William Morris
Chair, BIAC Tax Committee
13/15, Chaussée de la Muette, 75016 Paris
France

Tax Treaties, Transfer Pricing and Financial Transactions Division
Organisation for Economic Cooperation and Development
2 rue André-Pascal
75775, Paris, Cedex 16
France

Submitted by email: TransferPricing@oecd.org

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REVISED GUIDANCE ON PROFIT SPLITS

Dear Acting Chair and Members of Working Party No. 6,

Thank you for the opportunity to comment on the Discussion Draft: BEPS Action 10 – *Revised Guidance on Profit Splits* (the "Discussion Draft") issued 22 June 2017. We thank the OECD for the time and effort put into this draft.

However, while BIAC believes that the Discussion Draft does improve on certain aspects of the prior guidance, we also believe that the majority of the guidance still needs further development. In particular, it does not, unfortunately, reinforce the critical and generally accepted notion that profit splits should only be used in limited circumstances where the actual transaction under consideration is one that would be subject to a similar methodology when negotiating with unrelated parties. So, while portions of the guidance are helpful, we believe that a lack of detailed guidance may result in the transactional profit split method ("TPSM") being applied more often – and inconsistently – by countries that are still developing their respective transfer pricing administrative guidance and examination framework. It is crucial that the guidance strongly and explicitly emphasise that the TPSM is only of limited application – and is not the default method.

BIAC acknowledges the considerable attention given to this important topic but we urge the OECD to further develop this guidance, providing greater detail and more detailed examples, so that this guidance can become a tool that bolsters tax certainty and taxpayer-tax authority relationships. In particular, the term "unique and valuable" is left vague in the guidance, with the result that the term could be used to support TPSM in a much broader range of transactions than would be appropriate. The thresholds in the examples further exacerbate this risk.

With regard to the above, the process of developing guidance that is practical is helped by inclusive consultations and discussions. If it would be useful in building consensus and understanding in WP6 (and interested participating countries), BIAC would be happy to provide additional input (e.g. in-person meetings/workshops) to explain the steps involved in agreeing pricing between unrelated

The Business and Industry Advisory Committee to the OECD
Comité consultatif économique et industriel auprès de l'OCDE
13/15 Chaussée de la Muette, 75016 Paris, France
Tel. +33 (0)1 42 30 09 60 | Fax +33 (0)1 42 88 78 38
email: biac@biac.org | www.biac.org

parties in the scenarios that are considered within the scope of the profit split guidance, and the difficulties that they may face in pricing similar intra-group transactions.

Finally, we encourage WP6 to consider the impact of any proposed changes to the profit splits guidance caused by the upcoming conclusions of the OECD's follow up work on BEPS Action 1 (the tax challenges of the digital economy). At the very least, we would recommend that any profit splits guidance should remain in draft until the outcome of Action 1 workstream.

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

Sincerely,

Will Morris

Will Morris
Chair BIAC Tax Committee

The Business and Industry Advisory Committee to the OECD
Comité consultatif économique et industriel auprès de l'OCDE
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General Comments

1. BIAC believes that the arm's length principle ("ALP"), properly applied by both taxpayers and governments, still offers the best prospect of classifying transactions according to "real-world" economics, and equitably and consensually dividing income between countries based on economic activity. If this is not clearly articulated, and practical supporting guidance is not provided, then we are concerned that we will see an acceleration in a worrying trend (already apparent in the transfer pricing audit practices of numerous countries), where a broad interpretation of "BEPS principles" is used to justify new unilateral theories and automatic application of non-arm's length approaches in routine situations.

2. BIAC urges the OECD to reiterate in the Discussion Draft that the goal of this guidance is not to alter the way in which the most appropriate transfer pricing method (only one) is selected or to promote the application of the TPSM but it is simply to provide additional clarity to the application of the TPSM. BIAC believes additional language in this regard is necessary to ensure that tax administrations do not rely on the TPSM as an additional or corroborative method where the comparable uncontrolled price ("CUP") method or other traditional transfer pricing methods are the most appropriate method in assessing the arm's length nature of transactions. The underdeveloped concept of "unique and valuable" and the low threshold of requiring only closely related risks to be shared cause us the most concern in this regard.

3. BIAC welcomes the language in para 2 of the Discussion Draft that "reference to 'profits' in this section should generally be taken as applying equally to losses." However, it is critical that the inconsistent selection of transfer pricing methods is strictly refrained from so we believe that it is necessary to reinforce this point throughout the Discussion Draft. An example of such practice is, with regard to MNEs' controlled transactions, applying the TPSM to a case with combined profits for the purpose of levying taxes, while applying the Transactional Net Margin Method ("TNMM") to a case with combined losses with the impact of artificially creating profits.

Most appropriate method

4. BIAC welcomes the language in para 4 of the Discussion Draft which states that "a transactional profit split should not be automatically selected on the basis that one or more of the listed indicators applies." However, the overall message in para 4 fails to emphasize the limited circumstances in which a TPSM would be appropriate and instead implies that the TPSM could be applied with the same frequency and to the same extent as other transfer pricing methodologies. BIAC recommends that this language include reference to the limited circumstances in which application of the TPSM would be appropriate and draw a distinction between profit splitting "factors", such as integration and risk sharing, versus profit splitting "indicators", which should only be the contribution of unique and valuable intangible by both parties. There terms should not be used interchangeably.

5. The 4 July 2016 Discussion Draft included a clearer statement on the inappropriate use of the TPSM in the final sentence of paragraph 16:

   "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

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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 should be reinstated in the Discussion Draft as clear guidance to tax administrations that the absence of comparable data is not a valid reason for the use of the TPSM and that other pricing methodologies will be appropriate in most circumstances, whether or not directly comparable data on similar transactions is available.

6. Paras 6 through 9 of the Discussion Draft focus on the strengths of the TPSM. Whilst we agree that there are strengths and weaknesses, the way in which these are described gives the implication that they can be used to determine whether the TPSM is the most appropriate method. We consider this to be an inappropriate conclusion because the most appropriate method should be decided based upon the facts and circumstances of the transaction in question, not on the ease or difficulty of applying the method. This is particularly concerning because the weaknesses of the TPSM included in para 10 are considerably understated compared to the substantial detail regarding the strengths of the TPSM in paras 6 through 9.

7. More detail should be given regarding weaknesses and additional guidance provided on how these may be addressed during application. By focusing more on the strengths of the TPSM, a significant risk arises that tax administrations with limited experience in applying traditional transfer pricing methodologies will default to the TPSM in instances where it is not appropriate because they do not appreciate the significant limitations associated with the TPSM in real-life application that may make it less appropriate

8. We also believe that it should be explicitly reiterated throughout that the strengths are only strengths to the extent that they reinforce or complement the method as the most appropriate method. For example, para 6 could be updated as follows (with changes underlined):

   6. The main strength of the transactional profit split method is that it can offer ~~a solution~~ an appropriate pricing methodology for cases where both parties to a transaction make unique and valuable contributions (e.g. contribute unique and valuable intangibles) to the transaction. ~~In such a case~~ This may be most likely to be the most appropriate pricing method in such cases where independent parties might effectively share the profits of the transaction in proportion to their respective contributions, making a two-sided method more appropriate…

9. The Discussion Draft makes the point in para 11 that the infrequency of the use of the TPSM among independent enterprises should not be a factor in applying the TPSM since "transfer pricing methods are not necessarily intended to replicate arm's length behaviour, but rather to serve as a means of establishing and/or verifying arm's length outcomes for controlled transactions." BIAC strongly disagrees with any language that implies a disregard for the ALP and believes that the 'most appropriate method' approach, under the ALP should be preserved, and that the profit split should not be automatically applied in situations where one-sided methods can provide a reliable result. This apparent limitation on the application of the ALP should be removed.

10. BIAC welcomes the language in para 14 which states that a "lack of information on closely comparable, uncontrolled transactions which would otherwise be used to benchmark an arm's

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length return for the party performing the simple functions should not *per se* lead to a conclusion that the transactional profit split is the most appropriate method." However, BIAC would strongly encourage the OECD to simplify this language to be consistent with the more concise language in para 28 which states that "a lack of comparables alone is insufficient to warrant the use of a transactional profit split." The additional qualifications and caveats in the language in para 14 implies that there will be instances where the lack of comparables alone would justify the application of the TPSM.

11. The Discussion Draft notes in para 25 (and implies in paras 13 and 14) that the TPSM may be the most appropriate method "where, according to the accurately delineated transaction, each party to the controlled transaction shares the assumption of one or more of the economically significant risks in relation to the transaction." BIAC suggests that "sharing of a control function with regard to economically significant risks" may better define situations where profit splitting is the most appropriate method. Constituent entities of a MNE group share business outcomes to some degree, but sharing business outcomes does not always mean sharing economically significant risks. Our concern is that tax authorities will first look at business outcomes and then determine that there is sharing of economically significant risks, without looking at how that risk is managed.

12. We strongly believe that while risk sharing is a necessary precondition to the use of the TPSM, sharing of risks alone is not enough to justify its application[1]. This should be made explicit. The existence of risk does not mean that third party comparables are not available (in fact, there are risks to both parties in many transactions which are either managed or accepted) and in most cases risks can be priced more accurately by looking to these comparables. The only exception is where the risks relate to unique and valuable contributions (of non-routine intangibles), because only under these scenarios are third party comparables likely to not exist and it is appropriate therefore that this should rather be used as the main indicator of when the TPSM is likely to be the most appropriate method. Paras 13 and 25 - 27 in particular should be amended to reflect this point.

13. Further, we see a distinction between "shared" risks and "closely related" risks. We consider the latter to be an inappropriate basis for a TPSM to be applied. We also question whether this is in line with Chapter 1 of the OECD Transfer Pricing Guidelines ("TPG") (which respects appropriately delineated transactions) and would welcome further guidance on their interaction.

14. Similarly, para 24 of the Discussion Draft refers to control and assumption of risk and makes a reference to paragraph 1.105 of the TPG, but to be consistent with the 6 step process recommended in Chapter 1 of the TPG, this cross reference should be expanded to paragraphs 1.72 through to 1.106, to ensure that this is not taken out of context.

[1] In many cases, risk can actually be addressed as a comparability factor through appropriate adjustments to one-sided methods (and if it would not materially impact the pricing of the transaction then would generally not be considered further).

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Unique and valuable

15. Para 13 notes that "[t]he existence of unique and valuable contributions by each party to the controlled transaction is perhaps the clearest indicator that a transactional profit split may be appropriate." The phrases "unique and valuable contributions" and "unique and valuable intangibles" are used throughout the Discussion Draft with considerable importance so BIAC would urge the OECD to provide greater clarification as to the meaning of these phrases beyond the limited definition included in para 6.17 of the TPG to avoid inconsistent interpretation that may result from the references and descriptions used for this phrase within the Discussion Draft.

16. For instance, para 16 defines contributions that are "unique and valuable" as those cases where the contributions are not comparable to contributions made by uncontrolled parties in comparable circumstances and their use in business operations represents a key source of actual or potential economic benefits. However, the contributions detailed in the examples seem to imply a lower threshold, which is not appropriate. More detail in para 16, and a broader range of more detailed examples would be very useful in assisting taxpayers determining whether something is "unique and valuable".

17. Example 9 (for example) gives the impression that a TPSM could be commonly used in relation to groups operating in the fashion or luxury goods sectors, as well as for groups owning very valuable trademarks. In fact, when groups owning valuable trademarks are in their development phase and/or enter new markets, they will often use local independent business partners (such as retailers, franchisees, wholesalers, agents). This means that, in general, independent comparables are likely to exist and will often represent a more reliable reference to set transfer prices in case a local subsidiary plays a similar role (with appropriate comparability adjustments, if needed). In a more mature and successful phase, such groups will tend to expand their control to the retail chain, operating more often with subsidiaries. However, in such phases the control of the retail chain will typically imply centralised business models, leaving very limited autonomy to local subsidiaries, notably in order to ensure that travelling customers will meet similar shopping experiences across the world.

18. Additionally, it is important not to confuse "making of unique and valuable contributions by both parties to a transaction" with making of unique and valuable contributions by both the parties at different stages of the value chain. For example, intangibles at the manufacturing and marketing stages of a supply chain are distinct and, in a scenario where different parties contributed an intangible at each stage, there is not necessarily the same integration of risks that would indicate that the TPSM could be appropriate.

19. Clarification of this important phrase and expansion of the facts and circumstances surrounding the supporting examples will be necessary to ensure this guidance is applied consistently by tax administrations. The method is difficult enough to apply on an *ex post* basis, and to accurately create the requisite books and records several years after the transaction has completed will be impossible in many instances. It is therefore imperative that a clear definition is included that makes it less subjective when the method is appropriate. In many respects, this is more important than the certainty over the detailed calculations. Sufficiently detailed examples would also assist in this regard. We have included an example in Appendix B that we believe includes the requisite detail and reasoning to determine why the profit split is the most appropriate

The Business and Industry Advisory Committee to the OECD
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email: biac@biac.org | www.biac.org

method, and for what elements of the transaction. Similarly detailed examples should be drawn to demonstrate the different features that would lead to a conclusion that profit split is not the most appropriate method.

Application

20. BIAC believes that the guidance should be updated to make explicit that the TPSM only applies to those residual profits over and above compensation for routine functions. Additional detail in this area would be very useful, but the guidance must also incorporate an appropriate amount of flexibility; a formula for profit splitting which is too prescriptive is unlikely to be economically justifiable in a broad range of circumstances to which it could apply. In its current form, the guidance in this area creates a great deal of uncertainty for taxpayers and tax authorities, as it is neither detailed enough to be easily applied nor flexible enough to be appropriately interpreted.

21. The Discussion Draft uses "operating profit" as a concept throughout, but this term is not defined in the 2017 TPG glossary. It would be helpful to include a definition, either in this draft or in the glossary of the TPG.

22. Para 1 of the Draft specifies that the method should first identify the "relevant profits". Para 35 notes only that these are "the total profits from the controlled transactions under examination". It should be specified more clearly that only profits arising from the transaction(s) between the related parties to which the TPSM is applied can be included, and not any other controlled transactions between the parties, or elements of the controlled transactions under investigation for which the TPSM is not the most appropriate method. While the language in paras 39 and 40 captures this message generally, we would welcome additional detail and a reinforcement of this important point throughout the Discussion Draft.

23. BIAC continues to believe that a great deal more detail is required regarding period to period adjustments. It is simply not realistic for unrelated parties to agree to prices (profits being split or otherwise) that do not change over the lifetime of a business relationship and/or piece of intellectual property. It is equally unrealistic for unrelated parties to agree for retrospective or frequent changes in their remuneration/returns. Thresholds and set points in time would generally be included to trigger such renegotiations, in order to give certainty over a period of time and to protect both parties to the transaction. This same logic could be used to ensure that taxpayers and tax authorities are appropriately protected. In order to allow taxpayers to follow the arm's length principle, guidance on how to deal with situations where profits are accrued on an ongoing basis is essential.

Splitting the profits

24. BIAC believes the Discussion Draft is quite helpful in highlighting the extreme instances where the transactional profit split of actual profits would be appropriate. However, the guidance also provides fairly limited circumstances where profits splits based on anticipated profits would be appropriate. While the overall application of the TPSM should be considerably limited, within that application it should be clear to tax authorities under which circumstances the TPSM should be applied to anticipated profits versus actual profits and flexibility should awarded for the application of the TPSM to one or the other. To this point, BIAC would recommend including additional examples and/or further guidance which support the application of profit splits based

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on anticipated profits as well as actual profits in the limited circumstances where the TPSM is considered to be the most appropriate method and also where *ex post* adjustments to the *ex ante* pricing are made based on actual results.

25. BIAC continues to believe that there is not enough clarity regarding how the anticipated profit split differs from a conventional CUP royalty analysis. Similar third party scenarios could even include adjustment clauses based on performance or milestone payments which result in a much closer outcome over time to a TPSM based on actual profits. We would welcome confirmation about the factors which should be taken into account in making the determination of which method to apply, and how this may change over time.

Administration burden

26. It would be appropriate for the guidance to emphasise that, where the taxpayer does not use a TPSM, there are likely to be very considerable difficulties in creating, after the event, the level of detailed analysis that would be required to support or quantify the outcome of a TPSM. Tax administrations should be advised that the circumstances in which a tax administration could estimate with a reasonable degree of accuracy the outcome of a TPSM, or require that a taxpayer should undertake the very significant work required to perform a reasonably accurate TPSM, are likely to be very limited.

27. Paragraph 46 contains some confirmation that the method must be applied on the basis of information known or reasonably foreseeable at the time the transactions were entered into and that the method of calculation should be based on written contracts documenting the intentions of the parties, and should not generally be varied over the lifetime of the agreement. The implications of this guidance for any tax administration proposal to assert the TPSM after the event should be highlighted.

Examples

28. Although we understand that there is not a model answer to transfer pricing problems, as each situation is unique and solutions must be based on the facts, we were hoping that there would be some directional quantified examples included in the Discussion Draft. We ask that some numerical examples are included in the final report. Such examples should include an explanation on how the gross and actual profits should be split, taking into account, for example, how Selling, General and Administrative expenses should be apportioned in the calculation.

29. It is not clear why in some examples (e.g. 1, 2 and 5) the TPSM is considered the most appropriate method as it appears that other pricing methodologies could be used so the Discussion Draft must explain the analysis used to reach such a conclusion.

30. It would be helpful for the examples to include a discussion of whether a split of anticipated or actual profits should be used (examples 1, 2, 3 5 and 7).

31. Examples 4 and 6 both conclude that TPSM is not the most appropriate method, but the conclusions are differently worded "..the profit split method may not be the most appropriate method…" compared with "..the profit split method is unlikely to be the most appropriate method". It is not clear from the examples why the strength of the conclusion is different. BIAC

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strongly recommends the consistent use of a clear statement that the profit split method is not the most appropriate method in these instances.

32. In example 10, it is not clear why, based on the information provided in the example, that an asset-based profit splitting factor is appropriate and the proviso "that the functional analysis concludes that there is a strong correlation between the assets of Company A and Company B and the creation of value.." would be better shown as a fact in an earlier paragraph, so that the conclusion is based on the presented facts, not an assumption.

33. We have stated throughout this response that we believe that more comprehensive examples are required. We believe specifically that more guidance is required regarding the definition of "unique and valuable". If a definition cannot be found that can be applied easily and with certainty, it is critical that the examples give enough detail to determine how the test is to be applied in determining the most appropriate method. We have included an example in Appendix B that we believe includes the requisite detail and reasoning to determine why the profit split is the most appropriate method, and for what elements of the transaction. Similarly detailed examples should be drawn to demonstrate the different features that would lead to a conclusion that profit split is not the most appropriate method.

34. We also believe that numerical examples would be helpful to assist in understanding *how* the method should be applied once it has been decided that it is the most appropriate method. In order to assist the OECD, we have developed some numerical examples in Appendix A that demonstrate the potential impact of applying an interpretation of the Discussion Draft under various conditions. We hope that the comparison of these outcomes with each other (and other non-TPSM pricing methods) is instructive and can be used to build consensus within WP6 on the appropriateness of the outcomes (either through endorsement or clarification in the final guidance).

Responses to Specific Questions

1. **The discussion draft addresses situations in which profit splits of anticipated profits or profit splits of actual profits are appropriate. Where it is established that the transactional profit split is the most appropriate method, please comment on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used.**

BIAC interprets "profit split of actual profits" as implying the use of an actual profit measure which has deducted more than just marginal transaction costs. We believe that form of actual profit split approach will only be appropriate in narrowly defined circumstances within the already limited application of the TPSM as the most appropriate method in independent and related party transactions. In contrast an approach which shares actual results with respect to a readily available marginal profit measure (or with respect to revenues where marginal costs are either small or not likely to produce distortion), based on consideration of appropriate contribution factors and the anticipated net profits of the parties, is appropriate in much more extensive circumstances within the limited application of the TPSM. BIAC believes that approach would mirror the approach which would be expected to be taken in comparable arms-length circumstances.

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Similar to the analysis provided in Example 9 of the Discussion Draft, BIAC believes that in the limited circumstances where the TPSM is the most appropriate method, profit splits based on anticipated profits are likely more appropriate where parties make distinct contributions (e.g., with respect to trademarks) and one party would not be able to generate profit without the other's contributions.

The guidance already notes at para 43 that the basis of a TPSM should be the accurately delineated transaction, based on written contracts (para 46). Whether the TPSM should be based on anticipated or actual profits will therefore depend on the nature of the relationship between the parties and the investment or contribution that each makes. Where unique and valuable contributions are made and one party could not realise profit without the other, anticipated profits may be appropriate (as suggested in para 45). It does not, however, follow that where the business operations are highly integrated or each party makes unique and valuable contributions, that actual profits should be used. Para 44 posits a scenario where business risks are shared and concludes that actual profits should be used in computing the split of profit. This may be appropriate where the relationship between the parties is close to a joint venture or partnership, but it should not be concluded that in all cases where there is some sharing of risk that actual profits should be used.

2. A number of profit splitting factors are addressed in the discussion draft.

Generally, the profit splitting factors should be identified as those which are most appropriate to the accurately delineated transaction. However, we would welcome examples of what these may be and suggest the following points could be used to refine and guide the application of examples.

Comments are particularly invited on:

a. Whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained, and if so, what factors need to be taken into account for its selection and application as a reliable profit splitting factor.

Reference to capital or capital employed as a potential profit splitting factor should be retained as this is an important factor for use with regard not only to financial services but also other capital-intensive industries, given the role of capital and that capital is in itself a risk. Some of the factors to take into account prior to selecting capital / capital employed are:

- Whether the entities involved perform valuable functions with respect to the transaction;
- Importance of capital contributions / investment to the transaction, with reference to comparable third party transactions; and
- Whether capital / capital employed can be used reliably as a profit splitting factor without adjustments, or where adjustments are necessary, whether the adjustments can be performed reliably to yield reasonable results.

b. Should headcount of similarly skilled and competent employees be included as a potential profit splitting factor, and if so, in what circumstances would it be relevant?

Headcount could be a suitable factor, in limited circumstances, but would need to be used with care. It would not be appropriate to use headcount as a proxy for the relative value of research and development or the development of marketing intangibles or market share, for

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email: biac@biac.org | www.biac.org

example. In the limited circumstances in which headcount could be used as a profit splitting factor, consideration should be given to applying weighting factors to headcount, and these weightings will often not be the same as payroll/employment costs.

c. Given the existing guidance in Chapters I and IX of the Transfer Pricing Guidelines, should adjustments for purchasing power parity be made for profit splitting factor amounts, and if so, in what circumstances?

Purchasing Power Parity ("PPP") is an economic concept that compares different countries' currencies through a market "basket of goods" approach. Under PPP, two currencies are in equilibrium or at par when a market basket of goods is priced identically in both countries after exchange rates are computed. As such, it is an alternative to exchange rates and should not be used for determining profit splitting factors. Calculating PPP is complex and unreliable given the challenges with data reliability. Additionally, the use of PPP as a profit split factor would also necessitate the use of PPP for all costs and revenues associated with the transaction, a major change in global accounting and tax standards. Lastly, we note that the references to "purchasing power" in the TPG are particularly broad and not meant for a specific calculation such as profit splitting factors.

d. What other profit splitting factors should be included in the guidance, and in what circumstances?

The Guidance should include profit splitting factors that drive the economics of the business / transaction. For example, the use of multifactor keys which are weighted to the economic reality of the transaction could produce results that are more in line with the arm's length principle.

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Appendix A – Numerical Examples and associated concerns

Background, assumptions, and methodology

Despite the concerns noted in the body of this letter (paras 19 and 38, in particular) regarding Example 9 of the Discussion Draft, it has the unique feature of comparing a scenario of split of anticipated profits with a scenario of split of actual profits. For this reason it has been chosen as reference to develop a numerical example to illustrate some concerns, uncertainties, and implications of the TPSM as described in the Discussion Draft.

Profit split models tend to be very complicated. We have tried to simplify the example as much as possible in order to make it understandable, whilst preserving the key elements. The tables below illustrate five cases which help identifying issues and concerns.

- Base case: represents the reference simplified P&L and profit split model (in case of anticipated profits split, this should be intended as showing data related to an "appropriate period"; details about how to bring values to the same time-reference are omitted for simplification purposes). The Base case results, based on anticipated profits, imply a transfer price from Company A to Company B of 120 (lump sum) or 12% of anticipated revenue (royalty).
- Case 1: illustrates a lump sum payment approach as mentioned in Scenario 1 of Example 9 in the Discussion Draft. In this case the lump sum amount remains fixed at 120.
- Case 2: illustrates a sales-based royalty approach as mentioned in Scenario 1 of Example 9 in the Discussion Draft. In this case the transfer price is represented by a 12% royalty calculated on actual sales.
- Case 3: illustrates the case of actual profits split. In this case the transfer price can be either a lump sum or a royalty, adjusted ex-post on the basis of actual results in order to ensure a 50/50 split of actual profits.
- Case 4: is similar to Case 2 and illustrates the fact that, in this example, if the proportions of costs and expenses remain stable, using a sales-based royalty brings the method based on anticipated profits and the method based on actual profits to coincide.

Each case is presented in two alternative models:

- "Positive model", illustrating each case in a situation where actual sales were higher than anticipated.
- "Negative model", illustrating each case in a situation where actual sales were lower than anticipated.

Anticipated vs Actual Profit Split

Each line of the model is briefly described here below:

- A. Revenue: represents the (actual sales) customer revenue of Company B; the "positive model" assumes actual revenue to be 30% higher than anticipated; the "negative model" assumes actual revenue to be 30% lower than anticipated.
- B. Other items: represents all "routine" costs and expenses, including routine profits; the average amount is assumed to decrease/increase of 3 percentage points in the two models, due to the lower/higher average impact of fixed costs and expenses.

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Tel. +33 (0)1 42 30 09 60 | Fax +33 (0)1 42 88 78 38
email: biac@biac.org | www.biac.org

- C. Expenses of Company A: represents the "residual driving" expenses of Company A; the average amount is assumed to decrease/increase of 1 percentage point in the two models, due to the lower/higher average impact of fixed expenses. It should be noted that Company A's contribution is assumed to be the sum of the initial value of the trademark and associated goodwill and know how (which doesn't appear on the P&L), plus Company A's recurring expenses to maintain/enhance/protect/etc. such intangibles.
- D. Expenses of Company B: represents the "residual driving" expenses of Company B; the average amount is assumed to decrease/increase of 2 percentage points in the two models, due to the lower/higher average impact of fixed expenses.
- E. Residual profit: A – B – C – D
- F. and G.: (for simplification purposes) it is assumed that the profit split calculations will drive a split of residual profits in a proportion of 50/50 between Company A and Company B. Lines F. and G. illustrate the actual results occurring in the various cases.

POSITIVE MODEL	Base	Case 1	Case 2	Case 3	Case 4
A. Revenue	1000	1300	1300	1300	1300
B. Other items	680	845	845	845	884
Other items %	*68%*	*65%*	*65%*	*65%*	*68%*
C. Expenses of Company A	70	78	78	78	91
Expenses of Company A %	*7%*	*6%*	*6%*	*6%*	*7%*
D. Expenses of Company B	150	169	169	169	195
Expenses of Company B %	*15%*	*13%*	*13%*	*13%*	*15%*
E. Residual profit	100	208	208	208	130
F. Residual profit Company A	50	42	78	104	65
G. Residual profit Company B	50	166	130	104	65
Lump sum or Royalty	120	120	156	182	156
Royalty %	*12.0%*		*12.0%*	*14.0%*	*12.0%*

NEGATIVE MODEL	Base	Case 1	Case 2	Case 3	Case 4
A. Revenue	1000	700	700	700	700
B. Other items	680	497	497	497	476
Other items %	*68%*	*71%*	*71%*	*71%*	*68%*
C. Expenses of Company A	70	56	56	56	49
Expenses of Company A %	*7%*	*8%*	*8%*	*8%*	*7%*
D. Expenses of Company B	150	119	119	119	105
Expenses of Company B %	*15%*	*17%*	*17%*	*17%*	*15%*
E. Residual profit	100	28	28	28	70
F. Residual profit Company A	50	64	28	14	35
G. Residual profit Company B	50	-36	0	14	35
Lump sum or Royalty	120	120	84	70	84
Royalty %	*12.0%*		*12.0%*	*10.0%*	*12.0%*

The Business and Industry Advisory Committee to the OECD
Comité consultatif économique et industriel auprès de l'OCDE
13/15 Chaussée de la Muette, 75016 Paris, France
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email: biac@biac.org | www.biac.org

Scenario 1 of the Discussion Draft

The Discussion Draft states that the payment for the transaction may take a variety of forms, including a lump sum payment to Company A or a sales-based royalty. Both appear to be perfectly arm's length options, in appropriate circumstances. However, the wording of the Discussion Draft could be interpreted as considering the two options as equally applicable to a same situation. The analysis in this example highlights some concerns and drives some conclusions:

- Case 1 above illustrates the lump sum option. Company A will receive a fixed amount of 120 and this will not change. The examples above show that in case of better results for the group (positive model), Company A is expected to be penalized by additional variable costs driven by higher volumes, while its lump sum reward will not change. The opposite will occur in the negative model.
  In the "positive model", if Country A's tax authorities interpret the OECD guidance as indifferently allowing the option of a sales-based royalty, they are likely to challenge Company A's results by asserting that a sales-based royalty approach should have been applied, instead of a lump sum (bringing Company A to the much healthier results of Case 2). In the "negative model", the opposite is likely to occur, i.e. Country B's tax authorities could challenge Company B's results with similar arguments.
- Case 2 and Case 4 highlight a different type of concern: as long as actual revenue differs from anticipated revenue, a sales-based royalty will drive Company A to get some share of the (higher or lower) actual profits. (Case 4 shows the extreme case where the stability of proportions of costs and expenses brings the method based on anticipated profits and the method based on actual profits to coincide).
  The concern is opposite to the that of Case 1: In the "negative model", if Country A's tax authorities interpret the OECD guidance as indifferently allowing the option of a lump sum, they are likely to challenge Company A's results by asserting that a lump sum approach should have been applied instead of a sales based royalty (bringing Company A to the much healthier results of case 1). In the "positive model", the opposite is likely to occur, i.e. Country B's tax authorities could challenge Company B's results with similar arguments.
- One additional concern is represented by the fact that a literal interpretation of the concept of "anticipated profits" could lead Country A's tax authorities to assert that that Company should get an amount of profit equal to 50 in any case, and therefore challenge the results of the "positive model" in Case 1 or challenge the results of the "negative model" in Case 2.

Scenario 2 of the Discussion Draft

Scenario 2 describes circumstances under which the transactional profit split method applies on actual profits. The main concern in relation to actual profits is related to the fact that the wording in the Discussion Draft seems to impose retrospective adjustments. This seems to exclude the possibility that adjustments to actual results will be built into the next period's price setting. In our experience, a prospective approach is more likely to represent an arm's length outcome (also considering the significant operational difficulties of retrospective adjustments).

In addition, also due to the self-adjusting nature of a sales-based royalty (i.e. the fact that it

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13/15 Chaussée de la Muette, 75016 Paris, France
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email: biac@biac.org | www.biac.org

automatically reflects an impact of actual profits), royalty agreements between independent parties are more likely to establish fixed royalty rates for a period of at least few years, rather than imposing year-end adjustments to actual results, and are consistent with the desired outcomes.

TNMM Scenario

The figures developed in our example can also be used to simulate another scenario, under which the taxpayer or one of the tax authorities could reach the conclusion that the best method should be one based on independent comparables' results (with comparability adjustments, if needed), e.g. using the transactional net margin method (TNMM). This scenario is intended to demonstrate the considerable differences that will result without additional clarity as to the application of the TNMM versus the TPSM.

In this "TNMM" scenario, we compare the results of the "positive model" and "negative model" to a model under which Company B is rewarded using the TNMM method and the return on sales (ROS) is chosen as profit indicator.

In order to develop the TNMM scenario, we make two additional assumptions:

- In the profit spilt scenario, on top of its residual profit (or loss), Company B is also entitled to a routine profit of 10 in all cases; this amount is assumed to be included in line "B. Other items" in the above tables (for simplification purposes, this amount is kept fixed in all cases).
- In the TNMM scenario, Company B receives a 4% return on sales (ROS).

Using these assumptions, the profits of Company B will be the following:

POSITIVE MODEL	Base	Case 1	Case 2	Case 3	Case 4
Profit split scenario					
Residual profit Company B	50	166	130	104	65
Routine profit Company B	10	10	10	10	10
Total profit Company B	60	176	140	114	75
TNMM scenario					
4% ROS Company B	40	52	52	52	52

NEGATIVE MODEL	Base	Case 1	Case 2	Case 3	Case 4
Profit split scenario					
Residual profit Company B	50	-36	0	14	35
Routine profit Company B	10	10	10	10	10
Total profit Company B	60	-26	10	24	45
TNMM scenario					
4% ROS Company B	40	28	28	28	28

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The positive model is apparently very favorable to Company B if the profit split method is chosen, in particular in the case of split of anticipated profits (Case 1 and Case 2[2]). However, the wide gap vs. the TNMM approach is likely to generate disputes. In fact, County A's tax authorities are more likely to react to a large disproportion of profit allocation, in particular in the case of split of anticipated profits which appears to be particularly unfit to reflect the reality of centralized business models as those common within the fashion industry.

More generally, in the "positive model" Country A's tax authorities are likely to challenge all cases where the TNMM appears to be reasonably applicable. For example, in the scenario described by Examples 3 and 4 of the Discussion Draft, there may be situations where strong facts support the choice of profit split or TNMM, but there may also be many cases where the situation is much more uncertain and diverging interpretations have both a certain degree of justification.

The negative model shows that the profit split scenario may be particularly negative for Company B if profit split is adopted instead of TNMM, in particular in the case of split of anticipated profits (Case 1 and Case 2). We fear that the likelihood of occurrence of negative scenarios may be underestimated on the basis of an optimistic view that (for tax authorities) profit split generally means more taxable income. On the contrary, downturns and crisis periods may affect any group and sector, at some point. As shown in the example, in Case 1 of the negative scenario Company B faces significant losses.

[2] Case 4 is also based on anticipated profits, but must be considered a theoretical, testing case, based on the unlikely assumption that all costs and expenses will be variable and remain in the same proportion to revenue.

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Appendix B – Detailed Examples to assist in delineating the factors appropriate to determine profit split as the most appropriate method

As noted in the body of this letter (and in particular in paras 21 and 37), we believe that understanding of the definition of "unique and valuable" could be enhanced by providing more details around the facts and circumstances under which it is expected to apply. We believe that the following examples include the requisite detail and reasoning to determine why the profit split is the most appropriate method, and for what elements of the transaction. Similarly detailed examples should be drawn to demonstrate the different features that would lead to a conclusion that profit split is not the most appropriate method.

Example 1

Company A is the parent company of an MNE group which has owned and invested in a trademark for many years, and has always controlled the DEMPE functions related to that trademark. Company A has entered into a contract with Company S, a subsidiary company, according to which it licenses the use of the trademark to manufacture and sell products bearing the trademark in the territory of country S. The contract stipulates a royalty to be paid by Company S to Company A, which is based on a CUP benchmark.

Company S exploits the licensed right to the trademark in the territory by manufacturing and selling the product in the territory. Company S conducts all local marketing activities with regard to selling products bearing the trademark, and incurs substantial advertising and promotion costs to generate and increase sales of products bearing the trademark in the territory. None of the activities performed by Company S are related to Company A licensing the trademark to companies in other territories.

Under these circumstances, CUP is the most appropriate method to determine the level of royalties to be paid by Company S to Company A. Functional analysis of the transaction indicates that in this transaction Company A makes no other contribution to the profits of Company S other than the provision of the trademark, and therefore a split of the profit made by Company S would be inappropriate. The transactional profit split method is therefore not the most appropriate method.

Example 2

Company A is the parent company of an MNE group which carries out significant and continuous R&D innovation and improvement programs through various R&D centres set up in subsidiaries across countries. It therefore owns substantial technical know-how with regard to the technologies that goes into products/brands it owns. It always controlled the DEMPE functions related to development/generation of such technical know-how and recovers royalties from MNE group company for use of such technical know-how.

Company A has entered into a contract with Company S, a subsidiary company, to provide contract R&D service on the specific areas assigned by Company A. Company S performs its research activities within the overall guidance and framework laid down by Company A. Further, the allocation of resources, budget, timelines, etc. in respect of the research activities are approved by Company A. Company S does not bear any responsibility or liability on account of failure of the research which it

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performs and is merely entitled to a fixed return on its cost irrespective of the outcome of the research. The contract stipulates a Cost plus mark up to be paid by Company A to Company S.

Company S does not own any intangibles in the form of patents or technical know-how. The results of the research carried out by Company S are assigned to Company A or any other operating company within the MNE Group as nominated by Company A for further development and other application in any of the products.

Under these circumstances, cost plus method ('CPM') which evaluates the arm's length nature of a controlled transaction by reference to the gross profit mark-up basis similarity FAR assumed by the controlled and uncontrolled parties can be an appropriate method however, in reality CPM cannot be used as difference between direct and indirect cost attributable to providing services cannot be determined therefore the CPM starts to approach a net margin rather than gross margin, thus falling within the definition of the Transactional Net Margin Method ('TNMM').

One strength of the TNMM is that net profit indicators (e.g. return on assets, operating income to sales, and possibly other measures of net profit) are less affected by transactional differences than is the case with price, as used in the CUP Method. Net profit indicators also may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins. Differences in the functions performed between enterprises are often reflected in variations in operating expenses. Consequently, enterprises may have a wide range of gross profit margins but still earn broadly similar levels of net operating profit indicators. Accordingly TNMM is considered as the most appropriate method for determining the arm's length operating results for the provision of contract R&D services of Company S. In any event application of transactional profit split method whereby the royalty recovered by Company A is split between Country A and Country S would not be appropriate given the FAR analysis wherein all risks are assumed by Company A.

Example 3

Company X sets strategies and monitors performance in the supply chain and brand marketing processes for the MNE group. It is also responsible for key decision in supply chain as well as brand marketing including brand strategies, planning, development, communication, and product innovation. Further, it holds the licence to use trademarks to manufacture and sell products bearing the trademarks in various territories.

Company X has entered into a distribution contract with Company B, a related company, under which Company B is a distributor of Company X's products to customers. Company B(I am not sure of the antecedent here – I think it is B, but you should clarify) is responsible for developing customer relationships, executing marketing plans and managing product promotions with customers to maximise sales in its territory. Company X provides a royalty-free license to Company B for the use of the trademarks to sell its products in the territory.

Company B only activates marketing plans developed and/or provided by Company X and incurs third party advertising and promotion costs in activating those plans. Company X bears the marketing costs relating to creation of marketing assets such as advertisement production. The marketing team involved in brand development, planning and communication are employed by Company X.

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The marketing costs incurred by Company B can be high and fluctuate because they relate to third party media buying costs e.g. purchasing space or time slots in various media channels. Company X's costs are relatively stable because a significant proportion relates to personnel costs of the marketing teams. Notwithstanding the level of marketing spend, valuable intangibles are created from the brand development and product innovation activities in Company X. Hence, marketing spend should not be used as the sole indicator of the existence of valuable marketing intangibles.

In these circumstances, the TNMM method is the most appropriate method to determine the pricing of products from Company X to Company B under the distribution contract. The functions performed by Company B are less complex than those performed by Company X, and Company B does not own or create any valuable intangibles in its overall distribution operations. Hence, transactional profit split method is not an appropriate method to apply.

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