service line development, or senior management productivity.

### Example B: Global manufacturer

Example B: A global manufacturer has R&D and manufacturing centers in countries A and B and manufacturing and sales companies in countries C and D. Countries A and B both have jointly develop projects, share technology and know-how, and the products are of similar profit potential. Both countries license finished technology for manufacture and sale to countries C and D. Here, it may be appropriate to employ a transactional profit split method between countries A and B. It would be inappropriate to include countries C & D that do not have direct ownership or control of the manufacturing intangibles. As countries A and B are also manufacturers, a residual profit split is likely most appropriate. A value driver specific to product technology and know-how, such as capitalized cost, may be a potential profit split factor.

Example B1: Same as example B, except here country A and B specialized in design and development of different products with different profit potentials (e.g., small cars vs. large trucks). Here, without the level of integration between the intangible development teams between country A and B the transactional profit split method is likely inappropriate. The

differing profit potential between the two bundles of technology preclude creating a common pool of profit required under the transactional profit split method. Other methods, such as the CUP, may be more appropriate.

Example B2: Same as B, except country A owns and manages the brand/trademark of the product. The trademark is separable from the product technology (i.e., is managed and developed independent of the product technology) and can be valued reliably under the CUP method. Here, the transactional profit split method may still be appropriate, but the residual income must exclude the value of the trademark owned by country A and the trademark profit allocated directly to country A.

Example B3: Same as B2, except the trademark and brand is integral with the product technology. It is developed jointly by countries A and B and cannot be reliably priced as a separable asset. In this scenario, the transactional profit split method may be the most appropriate method and the residual income includes all revenues and costs associated with trademark and brand development. Here the split factors would be based on technology development factors and would include brand development factors only if they could be reliably quantified.

Sincerely,



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September 4, 2016

By email to: [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

Andrew Hickman  
Head of Transfer Pricing Unit  
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Dear Mr. Hickman,

Thank you for the opportunity to provide comments on the Public Discussion Draft on BEPS Actions 8-10: *Revised Guidance on Profit Splits* dated 4 July 2016. Wisemove (Beijing) Consultancy Co., Ltd is a service provider in China which only provides tax services on transfer pricing, and the operation company under Wisemove brand. Here are our humble comments on the 16<sup>th</sup> question proposed in the draft. Thank you again for your attention.

*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 for profit splitting factors, we propose to add terms that these factors are relevant to the profits to be split and the arm's length, such as:

- “Although there may be some profit splitting factors not taken into account, in the case that the determined factor is used, the profit to be split is relatively determined”.
- “Profit splitting factors, especially supported by internal data which needs to be compared to the external comparables, should be supported by the profit and price of transaction at arm's length or the anticipated profit and price of potential transaction at arm's length”.

In paragraph [2.13] the existing profit splitting factor are described as objective, verifiable, and supported by comparables or internal data. However, no matter in Contribution analysis or Residual analysis, the used profit splitting factors are having judgement and assumption about business activity, and meanwhile the judgement and assumption restrict the profit to be split. Therefore the profit to be split is relatively certain. If the used factor has changed in further analysis or negotiation, then it is necessary to evaluate how the new factor affect the original profit to be split. This clarification may appear in other paragraphs, but this kind of feature is common in profit splitting factors, especially in the difficult case when judging the contribution of intangibles, such as how to identify the contributions of intangibles of a commercially successfully product, including

design fee covered in production cost, marketing channel cost and trademarks. Therefore, we suggest that “although there may be some profit splitting factors not taken into account, in the case that the determined factor is used, the profit to be split is relatively determined” can be added in paragraph [2.13].

As for the part involving the internal data supporting profit splitting factors, it's suggested that the connection with the arm's length can be added to it. The determination of the use of certain internal data in some case, which makes the case highly approximate the uncontrolled transaction, is relevant to the independent level of the certain internal data in the highly similar uncontrolled transaction. It's generally believed that the highly similar external comparables are rare or don't exist, especially in the case involving intangibles. However, certain internal data of some account records is universal in industry. It is being recorded and the transaction it accompanies are useful to the certain internal data.

For example, when determining the contribution of “marketing channels”, should the internal data of “retail store renovation costs” be included in the “marketing channels” factor (Notice Issued by the State Administration of Taxation Regarding The Printing and Distribution of the

“Implementation Measures of Special Tax Adjustments (Trial Version)” (Guo Shui Fa [2009] No.2) )? This may involve many industries and products. Once it's determined as profit splitting factor, it's often supported by internal data. The following retail store renovation costs belong to the internal data of company A. In the rapid developing mainland, China, some retail stores are required to be renovated by the company almost every two years.

One opinion holds that: The marketing channels profit splitting factor shouldn't include the large amount of cost on the renovation of retail stores, since this cost is often spent for only one retail store, instead of several, whereas the internal data of marketing channels should be about the cost incurred by several or all retail stores.

The other opinion holds that: The renovation style of retail store is unique and embodies the special concept of the company's trademark. Besides, there is a market fact proving that this retail store has stronger competitiveness than other competitive brands. Therefore, the marketing channels profit splitting factor should include the retail store renovation costs, and the division of profit should be amended.

In this case, we think that it's necessary to consider the internal data, which is the uncontrolled transaction of external market of “retail store renovation costs”. Although it's hard to find the ideal external comparable for the overall profit splitting, when it comes to certain internal data, it's relatively easy to identify and judge the external market fact of “retail store renovation costs”, and bring an answer to the controversial issue.

Therefore, we suggest that when using the internal data to determine the profit splitting factors, it's necessary to further confirm whether the contribution of used internal data is consistent with the

arm's length principle. Meanwhile, this kind of feature may be universal in profit splitting factor. It's suggested to add "Profit splitting factors, especially supported by internal data which needs to be compared to the external comparables, should be supported by the profit and price of transaction at arm's length or the anticipated profit and price of potential transaction at arm's length" to paragraph [2.13].

We hope our comments and suggestions are helpful. Please contact [leo@tax800.com](mailto:leo@tax800.com) for more information.

Kind regards

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## Comments on Public Discussion Draft: “BEPS 8-10 Revised Guidance on Profit Splits”

Dear All,

WTS is pleased to provide you with comments regarding the OECD Discussion Draft “BEPS 8-10 Revised Guidance on Profit Splits” (PSM Draft).

We appreciate the OECD’s ongoing efforts to provide guidance on this important topic and assess the provided draft as a very comprehensive and valuable basis for further discussions.

We generally appreciate that the transactional profit split (PSM) should qualify as the most appropriate method only under specific circumstances e.g. when the parties “... either share the same economically significant risk associated with the business opportunity or separately assume closely related risks associated with the business opportunity and consequently should share in resulting profits or losses” (sec 16 of the PSM Draft) and that this situation “...may be accompanied by a high degree of integration of functions or the making of unique and valuable contributions by each of the parties” (sec 19 of the PSM Draft).

The diverse hints in the revised PSM Draft that the PSM should not be applied for the remuneration of routine and/or low risk functions or due to missing comparable data are also very helpful and clarify that the PSM shall remain some kind of exceptional method. This is a welcome revision of the approaches described in the 2014 OECD draft.

The differentiation of actual and anticipated profits is a step in the right direction but too static in the PSM Draft. General guidance on timing issues exceeding sec 53 of

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the PSM Draft seems highly necessary to practically apply the concept of actual and anticipated profits at all.

We propose to put more efforts in the timing and “risk sharing and control” criteria in line with other aspect of BEPS 8-10 to make the PSM practicable.

Please find in the following our more detailed answers regarding the questions raised in the PSM Draft by the OECD:

*Q1.1: Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear?*

The concept of anticipated and actual profits is generally good and helpful. We fully agree that the basis on which actual profits should be split should be determined in advance (before the risks realize). Otherwise as stipulated in sec 10 of the PSM Draft, there is in fact no risk. In a situation where there is no risk the PSM will most likely not be applicable at all.

Nevertheless, we do not share the PSM Draft’s focus on the transactional profit split of actual profits. It seems that this focus contradicts the notion that the application of the PSM shall lead to the most appropriate method of an accurately delineated transaction. In that regard we consider the OECD’s assumptions as correct that the transactional profit split of actual profits is the most appropriate method regarding the remuneration of transactions when the parties share the same economically significant risk associated with a business opportunity and this situation is accompanied by a high degree of integration of functions or the making of unique and valuable contributions by each of the parties. From our perspective it is important to clarify that to apply the PSM of actual profits in order to “share the same economically significant risk” it is necessary that the integration of functions mentioned in sec 19 of the PSM Draft is horizontal (parallel) from a logical and timing perspective.

Accordingly, the PSM of anticipated profits can be a possible method for the remuneration of transactions where functions are vertically integrated (likewise covering the logical and temporal dimension). In these particular cases it is not possible for the proceeding contributor to control the risks at a following stage of the value chain. Therefore, a usage of the transactional profit split of actual profits is not possible, as the proceeding contributor is not able to control the risks associated with the contributions of the successor. In that regard we would assume that there are numerous cases where a transactional profit split of anticipated profits is not linked to the transfer of intangibles as intangibles may remain with the contributor and change their value over the duration of the PSM agreement. The usage of a discounted cash flow valuation technique as described in sec 4 of the PSM Draft can therefore only be used in some of these cases. We further recognize that the application of a transactional profit split of anticipated profits needs to be accompanied of an arm’s length price adjustment clause in most cases.

As a conclusion we would highly appreciate if the OECD would consider the PSM of anticipated profits equally relevant and provide additional guidelines in that regard.

Additionally, the PSM Draft requires some more work on the timing aspects of the PSM. A transaction under a PSM will most likely be a long term transaction and it could no be possible to define the actual profit for a given tax year at all.

*Example: Affiliated entities (A,B) undertake a joint development activity of the of a pharmaceutical ingredient (drug). Before the development of the drug begins, a function and risk analysis shows that A&B will control the risk, cost, and other value contributions equally and should therefore receive under the PSM an equal share of profits as well.*

Now assume the following sample situations:

*Example A: After 5 years of development the drug shows a mayor fault and will never be marketable. According to the PSM A, B should bear and have borne the development cost equally so no further offsetting payment would be necessary.*

*Example B: After year 3 A took over the largest part of the development activities and related costs and risks. After 5 years of development the drug shows a mayor fault and will never be marketable at all.*

In Example B there is a clear shift in the function and risk profile between A and B. The PSM Draft should handle such an issue and answer the following question:

- What exactly is the actual profit in Example A and B? Is it the actual profit of the underlying transaction of the whole period of the project or the profit of the given fiscal year?
- How should changes in the function and risk profile during an ongoing project be handled?
- Which kind of adjustment should be required? E.g.: would Example B above require an offsetting payment from B to A after year 3 to take over the cost of A or should the ex ante agreement be unchanged because the PSM agreement was concluded from an ex ante perspective?
- Would the change in the functional structure after year 3 also lead to an adjustment of the anticipated/actual profit to be split?
- How and when would an adjustment be calculated?
- Would the answers to the questions above change when the drug would become highly profitable after year 5?

*Q1.2: Is the distinction between the two profit split approaches described useful?*

The distinction between actual and anticipated profits is quite useful. A clear definition of “anticipated” and “actual” should be given. This mainly relates to timing aspects, the period covered by the PSM and the underlying profits. In practice, the PSM will often be applied for long term transactions like joint R&D projects or long term marketing agreements. It will often be the case that before reaching profitability investment costs will occur, which need to be handled in more detail when defining the actual profits.

*Q2. 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.*

First of all the integration of a business activity does not necessarily lead to a situation of shared risks, those can be transferred by a contract. But it is likely that the control of the risks is shared in a vertically integrated transaction from an ex ante perspective. The PSM draft should be more precise on this aspect. Nevertheless, the PSM Draft should take into account that the contractual terms and conditions of a business relationship form the starting point for the transfer pricing analysis and that the sharing of risks cannot be assumed by neglecting an existing contractual agreement between the involved parties. If the involved parties decide to allocate the risks on a contractual basis for highly integrated functions to one party and the allocation of risks is considered within the transfer pricing arrangements of the same agreement resulting in arm's length prices the PSM should not be applicable even if a sharing of risk would have been possible in practice.

*Q3. 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.*

See our remarks regarding the differentiation of integration (vertical/horizontal), example B within the answer to Q1.1 and others further below.

*Q4. Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarized?*

Yes - no further guidance regarding these issues seems necessary from our perspective.

*Q5. 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 described above we consider the transactional profit split of actual profits most likely more appropriate in cases of horizontal integration. In comparison thereto the transactional profit split method of anticipated profits may be the most appropriate

method in cases of vertical integration or in cases of horizontally integrated functions rendered at different phases of a value chain.

With the PSM Draft lacking guidance in that regard and on timing issues both concepts are rather theoretical and could be attacked under the arm's length principle:

- No independent third parties would enter a PSM agreement based on anticipated profits without the possibility to adjust it based on the actual development of the project ( e.g. when the contributed values/risks of one party change during the PSM).
- The same is true for a PSM which is concluded on the basis of actual profits only (e.g. without an ex ante basis to split actual profits). One participant in the PSM could then influence the allocation keys based on the realization of risk.

*Example C should clarify these aspects: A is developing a high technology product jointly with B. After the development phase B alone will take over the marketing of the product. Both parties apply the PSM.*

If A and B do not decide ex ante and based on anticipated profits how the profits should be split in each period, B would have the strong incentive not to take into account A's development contributions in the marketing period. It is also obvious that if you would only analyze the actual profits and functional and risk profile of the marketing phase this could be very misleading: In the marketing period the application of the PSM is not obvious and the value contributions of the development phase are not seen anymore. Furthermore, A is most likely not able to control the risks that occur during the marketing phase of B due to a lack of know-how.

*Q6.1 Do commentators have any suggestions for clarifying the notion of risk sharing in this context?*

The sharing of risk as precondition for the PSM is somehow difficult to apply since the application of the PSM on actual profits will have a different impact on the allocation of risks between the contracting parties than e.g. the TNMM.

Assume the application of the PSM on Example C:

- Both parties apply the (contributory) PSM and herewith will participate in the market(ing) risk of B.
- B is remunerated with TNMM for its marketing activities. The market(ing) risk is herewith transferred to the joint development activities. For the joint development A and B apply the (residual) PSM. Even if A and B share the risk of the development phase this would not lead to an arm's length result if A is not able to control the market risk.

Both applications of the PSM will lead to a different allocation of risks and the conclusion on the correct implementation of the PSM will be based in the functional profile of

B's marketing activities and A's ability to control the (market) risks. Therefore, more emphasis should be given to the criterion "combined control over the risk" in the context of the PSM.

*Q6.2. 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.*

As described above, we highly appreciate that the PSM will be considered the most appropriate method only under specific circumstances. Nevertheless, the draft leads to being too restrictive in regard to the transactional profit split of anticipated profits. Please see our answer regarding Q8 below.

Example C above mainly refers to situations where functions are highly integrated such as joint development or joint marketing activities. Here as well it should not be "share the same economically significant" risks, but "control the same economically significant risks from an ex ante perspective" since the application of the PSM will highly influence the risk sharing profile from an ex post perspective.

*Q7. 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 would advise to include a reference to Chapter IX of the OECD's Transfer Pricing Guidelines regarding business restructurings, two sided valuations and price adjustment clauses.

Furthermore, we regard the transactional profit split of anticipated profits as a possible appropriate method regarding many cases of vertical integration described within sec 21.

*Q8. 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 agree that it is possible to find reliable comparables for discrete, sequential functions in some cases. Nevertheless, in a relevant number of cases comparables cannot be found. This does not mean that there are no comparable business transactions. These are just not transparent and visible for the multinational groups. In the cases of missing comparable data it seems important that the transactional profit split of anticipated profits can be considered as a possible transfer pricing method that will be accepted by tax authorities. We urge the OECD to clarify this issue and leave a possibility for the application of this method as this distinction does seem to contradict the statements regarding unique and valuable contributions within sec 22 of the PSM Draft.

*Q9. If so, how should the concept of parallel integration be further defined?*

Since the timing aspect becomes a crucial issue when discussing the application of PSM on the basis of anticipated and actual profits, more emphasis should be giving to the dimension of time in regard to value chains and product life cycles.

*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.*

As already discussed within our answer regarding Q 6.1. the application of the PSM will rather impact the allocation of risk between the participants of the PSM and can most often not be used as a precondition of the application of the PSM. Therefore, the main scope of the analysis should be on the integration of functions and the definition/identification of the valuable contributions and the **control** of the business risks in an ex ante state.

Furthermore, participants of the PSM should only participate in the risks connected to the stage of the value chain that they are involved in. Further guidance seems necessary regarding the separation of risks that are occurring at a later stage of the value chain leading to the actual profits.

*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?*

If in the example of sec 22 of the PSM Draft the “manufacturer of the product” would take over all costs of the “developer and manufacturer of the component” then most of the business risk of the transaction would be transferred to the manufacturer of the products. In this case it is very likely that due to a contractual agreement the risks are transferred from the party who controls the risks ex ante to another party who bears the risk of the (ex post) outcome of the transactions.

This leads to the fact that the (ex ante) control of the risk should be the decisive criterion regarding the application of the PSM. Who is bearing the risk (es post) will then depend on whether and how the PSM is implemented.

*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.*

As a group synergy cannot be considered a unique and valuable contribution by one single party as the synergy is created by all members of the group this topic does not

affect the application of the PSM regarding one distinctive transaction. The PSM is a **transactional** profit method whereas the questions above would require some kind of global formulary apportionment method. This section is therefore wrongly placed and should be deleted. In line with the OECD we absolutely reject any application of the global formulary apportionment method as contradictory to the arm's length principle.

*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?*

Yes. No further guidance regarding these issues seems necessary from our perspective.

*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.*

It could be added that value chain analyses can not only lead to the determination of relevant profit splitting factors as noted in sec 48 of the PSM Draft but need to support the chosen profit split factors. In that regard, a value chain analysis could be considered as the cornerstone of the application of the PSM. To make the application of the PSM of anticipated and actual profits possible more emphasis should be given to the timing aspects of value chains.

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

No further guidance regarding these issues seems necessary from our perspective.

*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 understand that the relevant sections do not generally exclude any profit split factors. As the factors may highly depend on the specific case and the cases are based on unique and valuable contributions multinational groups have to agree on profit split factors on a case-by-case basis. In that regard it seems important not to restrict the choice of the profit split factors as far as the profit split factors are reliable and verifiably measurable and furthermore deviated from the value chain and circumstances of the specific business case. As mentioned above also the timing aspects need to be handled in the determination and adjustment of profit splitting factors.



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

We do not consider any further guidance necessary as the decision regarding appropriate profit split factors needs to be based on the specific facts and circumstances of each business case.

*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 above answers regarding the vertical and horizontal integration of functions.

We hope that our comments are useful for the further discussion of this important topic.

Kind regards,

WTS Steuerberatungsgesellschaft mbH

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Vienna, August 22, 2016

**Subject: Comments on the Public Discussion Draft on BEPS Actions 8-10 "Revised Guidance on Profit Splits"**

Dear Mr. VanderWolk,

First of all, we would like to congratulate the OECD for the excellent work done on the Public Discussion Draft on BEPS Actions 8-10 "Revised Guidance on Profit Splits" (hereinafter the "Discussion Draft"), issued on 4 July 2016. We are grateful for the opportunity to provide comments and we hope that our suggestions might provide valuable inputs for future improvements.

## 1. Introduction

The Discussion Draft sheds light on some of the most fundamental issues with respect to the application of the profit split method (hereinafter the "PSM"). One of the most significant achievements seems to be the introduction of the sharing of economically significant risks, which could be of the same kind or different but closely related, as a relevant factor to indicate whether the PSM is the most appropriate method to be applied. Nevertheless, difficulties and challenges regarding the application of the PSM still exist, also in a so-called "post-BEPS" world. Therefore, we would like to take this opportunity to provide our comments on the Discussion Draft. These comments are of a general nature (see section 2, below), as well as referring to the specific questions raised in the Discussion Draft (see section 3, below).

## 2. General comments

### 2.1 Safeguard against the overuse of the PSM

The Discussion Draft points out that the PSM reflects participants sharing economically significant risks associated with the controlled transaction,<sup>1</sup> and thus implying that this is a factor to consider when determining the application of the PSM. It does not go beyond the “most appropriate method” criteria set up in para. 2.2 of the OECD Transfer Pricing Guidelines (hereinafter the “OECD TPG”), but acts as a clarification of the existing rule. Indeed, although the new extended wording of the chapter might lead to the understanding that the scope of application of the PSM will be broadened, the Discussion Draft limits such scope of application to specifically defined situations, by means of a “tailored rule”. In fact, both the old rule and the tailored rule for the application of the PSM emphasize the necessity to accurately delineate the actual transaction.<sup>2</sup>

The Discussion Draft advances the tailored criteria for the application of the PSM in a positive as well as a negative way, respectively. On the one hand, the PSM may be an appropriate pricing solution in case of highly integrated operations as well as in case of unique and valuable contributions.<sup>3</sup> On the other hand, the PSM would not be rendered as the most appropriate method when the sole reason to do so is the absence of comparables; neither would the exploitation of the (global) value chain in itself justify the use of the PSM.<sup>4</sup>

We understand and welcome the endeavour of the OECD to establish a proper boundary for the application of the PSM and to clarify that the PSM is not a “residual method”, i.e., to be automatically applied when the other transfer pricing methods (hereinafter the “TP methods”) are not applicable. However, some questions might still be left open for disputes, e.g.:

- The situation where the PSM applies as the most appropriate method is somewhat alien from situations for the rest of TP methods. As a result, it seems an unlikely scenario that other TP methods can replace the PSM if the accurate delineation of the actual transactions shows a sharing of economically significant risks amongst participants, or the other way round. Consequently, if TP methods are not interchangeable, then it might be a question whether it still makes sense to keep some sort of slight hierarchy of TP methods in para. 2.3 of Chapter II of the OECD TPG, when more than one method is appropriate.<sup>5</sup>
- The Discussion Draft provides preference to TP adjustment and interpretation of inexact comparable data, rather than the PSM, when one of the parties to the transaction assumes only limited risks, though reliable comparables data is scarce.<sup>6</sup> This might seem to imply that the degree of comparability is less strict if one of the

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<sup>1</sup> Para. 16 of the Discussion Draft.

<sup>2</sup> Para. 2.2 of the OECD TPG and para. 17 of the Discussion Draft.

<sup>3</sup> Paras. 21 and 22 of the Discussion Draft.

<sup>4</sup> Paras. 18 and 25 of the Discussion Draft.

<sup>5</sup> Para. 2.3 of the OECD TPG states that “where [...] a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method”.

<sup>6</sup> Para. 18 of the Discussion Draft.

entities involved bears limited risks and that TP adjustments can remedy flaws of comparables in that situation. Accordingly, it could be predicted that the use of cross-country and even cross-industry comparables will increase in the future. Since the current guidance in Section A.6 of the OECD TPG might be unable to stretch this concept so far, it would be of utmost importance to provide more practical guidance in this respect.

Therefore, although we recognize and welcome the newly introduced clarifications safeguarding against the overuse of the PSM, we would suggest further considering some clarifications to the above-mentioned points.

## **2.2 Assurance of the PSM free of the formulary element**

As far as the Discussion Draft is concerned, the PSM shows its respect to facts and circumstances of each case fully, following closely the arm's length principle. Moreover, it discerns itself from the global formulary appointment method, which works as a statutory way to divide profits of a group by a pre-determined formula. To some extent, this Discussion Draft makes this point clearer compared to the Public Discussion Draft on BEPS Action 10 "Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains" (hereinafter the "2014 Discussion Draft"), by establishing the following:

- The most appropriate criteria for the application of the PSM are highly reliant on a thorough understanding of the commercial or financial relationship of participants, revealed by the accurate delineation of the actual transaction. It further requires support from a functional analysis, assisted with the value chain analysis, consistent with what is set up in Section D.1 of Chapter I of the OECD TPG.
- When it comes to the application of the PSM, in particular the determination of the combined profits and the splitting factors, it is mandatory to comply with the accurate delineation of the actual transaction, which means to reflect the contributions made by the participants by taking into account functions performed, assets used and risks assumed.<sup>7</sup>

We would like to underline the relevance of these clarifications and we welcome them.

## **2.3 More endeavours expected on the profit split of anticipated profits**

The distinction made in the Discussion Draft between the profit split of anticipated profits and the profit split of actual profits is clearer than in the current OECD TPG. According to the Discussion Draft, the use of actual profits reflects "high level of integration of activities" and "greater sharing of uncertain outcomes resulting from risks associated with the transaction".<sup>8</sup> However, more clarifications on the aforementioned concepts with specific reference to the definitions of "high level" and "greater sharing" might be needed.<sup>9</sup>

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<sup>7</sup> Paras. 29, 40 and 48 of the Discussion Draft.

<sup>8</sup> Para. 6 of the Discussion Draft.

<sup>9</sup> *Ibid.*

Moreover, the usefulness of such clarification might be undermined due to the improper treatment to the profit split of anticipated profits. Indeed, the Discussion Draft deals with anticipated profits mainly in Section C.1, while leaves it unattended in the remaining sections.<sup>10</sup> The statement in para. 2 that “references to a transactional profit split method cover both applications of the method” might potentially make it even more confusing as to whether the application of the profit split of anticipated profits follows the most appropriate criteria set up in para. 16 of the Discussion Draft. If the two ways of profit splits are essentially different, as described in Section C.1, it makes more sense to conclude that the most appropriate criteria for each method are slightly different at least, provided that the differences brought in are subtle. Otherwise, one would be misled by the fact that the differences just stands out theoretically, and do not affect the applications in practice. Nevertheless, this part seems lacking in the Discussion Draft.<sup>11</sup> We would, thus, suggest providing more references to the PSM of both ways evenly and coherently throughout the entire report. Further alternatives to this approach are suggested in section 3.1, below.

#### **2.4 Adoption of an overly prudent approach for the PSM**

The Discussion Draft seems to adopt an overly prudent approach, seen from its cautious attitude towards subjectivity. Admittedly, the criteria of the profit splitting factors and the weight of the factors are meant to be objective especially if sourced internally.<sup>12</sup> The 2014 Discussion Draft initiated the RACI model,<sup>13</sup> which might appear to be easily manipulated. However, the RACI model as well as the bargaining analysis prove to be all useful in practice in the application of the PSM if dealt with properly. They can be essentially relevant to evaluate the relative contributions of associated entities conducting absolutely discrete activities in the supply chain, which requires the profit splitting factors to be uncongenial. The Discussion Draft does not explicitly recognize or deny the use of the RACI model and the bargaining analysis, and it simply no longer provides any reference in this respect. The lack of guidance on this topic might lead to the counterproductive effect that the RACI model and the bargaining analysis are misused for opportunistic benefits. Therefore, we would suggest further clarifying these topics.

### **3. Specific comments**

This section intends to deal with the specific questions posed in the Discussion Draft for public commentators. What calls for special attention here is that the comments we provide do not address each question separately. Instead, below please find our thoughts and understandings to the questions, organized by topics.

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<sup>10</sup> Para. 3 of the Discussion Draft.

<sup>11</sup> Para. 16 of the Discussion Draft.

<sup>12</sup> Para. 19 of the Discussion Draft.

<sup>13</sup> Para. 38 of the 2014 Discussion Draft.

### 3.1 Distinctions on the PSM of anticipated profits and that of actual profits (questions 1-3)

The new guidance developed in Section C.1 results in a distinction between the profit split of anticipated profits and the profit split of actual profits. However, as underlined before,<sup>14</sup> reference to the distinction between the two ways should be applied evenly and coherently throughout the entire report.

Such distinction could only be removed, if the application of the two approaches would lead to similar results. Theoretically speaking, the anticipated profits describe the profit level a rational entity is willing to accept without taking any risks, which means it should be equal to the actual profits in the long run provided that both scenarios are under exactly the same conditions. However, in practice predictions rarely work perfectly.

Hence, if the distinction between the profit split of anticipated profits and the profit split of actual profits will lead to different results (which, in our view, should be minimized), this might need to be further clarified. Alternatively, a clearer statement of the fact that the application of profit split of anticipated profits, on one side, and the application of the profit split of actual profits, on the other, should in principle lead to similar results might be required.

Irrespective of the different kinds of profits to be combined and split, the arm's length principle applies indiscriminately. The Discussion Draft reiterates that the basis upon which those profits are to be split, namely the combined profits and the profit splitting factors, is always determined **ex ante** by using the information available and reasonably foreseeable at the moment transactions are entered into.<sup>15</sup> However, the concept of "actual profits" might wrongly lead to the use of hindsight information, for example tax authorities might trace back arbitrarily and make TP adjustments by using the alleged "actual profits". One possible solution is to apply the profit split of anticipated profits at the moment of the transaction, while making adjustments based on realised profits at year end, namely calculating a so-called "true-up", before the tax return is finalized. Indeed, the true-up concept is not only useful in avoiding hindsight, but also it integrates "anticipated profits" with "actual profits" and provides safeguard against episodes of arbitrages between the two ways.

Likewise, it could also be suggested the development of further work aimed at designing an acceptable error range for the gap resulting from the two ways, thereby providing the tax authorities with the right to perform transfer pricing adjustment based on actual profits whenever a discrepancy over the established error range exists. To this end, the outcome of the follow-up work on the topic of "Hard-To-Value-Intangibles" developed in Section D.4 of Chapter VI might constitute a relevant reference, given the similarity of problems dealt with in the two scenarios.

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<sup>14</sup> See section 2.3, above.

<sup>15</sup> Paras. 3, 5 and 30 of the Discussion Draft.

### 3.2 Strengths and weaknesses (questions 4-5)

The strengths and weaknesses are well addressed in the Discussion Draft. Essentially Section C.2 stresses the point that the PSM can offer a pricing solution not to the scarcity of comparables in general, but to those arising from activities where two or more entities share economically significant risks. This is a relevant idea initiated by the Discussion Draft and works consistently with other sections in the whole Discussion Draft.

As mentioned before, there might be slight differences in respect to the level of risk sharing between the PSM of anticipated profits and that of actual profits; however we believe the key determinant as to which kind of profits to choose in practice is the accessibility of data at the moment of transaction. Accordingly, the strengths and weaknesses described in the Discussion Draft are more generalized aspects of the PSM as a whole, and thus should work for both. Yet, we also agree that profit split of anticipated profits would impose greater difficulties, despite the fact that it works out as a good solution when information is obtainable at the moment of transaction. Most of the time, the anticipated profits go along with the use of valuation techniques. This circumstance generates more complexities in the application, considering the assumptions to be made, the discounting rates to be determined, etc., which all require a high-level understanding of different disciplines as well as an accurate delineation of actual transactions to reach a reliable evaluation. Hence, we would suggest taking this point into consideration in the draft of para. 14.

### 3.3 The most appropriate method (question 6)

Para. 17 of the Discussion Draft seems to attempt differentiating the different risks assumed to clarify the notion of “sharing of economically significant risks”. However, the wording of para. 17 might potentially be confusing when stating 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 developments risk, Company A, that will bear the consequences associated with the success or failure of the intangible to be developed” (emphasis added).<sup>16</sup> It is misleading to hint that Company A and Company B both assume economically significant risks, while wind up with different pricing treatments. As a separate entity, the risk assumed by Company B is of economic significance to Company B’s business, which is associated with its sole responsibility of providing quality and quantity assured products at the request of Company A. It differentiates itself from the development risk assumed by Company A bound up with the success and failure of the whole project. In other words, Company A dominates Company B, which makes them inequivalent at the control level in the project. Hence, the following wording might avoid such misunderstanding: “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 the risk assumed by Company B is distinct from the development risk assumed by Company A and that it is Company A that will bear the consequences associated with the success or failure of the intangible to be developed.”

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<sup>16</sup> Para. 17 of the Discussion Draft.

As mentioned before, we agree with the Discussion Draft that the lack of comparables alone does not warrant the application of the PSM. In essence, the PSM is not suitable to solve the interplay between routine contributions and valuable and unique contributions, behind which there is the assumption of limited risks and economically significant risks respectively. In case the way MNEs do business departs from that of independent parties, which frequently happens (often implying that comparables are not traceable in the market), the right way to apply the arm's length principle is to find out what independent parties would hypothetically do if they were in the same situation. Apparently, the PSM does not work out in this situation as it will grant profits to the routine player way over its contribution.

### 3.4 Valuation techniques (question 7)

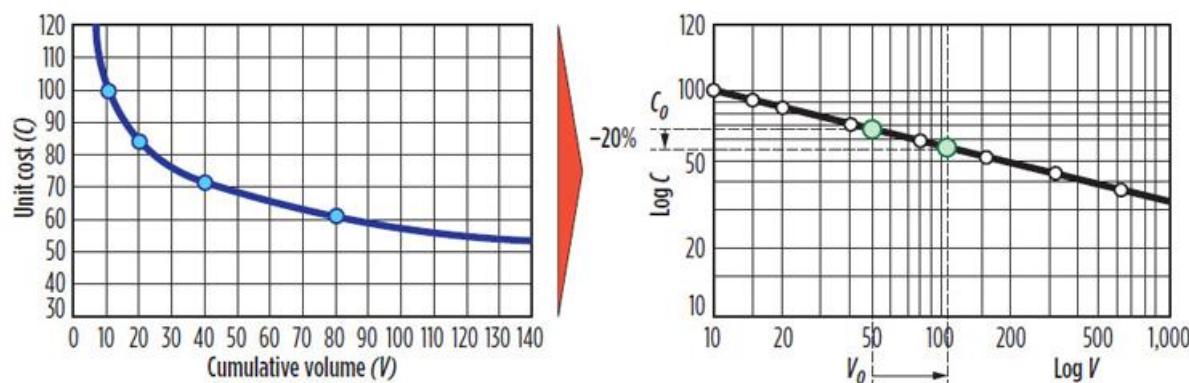
Valuation techniques are relevant elements for estimating anticipated profits. However, they might not be restricted to the discounted cash flow model discussed in Sections D.2.6.3 and D.2.6.4 of Chapter VI. Other valuation techniques might be considered and explained in detail. For example, the proper use of linear regression can also produce reliable results. With historical data available and relevant factors well considered the linear regression model is able to estimate future profitability within acceptable error range. One example is the application in procurement activities when the procurement entity acts as a supply chain company with multiple important functions and intangibles and works collaboratively with other group members with important marketing intangibles. In this case, the PSM would be presumed to be the most appropriate method to split synergetic benefits out of procurement activities. Nevertheless, the difficulty is how to evaluate the savings from such economies of scale. One effective solution is to use similar contracts, for example contracts requiring the same products from the same supplier. Among all the contractual terms, the goods volume will most probably be the most relevant factor to determine the goods price. In extreme cases, the volume gap is too large and beyond what the comparability adjustments can remedy. The linear regression model might then be a suitable approach, taking the experience curve developed by BCG founder Bruce Henderson in 1968 as an example.<sup>17</sup> The slope of an experience curve describes the percentage decrease in unit cost for a given percentage increase in cumulative volume.<sup>18</sup> The figure below illustrates an experience curve with a slope of 0.8, indicating that the unit cost falls 20% for every 100% increase in the cumulative volume.

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<sup>17</sup> Jean Le Corre et al, 'Investigating the Impact of Experience Curves on the Development of Brazil's Presalt Cluster', *bcg.perspectives* (01 September 2011). Available at: [https://www.bcgperspectives.com/content/articles/energy\\_environment\\_applying\\_experience\\_curves\\_to\\_oil\\_field\\_development/](https://www.bcgperspectives.com/content/articles/energy_environment_applying_experience_curves_to_oil_field_development/), accessed on 12 August 2016.

<sup>18</sup> *Ibid.*





Example of the experience curve<sup>19</sup>

To generate an experience curve adjusted to the case concerned, firstly one needs to collect all the existing data, namely the cumulative volume vis-à-vis the unit cost. It is undisputable that the more points one could gather, the more accurate the estimation would be. The next step is to choose the form of regression function that would best fit the relation between the unit cost and the cumulative volume. To take the above figure as an example, a linear regression on the log values is the most appropriate. In the regression, other relevant factors like exchange rates, inflation rate, geographical market and etc. are also considered as the explanatory variables to allow for the specific facts and circumstances of each case.

### 3.5 Highly integrated operations (questions 8-9)

Parallel integration and sequential integration are well-defined in this context. The PSM is more likely to apply in the parallel integration mainly because the allocation factors are of high-degree commonality. However, there might be the chance that the entities involved in the sequential integration in fact make unique and valuable contributions, and it is impossible to find comparables from independent parties. Therefore, it could be necessary to determine the profit splitting scenario also in sequential integration.

Furthermore, one flaw of the refinement of the parallel and sequential integration is that the notion overvalues "sharing", whilst bearing little relation to "economically significant risks". In other words, parallel integration can ensure that involved parties share risks of commonality, but cannot guarantee that the risks shared are economically significant. Moreover, the wording "cannot reliably be evaluated in isolation" might turn out too cryptic to identify the "**highly** integrated operations" (emphasis added).

Economically speaking, integration is a cost-saving choice for MNEs when the transaction cost in the open market is higher than the internal governance cost.<sup>20</sup> According to Oliver E. Williamson, the transaction costs are positively correlated with asset specificity, transaction uncertainty and transaction frequency, among which the first is of paramount importance.<sup>21</sup>

<sup>19</sup> *Ibid.*

<sup>20</sup> See the theory of transaction cost formulated by Nobel laureate Ronald H. Coase.

<sup>21</sup> See O.E. Williamson, *An Economic Institution of Capitalism* (1985), at 52.



In a word, the main factor driving companies to integrate rather than to contract out is asset specificity. The higher level of the asset specificity, the higher degree the integration is. So in defining the "highly integrated operation", we would suggest to adopt the concept of **"asset specificity"** as reference to allow for "economically significant risks".

### 3.6 Unique and valuable contributions (questions 10-11)

First of all, it seems that the definition of "unique and valuable contribution" is consistent with "unique and valuable intangible" defined in para. 6.17 of Chapter VI, hereby referring to concepts such as "incomparable" and "profit potential". The notion of unique and valuable contributions might overlap "sequential integration", as it has been discussed before.

The notion of unique and valuable contributions is consistent with the sharing of economically significant risks, which includes the two scenarios of "share the same economically significant risks associated with the business opportunity" and "separately assume closely related risks associated with the business opportunity and consequently should share in the resulting profits and losses".<sup>22</sup> It will never happen that a rational player will make unique and valuable contributions to a transaction without expecting to profit from the upwards of the transaction and to avoid the downwards. With the unique and valuable resources, the entity at the same time master authority and capability to make economically significant decisions regarding the business opportunity. Therefore, we firmly believe that unique and valuable contributions come with the assumption of economically significant risks.

### 3.7 Group synergies (question 12)

The Discussion Draft proposes to split the marginal or incremental system profits out of group synergies amongst the relevant associated enterprises, consistent with the pricing solutions to example 4-5 in Section D.8 of Chapter I. However, the Discussion Draft seems not to deal with the fundamental question of why the PSM cannot be applied as the most appropriate method in this case and whether the application of TP methods other than the PSM could account for the group synergies.

Based on our understanding, group synergies if defined broadly exist in every MNE and every intragroup transaction. Just like the value chain which cannot constitute itself as a reason to apply the PSM, group synergies would not do either. In terms of the passive association or implicit support, there is no doubt that they will not trigger the need of remuneration. Only when there are deliberate concerted group actions, it becomes necessary to compensate the relevant entities for their contributions to the creation of group synergies. The use of the PSM might suffice, but only on condition that the relevant entities share economically significant risks during the process of creating group synergies. Likewise, other TP methods than the PSM might also be useful in certain cases. First of all, it is arguable whether entities with market-comparable FAR profile<sup>23</sup> truly and effectively

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<sup>22</sup> Para. 16 of the Discussion Draft.

<sup>23</sup> FAR represents functions, risks and assets.

contribute to the creation of group synergies. If there are uncontrolled comparable entities in the market that can be easily taken as alternatives, or if replacing one group member with an open-market player makes little difference to the MNE, the contribution of this entity to the creation of group synergies can be deemed negligible. Furthermore, if the contribution by one entity to the creation of group synergies is not significant and effective, this entity is regarded in the same position as an independent party in the open market, the earning of which is at market level only. So in the situation when comparables are readily available, the price sought after comparables might override a profits splitting result.

### **3.8 Value chain analysis (questions 13-14)**

The value chain analysis elaborated in Section C.3.4 of the Discussion Draft serves more like a clarification that operating through a value chain is a general feature of MNEs and does not automatically enable the use of the PSM,<sup>24</sup> rather than a new requirement independent from the original functional analysis. This section is necessary and essential to avoid the abuse of the PSM. However, paras. 26 and 27 contain too many details of what a proper value chain analysis should be, and it might easily lead to the misimpression that the value chain analysis only serves for profit splitting purpose. To have a clearer and more logical structure, it is advised to keep paras. 24 and 25 unchanged in the guidance specific for the PSM, while move paras. 26 and 27 to Chapter I of the OECD TPG right after para. 1.34.

### **3.9 Guidance for the application (questions 15-18)**

The main part of Section C.4 seems to remain unchanged, apart from a material change on the different measures of profits introduced by the Discussion Draft in Section C.4.3. It is very clear as to differences resulted from the use of gross profits and operating profits.

In the application of the PSM, external joint ventures might be taken as reasonable comparables in the application of the PSM. Yet, it still remains a question in what situation third parties would choose to work together under a joint venture and whether third parties normally do profits splitting in a joint venture structure. Basically, the current Discussion Draft does not solve the problem of how to involve the third-party joint ventures properly into the benchmarking analysis and the application of the PSM.

As mentioned previously, we believe that the RACI model and the bargaining analysis are useful tools to produce reliable transfer pricing results. Specifically, they can solve problems related to scarce availability of external data, and meanwhile they can depict a well-represented picture of the MNE and the controlled transactions. It is hence suggested to take the two methods/approaches into consideration, and recognize them as equally important as the traditional means of splitting profits.

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<sup>24</sup> Paras. 24 and 25 of the Discussion Draft.

#### 4. Conclusive remarks

In general, we welcome the remarkable work OECD has done in the Discussion Draft on applying the PSM in the most appropriate manner. However, we would like to draw your attention in particular to the remarks below and we hope they can add value to the OECD's future work on the PSM.

- The new language and concepts proposed in the Discussion Draft might impose certain influence on the existing OECD TPG. It is suggested that OECD be aware of the potential inconsistencies, e.g. the hierarchy of TP methods and etc., and make corresponding alterations.
- To pursue a clearer guidance, more elaborations on the profit split of anticipated profits are expected in the Discussion Draft. Alternatively, the OECD might smooth the distinctions in Section C.1 as the two approaches theoretically should lead to similar results. In addition, the "true-up" concept could be used to define the timing for the actual profits. For the same reason, an acceptable error range could be designed to limit the resulting gap out of the two methods against manipulations.
- Apart from the discounted cash flow, the linear regression is also useful as a means of valuation techniques.
- The OECD could use "asset specificity" to highlight the level of integration as to "highly integrated business". There is certain overlap between "unique and valuable contributions" and "sequential integration" and as such the need of uncongenial profit splitting factors might arise. The OECD should take RACI model or bargaining analysis as possible approaches and provide more guidance in that respect.
- To avoid the misunderstanding that value chain analysis is exclusive for PSM, part of the value chain analysis in the Discussion Draft might be reallocated to Chapter I of the OECD TPG.

Faithfully yours,

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