6 February 2015

Andrew Hickman
Head, Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
and Development
Paris, France

Via Email: transferpricing@oecd.org

RE: Public Discussion Draft on BEPS Action 10: Profit Splits

Dear Mr. Hickman:

On 19 July 2013, the OECD published an *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Action Plan or the Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries' tax bases are being eroded or profits shifted improperly. Pursuant to Action 10 of the Plan, on 16 December 2014 the OECD published a document entitled *BEPS Action 10: Discussion Draft on the use of Profit Splits in the Context of Global Value Chains* (hereinafter the Discussion Draft or Draft).

The OECD solicited comments from interested parties no later than 6 February 2015. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD's request for comments.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 individual members represent over 3,000 of the largest companies in the world.[1]

TEI Comments

Background Comments

TEI commends the OECD for posing questions about experiences and best practices in applying transactional profit splits to further the overall goal of the BEPS project with respect to the arm's length principle to ensure transfer pricing outcomes are in line with value creation. TEI agrees that there are situations where the use of profit splits may be appropriate. We recommend, however, that the use of profit split methodologies be limited to scenarios where traditional transfer pricing methodologies do not provide reliable arm's length pricing. For example, instead of properly analysing or characterising the functions and risks, treaty partners and taxpayers may resort to the use of profit splits as an easy way out, which may lead to a profit allocation based more on convenience instead of arm's length principles.

Regrettably, the Discussion Draft provides very brief examples, describes the application of the profit split, and then asks whether and under what circumstances a profit split would be appropriate. This is a somewhat awkward approach, as the simple examples do not lend themselves to comprehensive replies from stakeholders that take into account the complexity inherent in business today. A more detailed approach, with real life examples at its base, would provide a better process for public input. Moreover, the examples in the Discussion Draft refer primarily to functions performed (although still very briefly) and rarely to risks assumed and assets used. This approach creates the risk that certain tax authorities will use the highly simplified examples in asserting transfer pricing adjustments against taxpayers without consideration of the taxpayers' specific circumstances and local market conditions.

Comments on Specific Portions of the Discussion Draft and Answers to Certain Questions Asked about Various Scenarios

The Discussion Draft states that: "there seems to be very little experience of using a transactional profit split method in a way that could appropriately and comprehensively reflect the range of contributions to value in a diverse value chain."[2] TEI concurs with this statement, and asks why this is the case? TEI submits that this may be because (i) the profit split method is extraordinarily complex to implement, and (ii) tax authorities would in many cases be unhappy with its outcome, particularly if it results in a lower profit allocation to their jurisdiction. In

[1] TEI is a corporation organised in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

[2] Discussion Draft, p.4.

addition, the profit split method is arguably less consistent with the arm's length standard than other transfer pricing methods.

Scenario 1. Applying a profit split to this scenario would be a complex endeavor and would have the same negative effects for tax administration as formulary apportionment, *i.e.*, applying a profit split will likely cause multi-national enterprises (MNEs) to move more functions into countries with a lower corporate tax rate.

Scenario 2. Question 5: *Can transaction profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how?* TEI suggests that, in the absence of a functional analysis that defines what kind of activities the local subsidiaries perform to "generate demand" and who bears the contractual risks of the transactions, it is not possible to adequately answer this question. Based on the brief factual description, however, a profit split is not likely to be the applicable method since the activities of the local subsidiaries are probably routine, especially in comparison with the functions and intangibles of Company R. Thus, a profit split would not be the right solution since one of the parties performs simpler functions than the other. On the other hand, it could be the case that subsidiaries generating demand are uniquely valuable to the organisation, because of the type of product produced or the industry in which the group operates necessitates targeted selling that can only be done locally. This shows that careful attention must be paid to the underlying characteristics of the particular industry being analysed.

Question 6: *What aspects of Scenario 2 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?* A functional analysis would need to be performed focusing on the functions of the local subsidiaries, how they generate demand, and the risks of all parties involved.

Scenario 3. Question 8: *What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method?* Who bears the contractual risks of the transactions should be described. In addition, a functional and risk analyses of Company S may be required to enable the application of traditional transfer pricing methodology without resorting to a profit split. A better understanding of how Company S contributes value to the group is needed. For example, is Company S providing market intelligence and contributing to the development of the global marketing strategy regarding global competitors located in Country S, or is it merely required to incur additional local marketing expenses to make sales in Country S due to higher competition in Country S?

Question 9: *Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm's length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?* Based on the current description, it is very likely that comparables can be found for Company S, either under a resale method or the transactional net margin method (TNMM). A profit split, which due to its complexity is often a method of last resort, therefore does not need to be analysed; should it nevertheless be applied, its application would need to be fixed through a functional analysis.

Question 10: *What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3?* A profit split method is usually to be avoided due to its complexity and its relative departure from the arm's length principle when compared to more commonly used methods. It is thus a method of last resort when the arm's length remuneration of the parties cannot be determined through other methods or it best fits the contractual risk allocation between the parties.

Moreover, the facts described are so brief, that the scenario can easily apply (or argued to be applicable) to many "common" distributors. All the marketing and research and development are performed centrally by the Parent. However, a profit split is applied with the distributor, as the scenario states that the distributor's "activities provide for a significant advantage as customers place high value on the reliability and performance of the equipment."[3] That opens discussions in many situations as distributors are always close (or at least closer) to the clients and have some role in after sales services, *etc*. This type of example just starts a sliding scale and opens room for many (subjective) discussions, resulting in double taxation. TEI recommends that the example be redrafted so that the description of Company S (the distributor) shows in greater detail the functions it performs and how they go beyond merely "routine" distributor activities to further distinguish the company from ordinary distributors.

<u>Scenario 4</u>. Question 11: *In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks?* This scenario represents an appropriate circumstance for applying a profit split method because this is the way that the parties have agreed to interact by contract ("The rewards to companies A, B, and C are contractually determined by the MNE group on a profit-sharing basis."[4])

Question 12: *Would a one-sided method produce more reliable results?* No, a profit split would be the best method under this scenario because tax authorities should follow the contractual arrangements of the parties.

Question 13: *What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?* As above, a functional analysis still needs to be performed; yet there should be a strong presumption that a profit split is the best method because it would follow the parties' contractual arrangement.

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3 *Id*. at p.7.

4 *Id*.

Fragmentation.[5] The Discussion Draft states that "[i]n some cases, it may prove difficult to find comparable uncontrolled enterprises that are similarly specialised in their activities and carry out just the narrow activity conducted by the controlled enterprise" and that "[b]ecause of fragmentation, available data on similar independent transactions may generally not have a comparable mix of functions, assets and risks to the tested party or parties." These statements are surprising. TEI submits that fragmentation makes transfer pricing documentation easier to perform and less controversial, not the opposite, and is one of the benefits of an MNE structuring its operations in this manner. TEI urges the OECD to use more neutral language or at least remind tax authorities of the benefits of fragmentation.

Question 14: *Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how?* TEI recommends that any guidance on profit split methods limit their scope to methods of last resort, otherwise taxpayers will shift functions to low tax jurisdictions, as noted above. When the arm's length remuneration of the parties cannot be determined through other methods or it best fits the contractual risk allocation between the parties, then a profit split method may be applied.

Scenario 5. Question 17: *How can comparables be found and applied in scenario 5? What method is likely to be appropriate for determining an arm's length remuneration for the activities of the group companies?* TEI submits that there is currently sufficient direction in the OECD transfer pricing guidelines on the search of both internal and external comparables as applied to Scenario 5 and therefore additional guidance is not needed.

Question 18: *How can comparables be found and applied in scenario 3 (or to any other relevant scenario in this discussion draft)?* The main difference between Scenario 3 and Scenario 5 is that a comparable uncontrolled price is more likely to be found in Scenario 5 than in Scenario 3; this should lead to the application of a resale method or the TNMM to Scenario 3.

Question 19: *What aspects of scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?* Additional functional and risks analyses are needed with respect to the regional activities that each company is performing for the other to determine what method is most appropriate.

Paragraph 32. The Draft asks two questions about this paragraph, which reads in full:

> In cases where available comparables for the application of a one-sided method may not reliably reflect the level of functions or risk in the tested party, concepts of a transactional profit split approach may sometimes offer the means to vary or flex the results under a one-sided method. For example, application of a one-sided method may result in establishing a range of operating margins of 4-10%

[5] *Id*. at paragraphs 26-27, p.8.

for one of the parties to the transaction: a baseline return of 7% is adopted which would vary in accordance with a pre-determined computation upwards to 10% and downwards to 4% depending on the levels of consolidated profits or sales achieved by the parties to the transaction.

Question 20: *In what circumstances, if any, might an approach described in the last sentence of paragraph 32 be appropriate?* While TEI does not disagree with the statement made by the OECD in principle, it has been of little relevance in practice to date. In fact, having already obliged the taxpayer to perform a one sided transfer pricing analysis, it would seem unreasonable in most cases to ask an MNE to also perform a profit split analysis. Most tax authorities have solved this issue by implementing concepts such as interquartile ranges.

Question 21: *More generally, in what circumstances would a transactional profit split approach be useful in supporting the application of other transfer pricing methods, and what guidance would be useful to develop for the supporting use of such approaches?* As noted, requesting a profit split in addition to a one-sided or comparable uncontrolled price analyses seems unreasonable in nearly all cases. In theory there may be cases when such additional analysis might be required, in particular when there is great uncertainty over the result of the more traditional methods and the materiality of the transactions warrant a further in-depth review.

Aligning taxation with value creation.[6] This section of the Discussion Draft focuses on how to develop objectivity in profit split factors so that transfer pricing outcomes are aligned with value creation. The section refers back to Scenario 1 and adds the additional facts that the associated enterprises (three manufacturing OEMs) split post-royalty residual profits or losses on the basis of three factors: production capacity, headcount, and value of production. These factors are then given a weighting. Question 22: *In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?* Scenario 1 does not have any reference to risk allocation or the contractual arrangements between the parties. TEI submits that these are essential tenets of the arm's length principle, and indeed in the OECD's own words these are the starting points of any functional analysis. Their absence in this scenario is troubling.

Scenario 6. Question 24: *How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for example approaches based on concepts of bargaining power, options realistically available, or a RACI-type analysis of responsibilities and decision making)?* The scenario states that "[r]isks and assets were not considered separately as they were considered by the MNE group to be embedded in the processes that managed them." This appears to ask tax authorities to disregard risks and assets. It thus seems to suggest that the OECD is moving away from the arm's length principle based

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6 *Id*. at paragraphs 33-37, p.10.

on assets and risks and that functions should be paramount. Is this intended by the Discussion Draft?

Question 25: *Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an MNE operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate?* From the facts provided, it seems that reliable comparable uncontrolled prices were available to determine the remuneration of Company C. Why would a profit split analysis then be substituted? As to Company D, it is a contract manufacturer located in the same country as its principal, Company B. If a one-sided method was chosen by the taxpayer that is willing to bear the risk of eventually running one company at a loss while the contract manufacturer is always running at a profit for the unique benefit of reducing its compliance costs, it would generally be expected that the tax authorities of Country B would readily accept that arrangement. Why would it then be necessary to impose an additional compliance burden of a profit split analysis? Extending the use of the profit split is inappropriate here.

The use of profit split in the circumstances presented by scenarios 3, 5 and 6 suggests a potential proliferation or application of profit splits to many MNEs since many MNEs have similar scenarios. Application of profit split methodologies should only be utilised where traditional transfer pricing methodologies do not arrive at reliable arm's length pricing (*e.g.*, where highly integrated, hard-to-value, unique and valuable intangibles exist).

Scenario 7. Question 27: *How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?* A transactional profit split can certainly be used to deal with unanticipated risk. In the case at hand, however, the parties have agreed to bear the risk of their own cost overruns. Such contractual arrangements are often used by management of certain MNEs to keep each side responsible for its own costs, and should be respected by tax authorities.

Scenario 7. Question 29: *In what circumstances might it be appropriate under the arm's length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss?* The only reason for splitting losses differently than profits is when this is decided beforehand in a contractual agreement between the parties. An MNE may, for example, create a limited risk distributor (LRD) whereby relatively high routine profits are allocated to the LRD as long as the principal has a positive earnings before taxes, in return for a zero profit for the LRD when the principal incurs loss; in such a case, the LRD bears more risks than a conventional LRD, yet also earns a higher return.

Question 30: *Are there circumstances under the arm's length principle where parties which would share combined profits, would not be expected to take any share of combined losses?* The OECD should maintain the existing guidance as referred to in paragraph 50 of the Discussion Draft, *i.e.*, that any reference to "profits" should be taken as equally applying to losses, and that profit splits should be applied consistently. Opening up the possibility that losses may be subject to different treatment would create significant uncertainty, may be abused by tax authorities, and leave MNEs facing the prospect of going through the MAP process to ameliorate double taxation. Experience shows that some tax authorities ignore relevant market factors, *e.g.*, a sales drop of 40% due to a local market collapse one year. Instead, the authorities maintain the position that a local entity of an MNE group should have the same level of positive operating profit no matter the circumstances based solely on comparables with prior year data, which does not reflect recent market changes. To avoid this approach by tax authorities, many MNEs adopted a principal structure, which leaves tax authorities worldwide with a steady, albeit smaller, profit allocation.

The official and unofficial process and environment surrounding most of the BEPS project has created the impression that many countries believe that MNEs have hidden abundant profits "somewhere," which will be reallocated to the "right" country as a result of the BEPS project. This may be true in a limited number of situations, but not as a general rule for MNEs. Based on the above assumption, and the fact that tax auditors often have key performance indicators tied to the amounts reassessed, it is likely that any exception for loss sharing proposed by the OECD may be subject to abuse by tax authorities taking a profit split approach in the case of overall profits, and then claiming that local entity should not bear any of the losses.

Such guidance would create non-arm's length results, as no independent third party is protected from various market factors and from incurring losses, unless it is has an extremely limited function and risk profile, in which case it would incur neither losses nor exceptional profits (in line with functions performed and risks assumed). It is important to keep at the forefront of this discussion that a loss is a negative profit. By applying a profit split method, the general approach is to determine the appropriate routine remuneration for routine functions and then share the residual profit based on certain criteria/contributions, *etc*. Thus, treating negative profit differently cannot be justified if functions performed and risks assumed by the parties remain the same. If one party should bear more or all of the losses given its functions and risks, then, all else being equal, it should also receive most or all of the positive profits. Otherwise, one of the two situations will not be in line with the functional and risk profile of the entity, and therefore not be arm's length.

<u>Examples 17 and 18</u>. TEI agrees with some of the country delegates that profit split methodologies should not be used in places where further functional and risk analyses may be needed to determine appropriate traditional transfer pricing methodologies or where re-characterisation or disregard of transactions may be more appropriate (the latter approach only being appropriate in exceptional circumstances).

Other Issues

Retroactive or hindsight application of all transfer pricing methodologies, including profit split methodologies, should only take place in exceptional circumstances. Profit split methodologies are often applied to situations where activities are highly integrated. Therefore, it is likely that unanticipated results or events may arise. Treaty partners need to recognise that the allocation keys or methodologies may need to change to arrive at more appropriate transfer pricing results over time (*i.e.*, it may be more of journey to arrive at a reasonable result rather than a direct path; therefore, taxpayers should not be subject to uncertainty if it took reasonable efforts to determine an appropriate transfer pricing methodology and allocation keys). To mitigate this issue, safe harbour rules should be introduced, and agreements between related parties under the safe harbour should be limited to no more than three years. This will allow treaty partners to agree on more reasonable profit split methodologies in subsequent years without the need to make adjustments by applying hindsight (*i.e.*, the use of hindsight would not be necessary because the contract expires in three years or less).

We also note that it will be difficult for countries to agree on an exact profit split for many reasons. Thus, it is critical that advance agreements (such as advanced pricing agreements) be in place between the tax authorities and the taxpayer. Agreements on profit splits between multiple tax jurisdictions may be extremely difficult due to a number of factors. Different approaches to financial accounting and the tax base will complicate matters between jurisdictions unless the same requirement is adopted by all countries. Thus, taxpayers may be required to calculate a profit split in numerous ways, which would likely result in double taxation in addition to increased complexity. If a general rule is to be implemented, we recommend that consolidated financial statements be used because such information will be more readily available, auditable, supportable, and simpler. If tax adjustments are required, the rules among the countries should be consistent or the MNE should be allowed to use the tax rules applicable in the parent company.

Summary of Prior TEI Comments on Profit Splits

In addition to the comments specific to the Discussion Draft set forth above, we reiterate the following general comments on the profit split method from our earlier letter[7] to the OECD regarding its 2013 discussion draft on intangibles:

1. The profit split method requires a great deal of international cohesion, expertise, and dialogue among different tax authorities. We are

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[7] *See* Letter from TEI to OECD regarding the OECD's Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, dated 1 October 2013, *available at* http://www.tei.org/news/Pages/TEI-Comments-on-OECD-Revised-Intangibles-Discussion-Draft.aspx.

skeptical of the ability of certain authorities to apply the profit split method fairly and efficiently.

2. Regular use of the profit split (and similar) methods also raises the specter of increased transfer pricing documentation and compliance costs.

3. The profit split method presents complex and difficult administrative issues for tax authorities and similar compliance problems for taxpayers.

4. As a practical matter, the use of two sided methods by tax authorities, through a wider use of the profit split method, will likely result in increased controversy and the risk of double taxation.

Conclusion

TEI appreciates the opportunity to comment on the OECD Discussion Draft regarding the use of profit splits under BEPS Action 10. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +41 786 88 3772, nickhasen@sbcglobal.net, or Benjamin R. Shreck of TEI's legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.

Mark C. Silbiger

Mark C. Silbiger
International President