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February 6, 2015

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

Dear Andrew,

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

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

So, elements of the proposed guidance in currently unclear areas such as risk or commodity transactions are greatly to be welcomed – but such guidance should build upon established concepts rather than upon new ones (such as, for example, "moral hazard"). Likewise, profit splits may well be appropriate in certain difficult cases – but the default position, nevertheless, should be application of the arm's length standard, with profit splits only being applied where the default position cannot be. Recharacterisation, or "special measures", which recast a contract or other legal arrangements from the form agreed by the parties into a new and different form, may be justified in egregious cases – but only when other alternatives, most particularly, the proper application of intercompany pricing principles, have been tried and failed. While it may sometimes be more time-consuming to run through a full functional analysis, than to move swiftly to a recharacterisation, such a functional analysis (the elements of which are broadly agreed and widely understood) not only provides more commercial certainty for taxpayers, but also benefits

governments because there will be fewer instances of double taxation as different countries seek to apply different rules with no commonly-agreed standards.

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

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

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

Sincerely,



Will Morris
Chair
BIAC Tax Committee

INTRODUCTION

1. **BIAC believes that the ‘most appropriate method’ approach, under the arm’s length principle (“ALP”) should be preserved**, and that the profit split should not be automatically applied in situations where one-sided methods can provide a reliable result. **We believe that the profit split approach should also not be seen as necessary to “corroborate” other arm’s length methods of pricing.**
2. **BIAC also believes that the splitting of residual (profits or losses) vs. a global profit split approach represents a more appropriate framework**, because it takes into account one-sided methods to price routine or ‘benchmarkable’ transactions before residual profit or losses are split between unique contributions.
3. Although we recognize that the diversity of the non-financial sector renders the exercise more complex, **BIAC would welcome a similar approach to the guidelines the OECD has issued for financial institutions, as it would clearly draw the line between the concepts of residual profit split, profit splits and formulary apportionment.**
4. This document is organized in four sections:
 - i. An introductory discussion about the conceptual framework in relation to Global Value Chains (“GVCs”);
 - ii. Comments on the conceptual background of the Transactional Profit Split (“TPS”) Method;
 - iii. A summary of responses from BIAC members to a BEPS Transfer Pricing questionnaire conducted in late 2014; and
 - iv. Specific comments in relation to questions included in the Discussion Draft.

GLOBAL VALUE CHAINS

5. When businesses implement profit splits, a “residual profit split approach” is preferred, whereby group companies first define and delineate routine functions and an appropriate return for such functions, and then allocate the residual profit to group companies based on a functional analysis. This approach has been used by financial institutions for many years.
6. In the case of financial institutions, the OECD has developed articulated guidelines, and we understand that work has provided financial institutions with some guidance on how to apply the profit split method within group companies.
7. Although we recognize that the diversity of the non-financial sector renders the exercise more complex, BIAC would welcome a similar approach to provide guidance beyond the financial services sector, as it would clearly draw the line between residual profit split approaches, profit splits and formulary apportionment.
8. BIAC observes that the global economy is characterized by a growing number of players, interacting in an increasing number of ways, resulting in complex networks and relationships that create value in different ways. These complex interactions result in a huge spectrum of fact patterns across Multinational Enterprises (“MNEs”), where products are made, services are provided, and intellectual property is created.

9. These networks and relationships create opportunities for MNEs to structure their value chains in new and innovative ways. As a result, greater choice is afforded between assigning (or outsourcing) activities to related or unrelated parties.
10. We observe that MNEs no longer only outsource back-office tasks, and that strategic core tasks within the value chain may also be outsourced such as R&D and production activities. For example, an MNE may sell ICT products where production may (partially or entirely) be outsourced to a third party contract manufacturer. This can be the case, even where the MNE's reputation and commercial success are significantly dependent on the quality of its products.
11. BIAC is concerned that the OECD appears to be focusing its analysis of transfer pricing in relation to GVCs on the basis of a paradigm where all MNEs operate as a single economic entity on a fully integrated basis. Although this may be true for some MNEs, it is not the case for all. In this regard, we believe that principles and rules should be developed in such a way that they are capable of flexible application to a wide range of business fact patterns through further practical guidance. This approach would reflect the increasing diversity and flexibility of business models that we see in our global economy, taking into account the fact patterns that are underpinned by legal agreements and the conduct of the parties. BIAC believes that each case should be analyzed on its own merits, and on the basis of commonly applicable principles. This would allow revised guidelines to be adapted to a rapidly changing world.

PROFIT SPLIT METHODOLOGY

12. The profit split method is generally used where the other OECD methods are not appropriate, particularly for transactions involving hard to value intangibles or unique and valuable contributions from various parties. We believe that this should continue to be the case, as the other methods (i.e. the Traditional Transaction Methods and the TNMM) still often offer the most appropriate and practical way to benchmark and analyze transactions. Compared to such other methods, profit splits are generally more subjective in nature and can lead to more burdensome and costly examinations, more disputes and, importantly, more double taxation. Here again, we would welcome some clarity on what profit splits cover.
13. Indeed, BIAC believes that the splitting of residual (profits or losses) represents a more appropriate framework, because it takes into account one-sided methods to transfer price routine or benchmarkable transactions before residual profit or losses are split between unique contributions.
14. As highlighted in paragraph 2.118 of the OECD Transfer Pricing Guidelines, there are a number of possible approaches for estimating the division of profits. Although BIAC is not suggesting a preference for a particular approach, we do consider that the fundamental distinction between unique and non-unique contributions should be maintained and supported by unequivocal wording.
15. BIAC believes that the profit split guidance should ensure, even in cases where perfect comparables cannot be found, that "residual" profit is not allocated to 'non-unique' contributions. An approach that would allocate residual profit to such non-unique contributions risks creating competitive distortions, and could be viewed as a violation of the principle of tax "neutrality".

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

BIAC SURVEY

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

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

18. Many respondents expressed concern in relation to the fact that the multi-factor profit split methodology (in relation to intangibles) carries a high degree of uncertainty, subjectivity and complexity.
19. It was also observed that it would be difficult for countries to agree on the same bundle of allocation factors (and their weightings) given the divergent interests of the tax authorities, which may lead to greater litigation and increased compliance burdens.
20. Overall, the majority of respondents were of the opinion that the Profit Split should be considered a method to be used in the rather exceptional and limited circumstances, where no simpler methods are appropriate.

SPECIFIC QUESTIONS

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

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

Value chains (ref. questions 3 and 4)

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

an exact science, tax authorities will disagree with the sharing of profits and losses, if they test one-sided transactions under the ALP principle with a global profit split approach.

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

Multisided Business Models

24. BIAC considers that the transfer pricing analysis of multisided business models should not be different from the analysis applicable to other types of businesses.
25. It should also be observed that multisided business models are likely to also be adopted by start-up or small businesses, which may look for independent suppliers if they need support in other Countries, rather than developing their own multinational structure. Under such a model, the independent suppliers may receive a routine remuneration than a share of the profit.

Unique and valuable contributions (ref. question 7)

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

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

27. In many cases, risk can be addressed as a comparability factor through appropriate adjustments to one-sided methods. For example, if a risk is shared, the first consideration should be whether the shared risk would materially impact the price of the transaction at arm’s length: if not, the “sharing” dimension should not be further considered in the pricing; if yes, a possible approach could be the one discussed at paragraph 32.
28. There will naturally be situations where risk bearing represents a unique contribution (or is even the essence of the transaction). In such cases, a profit split method may be appropriate, and risk should then be compensated through an appropriate share of residual profit (or loss). The profit split method can be an appropriate and reliable method in cases of multiple unique and valuable contributions.
29. Similar concepts must also apply to the sharing of risks and take account of material risks that MNEs choose to manage and measure which ultimately would have a detrimental effect on their business model if unmanaged: If a particular type of risk could normally be addressed with a comparability adjustment (when the tested transaction differs from comparables for that specific risk), the fact of being shared within a GVC should not automatically result in the sharing of residual profit to that particular risk.

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

30. As a general principle, BIAC considers that non-unique contributions should not receive a higher compensation as a mechanic consequence of being integrated or fragmented or due

to the lack of perfect comparables, especially where this would give a dramatically different result to that obtained by using a one-sided method.

31. BIAC believes that the tentative methodology described at paragraph 32 of the Discussion Draft could provide a potential practical solution, but we strongly disagree with the idea that a lack of comparables could result in a quasi-profit sharing mechanism (unless the intention is to apply a profit split approach that only tests the residual profit allocation). A lack of comparables is often due to an absence of information on existing firms in publically available databases, and therefore, should not be treated as an indicator of an entity having a unique, value adding function. Profit sharing mechanisms should be acceptable only if consistent with the ALP.
32. On the other hand, the methodology described at paragraph 32 of the Discussion Draft could be modified to develop a practical solution for cases where perfect comparables are not available. For example, in the case described at paragraph 32, once a range of operating margins of 4-10% has been established on the basis of a one-sided method, the analysis should remain conceptually based on a one-sided approach and seek refinement of the positioning within the range on the basis of an approximate assessment of the functions, assets and risks of the tested entities in relation to the comparables. Where a one-sided method can reliably be used to price the transaction, there should be no need to corroborate the result through the application of a profit split.
33. In case of fragmented functions representing non-unique contributions and for which a one-sided approach would be conceptually more suitable, the methodology could allow for the refinement of the allocation of profit to each entity while maintaining the one-sided nature of the approach in cases where the quality of comparables is not sufficient to directly apply the range of comparables results to the tested transaction.
34. BIAC considers that such a methodology could be explored in order to provide greater simplicity and certainty: in particular, it would be very important to preserve the concept that a range of acceptable results must be determined, rather than specific data-points.
35. BIAC suggests that further practical guidance would be welcomed to improve the use of one-sided methodologies when only non-perfect comparables exist. BIAC notes that slightly imperfect comparables may be more accurate in some cases than the application of a (potentially) largely subjective profit split.

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

36. BIAC is concerned that profit splits tend to imply higher risks of dispute due to their inherent subjectivity. BIAC therefore welcomes the efforts towards developing more objectivity in profit split factors. However, it is difficult to imagine how more specific rules could be developed, considering that profit splits usually deal with unique and valuable contributions, which, by their nature, should be analyzed on the basis of their own specific features.
37. The absence of detailed practical guidance as to the use of profit splits can make the assessment of the most appropriate methodology difficult. Developing further guidance on a consensus basis could assist governments and taxpayers reaching a more consistent and common understanding of when this method is most appropriately applied. We note that the subjectivity associated with a profit split methodology introduces an increased element

of uncertainty into the filing of tax returns, particularly where the opinions on the weight and significance of different allocation criteria may vary between tax authorities and taxpayers.

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

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

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

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

40. One common feature across a large number of businesses is the desire for relative certainty in results. Consistently, it should be recognized that in many arm's length transactions, parties prefer a fixed price or a fixed profit element, when compared to ex-post adjustments that could bring additional profits or unexpected losses. In addition, in many third party relationships, ex-post adjustments would not be possible.
41. Clearly, there are situations where independent parties will be willing to review and share the results on an ex-post basis. However, these are likely to represent a minority of cases. BIAC therefore recommends a principled approach, respectful of the ALP, that would not lead to pre-conceived assumptions that results should be adjusted ex-post.

Dealing with losses (ref. questions 29 and 30)

42. BIAC believes that any robust profit split methodology should be developed in such a way that can generally deal equally well with the generation of profits and losses.
43. Cases where losses may not be shared or shared in a different way appear to be marginal and exceptional: focusing the analysis of how to split losses in exceptional cases instead of standard cases could increase the risk of challenge by Tax Authorities.

Practical difficulties (ref. question 31)

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

- a. **Conceptual profit split:** defining how the (residual) profit should be split in a specific case;
- b. **Method development:** the desired split of profits must be converted into a pricing methodology applicable to specific transactions which must be capable of generating the target split of profit or at least a good approximation to be complemented with periodic adjustments (if adjustments are anticipated, this phase will also include the definition of how they can be implemented); and
- c. **Implementation:** specific functions in one or more entities within the MNE will be responsible for setting and updating prices of transactions, invoicing them, monitoring them and administering adjustments if required.

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

46. **Method development (b):**

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

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

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

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

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

47. **Implementation difficulties (c):**

The administration of a profit split model generally requires ad-hoc processes to be created and the cooperation of different functions and entities within a MNE. Ensuring proper staffing, education, timeliness and quality controls is often difficult. These issues are often compounded by the fact that the profit split method requires more regular refinements and

updates than other transactional methods. Even year-end adjustments, which might be seen as an 'easy fix' can be very complex - periodic adjustments can create significant challenges in their calculation, invoicing, accounting and related obligations (including indirect taxes and customs).

Conclusions on practical difficulties

48. In conclusion, the issues described above will become more prevalent if profit splits are to be applied more often. These burdens will be most severely felt by smaller taxpayers that may not have the necessary resources or expertise to effectively or appropriately deal with them. However, larger MNEs also can struggle to successfully deal with the substantial challenges that profit splits create.
49. Finally, we are concerned that a focus on sharing of 'profit' alone may lead to a gradual shift away from the fundamental principle that transfer pricing should apply to transactions. Even in the application of the TNMM, taxpayers have experience of audits focusing on the 'bottom line' profit without regard to specific transactions. This deprives the taxpayer of the fundamental means to resolving the resulting double taxation. We encourage the OECD to consider re-emphasizing the transactional aspects of the profit split method. More generally, we suggest that the OECD also keeps as a clear objective that any development in the guidelines on profit splits should not reduce a taxpayer's ability to achieve an effective solution to double taxation issues; this point is particularly important in relation to non-OECD member Countries participating to the BEPS project on an equal footing, as well as other Countries supporting the project.