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

Jefferson VanderWolk
Organisation for Economic Cooperation and Development
2 rue André-Pascal
75775, Paris, Cedex 16
France

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

Dear Jefferson,

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

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

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

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

used to justify new unilateral theories and the automatic application of non-arm's length approaches in routine situations.

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

Sincerely,

Will Morris, Chair
BIAC Tax Committee

General Comments

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

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

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

Actual versus anticipated profits

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

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

Valuation techniques

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

Profits and losses

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

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

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

Annexes II and III to Chapter II

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

Specific Questions

C. Transactional profit split method

1. **Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular:**
   1.1. **Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear?**

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

The existence of risk does not mean that comparables are not available. Many risks taken on by related parties are similar to risks that exist between unrelated parties and can be priced appropriately using other methods. It is BIAC's view, therefore, that in most cases risk can be priced accurately without resorting to the transactional profit split method unless both parties make unique and valuable contributions. The existence of unique and valuable contributions, in virtually all cases implies the use of non-routine intangibles.

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

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

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

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

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

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

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

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

- A profit split based on anticipated profits is more likely to be applicable in circumstances where there is a joint project[1], but one in which the contribution of the parties to the project are either sequentially or otherwise separable –in particular, with respect to cost aspects. The nature of the arrangement thus gives one party compensation determined *ex ante* based on anticipated profit assumptions, and the other a residue based on actual profits and a deduction for this expense. For example, if the compensation is in the form of a royalty, then this results in risks of errors in revenue projections being shared between the parties but each party bearing its own risk of errors in its cost assumptions. This form of agreement might for example arise where there is a staged development and exploitation of an intangible as set out in paragraph 4 of the Discussion Draft.
- At a simpler level the nature of a franchise agreement is essentially a modified form of an anticipated profit split (i.e. for a particular franchise project the franchisor receives a revenue based franchise fee and bears its own costs/risks with respect to the business format and broader brand franchised, while the franchisee retains the remaining revenues and bears its own costs/risks of the business operating under franchise). The reason we refer to this as a modified form of anticipated profit split is because, in direct terms, only the anticipated profits of the franchisee are considered –but the required rate of franchise fee will reflect both marginal cost assumptions and required rates of contribution to profit.

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

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

C.2 Summary of strengths and weaknesses

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

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

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

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

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

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

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

C.3 Most appropriate method

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

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

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

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

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

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

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

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

C.3.1 Highly integrated operations

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

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

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

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

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

C.3.2 Unique and valuable contributions

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

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

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

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

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

C.3.3 Group synergies

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

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

13/15 Chaussée de la Muette, 75016 Paris, France
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with the use of the phrase "total system profits" since that seems to be a reference to a global profit split. Applying a transactional profit split method wherever there are synergies would likely result in the transactional profit split method becoming the default method, which we believe is inconsistent with the TPG as a whole.

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

C.3.4 Value chain analyses

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

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

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

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

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

C.4 Guidance for application

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

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

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

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

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

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

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

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

- No specific comments.

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