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8 September 2017

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Via email: transferpricing@oecd.org

RE: BEPS Action 10 – Revised Guidance on Profit Splits

Dear Mr. Vanderwolk:

The Organisation for Economic Co-Operation and Development (OECD) published final reports pursuant to its base erosion and profit shifting (BEPS) project on 5 October 2015. The reports were the culmination of the OECD's *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Plan) published in 2013. The Plan set forth 15 actions the OECD would undertake to address a series of issues that contribute to the perception of tax bases being eroded or profits shifted improperly. Included in the October 2015 final reports was a report under Actions 8-10 of the Plan, *Aligning Transfer Pricing Outcomes with Value Creation*. Subsequently, on 22 June 2017, the OECD issued a public discussion draft under BEPS Action 10 regarding *Revised Guidance on Profit Splits* (the Discussion Draft or Draft). The OECD requested comments from stakeholders regarding the Draft's proposed revised guidance on the application of the transactional profit split method, as well as responses to specific questions.

I am pleased to respond to the OECD's request for comments on behalf of Tax Executives Institute, Inc. (TEI). TEI also requests the opportunity to speak in support of these comments at the public consultation to be held in November 2017 in Paris.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organization has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all

levels of government. Our nearly 7,000 individual members represent over 2,800 of the leading companies in the world.[1]

TEI Comments

General Comments on the Discussion Draft

TEI commends the OECD for the additional guidance on the use of the profit split method set forth in the Discussion Draft. Tax authorities have increasingly used the profit split method to address transfer pricing issues and thus the attention paid to this method by the OECD is appropriate. That said, we recommend the OECD clearly state in final guidance that the Discussion Draft is not intended to change the manner in which tax authorities and taxpayers identify the best transfer pricing method. The OECD has at various occasions confirmed in discussions that the additional profit split method guidance in the Draft is not intended to promote the method to make it more prevalent, but rather to assist tax authorities and taxpayers in the method's application. In TEI's view, and we understand the OECD agrees, the comparable uncontrolled price (CUP) method continues to be the most reliable way to apply the arm's length standard. Thus, where the CUP or other transfer pricing methods are considered the most appropriate method to assess the arm's length nature of transactions, there should be no requirement to use the profit split method as an additional or corroborative method. Moreover, when tax authorities apply the profit split method, they should be subject to the same diligence requirements as taxpayers and should avoid simplistic approaches to splitting profits.

We also note that, as a whole, the Discussion Draft appears to imply that it is easier to apply the profit split method than other transfer pricing methods, in particular the CUP. To dispel this implication, TEI recommends that the OECD note in final guidance that when confronted with complex taxpayer operational structures and supply chains, applying the profit split method correctly is at least as problematic as applying another method.

In addition, the Discussion Draft and its examples appear to assume that either the entire transactional profit should be split between the parties or, if another method is more appropriate, none of the profit should be split. While that may be the case in many situations, there are other situations where the profit split is the most appropriate method, but should only apply to a portion of the profit. Parties to a transaction that make unique and valuable contributions also often have activities that are routine and do not constitute unique and valuable contributions to the value chain. For example, parties may conduct both research and development (R&D) activities and manufacturing. While the R&D may constitute a unique contribution, manufacturing may not. Therefore, it may be appropriate to first use a one-sided traditional method to calculate the profit attributable to manufacturing, and then apply the profit split

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

method to the residual profits. Because the Draft does not discuss these frequent situations, TEI recommends the OECD include such a discussion in final guidance.[2]

The phrase "unique and valuable" is often used in the Discussion Draft. It would be helpful if the OECD clarified the meaning of this phrase in final guidance, especially given that the references and descriptions used for the phrase within the Draft are somewhat inconsistent. For example, in Paragraph 16, the phrase is narrowly defined implying a high threshold for a contribution to be described as "unique." However, Example 9 implies a lower threshold.

Another definitional issue arises in Paragraph 1, which states that the profit split method "first identifies the profits to be split from the controlled transactions—the relevant profits . . . ." However, nowhere in the Draft is the term "relevant profits" clearly delineated. Additional guidelines on the meaning of this term, as well as a discussion of how to take into account certain costs (*e.g.*, restructuring costs, foreign exchange costs), would be helpful.

TEI commends the OECD for recognizing in Paragraph 1 that losses should also be split. We recommend that the final guidance include examples that split losses.

In TEI's opinion, the OECD sometimes over generalizes the advantages of the profit split method. For example, Paragraph 6 states that "since those contributions are 'unique' and 'valuable' there will be no reliable comparables information which could be used to price the entirety of the transaction in a more reliable way . . . ." TEI suggests this sentence should be amended as follows: "since those contributions are 'unique' and 'valuable' it is less likely for there ~~will~~ to be ~~no~~ reliable comparables information which could be used to price the entirety of the transaction in a more reliable way . . . ." As another example, Paragraph 8 states that "Another strength of the transactional profit split method is that it offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises." TEI recommends this sentence should be amended to read "Another strength of the transactional profit split method is that it may sometimes offer~~s~~ more flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises."

With respect to Paragraphs 10 and 40, greater emphasis should be placed on the need to determine the profits to be split between group entities using a common accounting standard. Tax authorities may often utilize local statutory or taxable profits and dismiss international or group accounting standards. However, local statutory accounting financial statements may vary significantly from group or international accounting statements. While most of these variances are timing differences (*e.g.*, depreciation expense, pension expense, unrealized currency gains and losses), they can be substantial and result in large differences on a year-over-year basis. Thus, splitting profits that are not determined under the same accounting standards and methods would not lead to an arm's length result, would likely increase controversy and litigation, and in

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[2] An example of such a scenario is set forth below in response to the OECD's specific question number three on page two of the Discussion Draft.

the end would be essentially meaningless. The Draft should therefore highlight and further emphasize the need for common financial accounting standards for measuring profits.

Paragraph 10 also posits that taxpayers and tax authorities may have difficulty accessing information. In TEI's view, even though it may be challenging, access to information determined under a common accounting standard in most instances should be less of an issue within most multinational groups. A supplemental difficulty may reflect a lack of trust in a group's financial statements by tax authorities, which is reflected in the additional assurance they may require that the data was audited by independent accountants. This may not always be feasible, however. Whatever the case may be in a specific factual situation, TEI urges the OECD to clarify in Paragraph 41, addressing financial accounting and other financial data, that it expects profit splits to be made based on the harmonized accounting standard the multi-national group applies for its consolidation in an overwhelming majority of the cases. TEI also recommends deleting the word "tax" in "harmonized tax accounting standards" in Paragraph 10, or to provide a definition of what the OECD means by this phrase.

TEI agrees with the statement in Paragraph 10 that identifying appropriate profit splitting can be challenging. However, despite this difficulty, the standard to prove that the chosen profit splitting factors are appropriate should remain reasonable, *i.e.*, factors should be deemed acceptable if the results attributable to the group entities are within the arm's length range.

The Discussion Draft implies (*e.g.*, in Paragraphs 13 and 19) the profit split method is more likely to be appropriate to horizontally integrated entities and operations. The previous iteration of this Draft document used the phrases "horizontal integration" and "vertical integration." It would be more appropriate to revert to using these phrases. In addition, guidance should be provided on what level of integration should be considered when using the profit split method as too wide a level could result in non-arm's length results. In that regard, it would be helpful to include explanations and/or examples of situations in the final guidance where the use of the profit split method would clearly not produce an arm's length result.

Paragraph 15 states that for purposes of applying the profit split method it may be relevant to consider industry practices. TEI notes, however, that the use of profit splitting approaches between independent parties is likely to be confined to industries where joint ventures are common practice, such as oil & gas, chemical, automotive, pharmaceutical and perhaps a few others.[3] Even in such industries, data on profit splitting between independent parties may be difficult or impossible to find. Thus, the final guidance should note that it may be difficult to find comparable profit splits (or other methods of dividing the profits from a joint venture) among unrelated parties, depending on the industry.

Paragraph 27 notes that if a profit split is the most appropriate method, "it is likely that a split of actual profits, rather than anticipated profits, will be warranted since those actual profits will reflect the playing out of the risks of each party." Besides being unusual between independent parties, this appears to assume that a taxpayer can initially use anticipated or

[3] The Discussion Draft mentions certain industries in Paragraph 52.

forecasted profits during the year and then utilize a "true-up" at the end of the year to accurately account for actual profits. However, such a true-up may raise customs and indirect tax issues, among others, that create additional problems for taxpayers. The OECD should note and discuss these collateral effects in the final guidance.

The Discussion Draft in Paragraph 33 states that "[i]f the transactional profit split method is used to set transfer pricing in controlled transactions (*ex ante* approach), it would be reasonable to expect the life-time of the arrangement . . . to be agreed in advance of the transaction . . . ." We note that determining the lifetime of an arrangement may not be simple. Of course, arrangements may have a single, fixed term. However, in the intra-group context, many arrangements, after an initial fixed term, may include a clause providing for automatic one year renewals, unless terminated by one of the parties. Whether such arrangements should be considered long term or perpetual arrangements may depend on past practice or other contractual provisions. Moreover, in such arrangements, the parties should be able to change transfer prices periodically to reflect changes in the business and economic environment, as well as revised profit expectations.

With respect to Paragraph 53, TEI agrees that when there is no reliable evidence of how independent parties would split profits, the only practicable approach is to split profits based on the relative contributions of the parties. Here the Draft indicates that such contributions are measured by functions performed, assets used, and risks assumed. Assets used can be easily measured by their value on the balance sheet of the parties, or in the case of self-created intangibles which do not have a book value, a value can be determined using valuation techniques. The Discussion Draft, however, should further clarify how functions and risks are to be measured, particularly in the context of *ex-ante* profit splits. For example, are functions to be measured simply by the costs incurred by the parties to perform such functions? What are the acceptable methods to measure risks? Risks like customer insolvency may be measured statistically. However, other risks may be difficult to measure, such as the risk that a new product or technology will not be successful in the market. Further guidance in this area would be helpful.

Paragraph 61 states that "it may be necessary to draw up transactional accounts that identify . . . expenses that are related to the controlled transaction at hand and those that should be excluded from the determination of the profit splitting factor." In TEI's view, when related parties enter into numerous transactions together, or if there are multiple entities involved in the transactions, analytical financial data may not be available at the transactional level. Indeed, obtaining such information may be extremely complicated and cumbersome, and may not be reliable because of how costs are allocated. Instead, data at a higher level may be more accurate, for example at the entity or product family level, for use in a profit split. TEI recommends the OECD address this situation in final guidance.

TEI agrees with the statement in Paragraph 68 noting when expenses are incurred and when value is created or realized, these events often take place in different periods. TEI notes that expenses can also be volatile from one year to another: R&D costs during the life of a project and marketing and advertising expenses associated with new product launches are seldom linear. Using pools of costs incurred over several years may be a way to reduce the impact of time lags

and volatility, as is using notional amortization of such pool of costs. TEI recommends that the OECD consider these approaches as it moves forward with its profit split guidance.

Comments on Certain Examples in the Draft

Although presented with limited facts, the number and diversity of the examples is helpful. Examples 8 and 10 provide some limited discussion on the determination and selection of appropriate profit splitting factors. This discussion should be expanded – adding a similar discussion to examples 1, 2, 3, 5, 7, and 9 would greatly improve the Discussion Draft. In addition, Example 9 is the only one addressing splitting profits on an actual versus anticipated basis. Discussing this issue in other examples or adding a few additional examples addressing it would also be helpful.

TEI also recommends the OECD conform the conclusions in its examples to the guidance provided in the body of the Discussion Draft. For example, instead of stating that "the transactional profit split method is likely to be the most appropriate method", the OECD would be better served by stating that "under certain circumstances, the transactional profit split method may be the most appropriate method". This would also align the wording to the examples where the OECD concludes that "the transactional profit split method *may not be* the most appropriate method", and would avoid the impression that the report is biased towards the application of the profit split over other methods.

Example 1. It is not clear from the example why the profit split method is the most appropriate method. The value of Company A's patent license to Company S could potentially be valued under a traditional transfer pricing methodology at the time of license. Once Company A licensed the patent rights to Company S, Company A does not appear to share in significant ongoing risks (*i.e.*, Company S is wholly responsible for the subsequent development of the products, including costs associated with the development) – other than if the license was based on ongoing percentage of revenue, then its license fee may be reduced if Company S is not successful. On the other hand, if the license fee was in the form of an upfront lump sum, there would be no risk to Company A at all. Further, it is clear in the pharmaceutical field that the basic research performed by Company A is nearly always more risky (*i.e.*, has a higher chance of failure) than the clinical trials performed by Company S to obtain the authorizations by the relevant regulatory bodies. It is also not clear in this example how losses could be split should the product not obtain the authorization from the relevant regulatory bodies, or fail commercially. In TEI's opinion, this example is therefore more appropriately dealt with under the OECD's guidance for hard-to-value intangibles.

Example 2. It is not clear from the example why the profit split method is the most appropriate method and why the tea sold by A Co to B Co cannot be valued under a traditional transfer pricing methodology. The facts in this scenario could justify the use of the profit split method in almost any situation (*e.g.*, A Co manufactures Product X using extensive proprietary manufacturing know-how and B Co owns the tradename and trademark, which are both unique and valuable). For this reason, TEI strongly recommends the OECD withdraw this example.

Example 5. For reasons similar to those noted with respect to Example 1, it is not clear from the example why the profit split method is the most appropriate method. The value of Webco's contribution could be determined under a traditional transfer pricing methodology at the time of license. Once Webco transferred the program to ScaleCo, Webco does not appear to have any further involvement or share in significant ongoing risks – other than if Webco's compensation is in the form of an ongoing license based on percentage of revenue, then its license fee may be reduced if ScaleCo is not successful. On the other hand, if the license fee was in the form of an upfront lump sum, there would be no risk to Webco at all.

Example 10. Further clarification is needed as to why an asset-based profit split factor is appropriate, as opposed to gross or operating profit of Company A and B (or some other factor). If an asset-based profit split factor is appropriate, it would be helpful to provide additional guidance regarding what would be included in the asset base. For example, should it include inventory, plant & equipment, intangibles (if self-developed, may need to value), and/or working capital?

Responses to Specific Questions

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

As in Example 9, a split of anticipated profit is more likely to be appropriate where parties make distinct contributions (*e.g.*, with respect to trademarks) and one party would not be able to generate profit without the other's contributions.

That said, while Paragraphs 43 through 46 and Example 9 address a transactional profit split of actual or anticipated profit, further clarification is needed on when a transactional profit split using anticipated profits should be used. The use of transactional profit split using anticipated profits seems to apply to scenarios where one of the parties may have made a unique and valuable contribution but does not share in significant ongoing risks. It is unclear from the Discussion Draft why a transactional profit split is applicable in such a scenario and the lump sum payment/sales based royalty cannot be determined using traditional transfer price methodology. For instance, in Example 9, Company A's intangibles do not qualify as hard-to-value intangibles; therefore, the assumption should be that the value of Company A's contribution can be determined with a traditional transfer price methodology. It is not clear why Company A should share in anticipated profits of Company B when it does not share in significant ongoing risks.

Attempting to distinguish scenarios between when a transactional profit split should use actual versus anticipated profits can cause additional confusion. It may make sense in certain circumstances for taxpayers to initially use anticipated profits to estimate profit split and adjust them to actual – it may just be a continuum of where the taxpayer is in its profit cycle. If there is no history available, because the parties are launching a new disruptive technology, adopting a

new business model, or starting a new business, determining transfer prices based on anticipated profits would seem the only practical option. If the parties use anticipated profits, then those projections should be revised periodically and transfer prices reset accordingly, perhaps every one to three years. In such a case, the changes should be prospective, rather than retrospective true-up adjustments based on actual profits when they differ from anticipated profits. Historical data may not be predictive of future profits due to a number of factors, some of them beyond the control of the related parties; in such a case, future profit projections may be more reliable than past actual profits.

Question 2. A number of profit splitting factors are addressed in the discussion draft. Comments are particularly invited on:

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

Reference to capital or capital employed as a potential profit splitting factor should be retained as this is an important factor regard to financial services given the role of capital in that industry. Some of the factors to consider prior to selecting capital/capital employed are: (i) the entities' involvement in the performance of valuable functions with respect to the transaction; (ii) the importance of capital contributions/investment to the transaction, with reference to comparable third party transactions; and (iii) the reliability of the profit splitting factor to yield reasonable results without adjustments.

Further, as noted in Paragraph 56, the use of capital or capital employed may be appropriate where the relative contribution of the parties are important drivers of the business' profit (*e.g.*, in a capital intensive industry). The use of the taxpayer's audited balance sheet to determine capital or capital employed has the advantage of verifiability, reliability and simplicity. However, as noted in Paragraphs 60 and 61, self-developed intangibles and other assets may not appear on the balance sheet and the determination of their market value will require a separate evaluation. In such a case, TEI recommends adjustments only be made where they are material.

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

Headcount may be an appropriate profit splitting factor if it is one of the key profit drivers of the business. In practice, delineating headcount among similarly skilled and competent employees may be difficult and may be subject to dispute unless a more general approach using departments or job categories can be used.

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

In theory, it would be useful for accurate adjustments to purchasing power parity to be made for profit splitting factor amounts. However, given the challenge with data availability, the

reliability of adjustments made and the results obtained from the adjustments may be called to question. Moreover, adjusting for purchasing power parity would complicate an already complex process.

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

The guidance should provide flexibility to use profit splitting factors that drive the economics of the business/transaction. The final guidance should also make clear that the profit split factors in the guidance are only examples and that the key profit drivers in a business should be considered or used. If such profit drivers are not used as factors, explanation should be made as to why they are not being used.

TEI notes that it is important to select factors that are measurable, easily identified, and can be tracked in the parties' enterprise resource planning software; otherwise the profit split could become extremely difficult to determine, and would not be reliable. In addition, in TEI's view, while sales can be a useful factor when applying the profit split method, it should be used sparingly and only in cases where it is a key profit driver.

Question 3. Additional examples of scenarios in which a transactional profit split is found to be the most appropriate method due to the high level of integration of the business operations are sought, together with an explanation as to the reasoning thereto.

TEI suggests the following as an additional example of a scenario in which a transactional profit split is the most appropriate method due to high integration:

Example X: Company A and Company B are members of the same multi-national enterprise (MNE) group. Product X and Product Y are different but highly integrated products.

Company A is the parent company and operates in Country A as follows: (i) it manufactures Product X in Country A for global sales (assume there are no significant manufacturing intangibles); (ii) it performs R&D in Country A for Product X, assumes the economic risks related to the R&D, and owns the title to the MNE's global intangibles; (iii) it sells Product X and Y in Country A and the rest of the world, except for Country B; and (iv) it is responsible for global marketing of both Product X and Y (assume there are no significant marketing intangibles).

Company B is a subsidiary of Company A and operates in Country B as follows: (i) it manufactures Product Y in Country B for global sales (assume there are no significant manufacturing intangibles); (ii) it performs R&D in Country B for Product Y, assumes the economic risks relating to the R&D, and has exclusive right to exploit the MNE's global intangibles regarding Product X and Y in Country B; (iii) it sells Product X and Y in Country B; and (iv) is responsible for global human resources, legal, billing and other finance functions.

Reasoning: Even in a highly integrated operation, there may be routine functions. Those functions would need to be separated and comparable returns for them determined using traditional transfer price methodology (*e.g.*, routine manufacturing, or low value added functions

such as human resources, legal, billing and other finance functions, or other value added functions that have comparables, in the above example this would include marketing with no significant marketing intangibles). Assuming no better methodology is applicable, a transactional profit split may then be used to allocate the residual profit.

Conclusion

TEI appreciates the opportunity to comment on the Discussion Draft regarding revised guidance on profit splits. As noted above, TEI requests the opportunity to speak in support of these comments at the public consultation to be held in November 2017 in Paris.

These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Giles Parsons. If you have any questions about the submission, please contact Mr. Parsons at +44 (0)1455 826561, Parsons_Giles@cat.com, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 464 8353, bshreck@tei.org.

Sincerely yours,
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