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## RE: Revised Guidance on Profit Splits

To Whom It May Concern:

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, the OECD issued a public discussion draft under those actions on 4 July 2016 (the Discussion Draft), requesting comments regarding revised guidance in Chapter II of the OECD Transfer Pricing Guidelines (the Guidelines).

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 on 11-12 October 2016 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.<sup>1</sup>

### **General Comments**

TEI commends the OECD for its continued work on issues regarding base erosion and profit shifting, even as the “final” reports under the Plan were issued more than ten months ago. Issues and controversy surrounding transfer pricing, including the use of the transactional profit split method, continue to be of significant concern to multinational enterprises (MNEs) as well as tax authorities around the world. TEI particularly appreciates the confirmation in the Discussion Draft that not only should profits be shared among associated enterprises under the transactional profit split method, but that losses among associated enterprises must be shared as well.

Overall, the Discussion Draft depicts two approaches to splitting profits. The first approach splits anticipated profits from a transaction and the second splits actual profits. The content of the Draft focuses in great measure on splitting actual profits based upon a very detailed economic analysis and transaction monitoring. This is a difficult approach to administer. In light of this difficulty, in TEI’s view, more guidance is needed on how to properly perform a profit split analysis. In general, one-sided methods are easier to apply in practice and are less subjective. On the other hand, the profit split method has historically not been used as frequently because of its subjective element, although it does provide for greater flexibility in application. Moreover, developed markets tend to prefer one-sided methods while developing countries – which tend to have no or significantly fewer comparables – view profit splits as an attractive option. To avoid this natural bias, additional guidance would be helpful to assist tax administrators in applying the profit split method properly. In that regard, TEI recommends that splits of actual profits, as opposed to anticipated profits and excluding those contractually provided for between the parties, be limited to cases of abuse.

Finally, TEI is concerned that in the current economic environment there is a substantial risk that the first jurisdiction to audit a taxpayer will use the profit split method, or even formulary apportionment, to propose significant adjustments in an attempt to obtain the largest share of an MNE’s profits as possible. This would lead to increased controversy and litigation as other countries propose their own adjustments. Such an aggressive approach, if especially punitive and non-economic, will eventually cause MNEs to outsource their local operations, which likely would lead to a lower net profit in the outsourced jurisdiction. Thus, the final

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<sup>1</sup> 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).

guidance should continue the strong emphasis on the limited circumstances in which the transaction profit split method is the most appropriate method for setting transfer prices.

### **Responses to Specific Questions in the Discussion Draft**

This section sets forth TEI's responses to the specific questions posed by the OECD in the Discussion Draft. The lack of a response to a question should not be taken as agreement with the analysis in the Discussion Draft.

*Q1. Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular: (1) Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear? (2) Is the distinction between the two profit split approaches described useful?*

TEI agrees that the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits is clear. In TEI's view, however, concrete numerical examples are needed to differentiate between transactional anticipated profits and transactional actual profits. For example, it is not clear under what circumstances a purchase price adjustment is needed if anticipated profits are used.

Moreover, while it is useful to acknowledge the distinction between anticipated and actual profits, the Discussion Draft is unclear on the preferred approach. For example, in certain cases the Draft makes comments in the context of actual profits that could also be applicable to anticipated profits. More broadly, and other things being equal, parties might prefer to split actual profits because it better fits the general approach of the parties to share in the risks and outcomes of a transaction. Nevertheless, in practice other things are rarely equal, and, in particular, the subsequent determination of prices in the case of a split of actual profits faces significant administrative obstacles. These include the need to adjust retroactively the price of units already sold, as well as changes in VAT returns and customs clearance documents. Overcoming these obstacles requires additional costs, which do not add value to the business. In such a case, splitting actual profits would only be prudent if the achieved precision of the transfer pricing determination is worth additional administrative efforts. This is a rather simple and practical test which would benefit the guidelines if included.

Finally, paragraph 20 notes "However, as discussed in paragraph 6, a transactional profit split of anticipated profits does not require the level of integration or risk sharing required for a transactional profit split of actual profits."<sup>2</sup> The Discussion Draft does not provide any support for this statement in paragraph 20 (nor does paragraph 6) and thus it is not clear why split of

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<sup>2</sup> *Id.* at 9.

anticipated profits requires less integration than splits of actual profits. TEI recommends that the OECD substantiate this assertion or remove it.

*Q2. 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 unclear why the comments on integration of business activities were made solely in the context of profit split of actual profits. These comments would also be valid for splits of anticipated profits.

*Q3. 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.*

Splitting actual profits may be more appropriate where there is a high degree of uncertainty involved (e.g., research and development of a product is not complete or a market has not yet developed). In contrast, splitting anticipated profits may be more appropriate where research development is complete or in a developed market. In any event, TEI recommends the OECD acknowledge that both approaches have merit, especially where MNEs apply one of the methods consistently from year to year.

An example of the appropriate use of anticipated profits is when an MNE determines its transfer pricing during the budgeting process for recurring transactions, and the use of anticipated profits is applied consistently from year to year. Profit splits using anticipated profits is also appropriate in the context of a complex supply chain, where there are several different legal entities to the profit split, and the financial information to apply an actual profit split is not readily available. In these situations, there are practical obstacles when attempting to perform complex “true-up” calculations.

Another example when anticipated profits could be appropriate would be when a profit split is performed near year-end, using actual data for 10 or 11 months and forecasted “anticipated profits” for 1 or 2 months. In this case, any variation between anticipated profits and actuals may not be significant. Again, this assumes that the same methodology is applied from year-to-year to maintain consistency and to ensure the taxpayer is not “cherry-picking” favorable results.

Conversely, actual profits might be most appropriate in supply chains that have less complexity; for example, where there are few participants and reliable and readily available financial information is available to easily perform true-up calculations.

In addition, it should be kept in mind that the data on actually achieved profits is usually available after the end of the year in which the profit was earned. Thus, it may be that additional payments to reflect the profits earned in fiscal 2016 may appear in the books of one of the parties

only in fiscal 2017. This is a typical situation for related and unrelated party transactions, and thus the tax administrators should not consider such situations as a breach of the arm's length principle.

*Q4. Are the strengths and weaknesses of the transactional profit split method appropriately captured and summarised?*

At a high-level, the main strengths and weaknesses of transactional profit splits are appropriately captured and summarized in the Discussion Draft. We note that the strength described in paragraph 13 of profit splits (it is "less likely that either party to the controlled transaction will be left with an extreme and improbable profit result") would also apply to splits of anticipated profits (*i.e.*, this is a strength of profits splits in general).

In addition, paragraph 15 states that one of the disadvantages of the profit split method is that "in most cases a tax administration will not be able to perform the analysis or verify the information without full co-operation from the taxpayer." TEI agrees with this statement, which helpfully warns tax administrators that they will rarely, if ever, have enough data to perform a completely accurate profit split analysis. Thus, administrators should not propose a profit split as an alternative to the taxpayer's method when the latter is properly applied under the Guidelines.

TEI also recommends, that the final guidance state that the transaction profit split method – as opposed to a residual profit split – does not necessarily require benchmarking studies. Such studies are expensive and complex to produce and thus, if required, are a significant compliance burden.

*Q5. Do transactional profit splits of anticipated profits and transactional profit splits of actual profits have different strengths and weaknesses? If so, what are they?*

Transactional anticipated profit splits may require purchase price adjustments especially if the profit projection is materially different than actual profit. An additional weakness of profit split methods is that they often requires a degree of subjectivity and professional judgement. This results in an increased risk of controversy and compliance costs, for both taxpayers and tax administrators, even when there is full cooperation from taxpayer.

*Q6. 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. (1) Do commentators have any suggestions for clarifying the notion of risk sharing in this context? (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.*

TEI recommends that the Discussion Draft make clear that for the profit split method to apply it is not necessary that the parties share or control approximately equal risks. One of the parties may control less risks than another party, but still control some of them and share profits or losses.

*Q7. 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.*

This question assumes that anticipated profits would be used when valuing intangibles, hence the reference to valuation techniques. However, the anticipated profits approach could also be valuable in pricing “day-to-day” transactions. For example, in practice, transfer prices are often determined during the budgeting process using anticipated profits consistently from year to year. For practical purposes, the compliance costs and complexity of performing true-up calculations may not be worth the effort if all parties end up with reasonable profit allocations given their relative functions, risks, and assets.

*Q8. 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?*

The Discussion Draft can be read to imply, although it does not state explicitly, that in the case of parallel integration the OECD favors the profit split method, and in the case of sequential integration, the OECD favors one-sided methods. This is particularly helpful because the distinction between methods of integration can be used to determine when the profit split method is not the most appropriate method. Nevertheless, this is an oversimplified portrait of the operational environment faced by MNEs. Different functions are more and more often split into different legal entities and different locations. Workforce and hence significant people functions become more and more mobile and cross-functional project teams become more and more common. Such a distinction between parallel and sequential integration may have been a useful tool a few decades ago but it does not fit well with the current business environment and the prevailing business organization trends show further blurring of such a distinction for the foreseeable future.

*Q9. If so, how should the concept of parallel integration be further defined?*

No response.

*Q10. 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.*

It is important not to confuse making unique and valuable contributions by both parties at different stages of the value chain with making unique and valuable contributions to the overall transaction. For example, one party may make unique and valuable contributions to the marketing stage and another at the manufacturing stage. The distinction between the two situations should be noted in the final guidance as it would impact the analysis.

*Q11. 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?*

Parties may make unique and valuable contributions but they may not share economically significant risks. For example, manufacturing, marketing, or research and development contributions may all be unique and valuable but the level of risks may be quite different.

*Q12. 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.*

TEI agrees that the use of the profit split method is not appropriate based on the presence of group synergies alone.

*Q13. 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?*

In certain ways the “value chain analysis,” described in paragraphs 24 to 27, is similar to the functional analysis that taxpayers and tax administrations currently prepare and apply. The additional guidance on the use of a value chain analysis is helpful to explain the concept, since it coincides with the analysis taxpayers currently prepare. TEI recommends that the OECD make clear it is not creating a new documentation requirement in addition to the existing one.

TEI agrees with the Discussion Draft in paragraphs 25 and 26, which notes that the existence of a supply chain is not conclusive proof that the profit split method is the most appropriate method.

*Q14. 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.*

No response.

*Q15. What further guidance or clarification of existing guidance would be helpful in these sections? Please provide practical examples in support of the response.*

No response.

*Q16. 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.*

When unrelated parties create a partnership or joint venture, they take into account a wide range of factors when determining how to split future profits. As described in section C.4.5.1. of the Discussion Draft, the asset based factors and cost-based factors are useful examples, but attention should also be paid to future contributions of the parties. In unrelated party negotiations, difficult-to-value contributions often play important roles, and such contributions are based upon, and documented using, expert estimations. Such contributions are not always carefully reflected by asset-based or cost-based factors. For example, a contribution of a highly qualified scientist may be much more valuable than reflected by the underlying cost factor (e.g., his/her salary). Such estimates are usually documented in advance by the parties and it would also be reasonable if the related parties used this method of determining the profit splitting factors. The Discussion Draft would be improved by including considerations on determining the profits splitting factors by expert estimates.

*Q17. What further guidance would be useful in this section relating to identifying and measuring profit splitting factors? Please illustrate your response with examples.*

No response.

*Q18. 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.*

In practice, the application of a profit split works well in a collaborative environment between tax authorities and taxpayers, such as an advanced pricing agreement situation, regardless of whether the actual profits or anticipated profits method is used.



**Conclusion**

TEI appreciates the opportunity to comment on the Discussion Draft regarding the revised guidance on profit splits. As noted above, TEI requests the opportunity to speak in support of these comments at the Public Consultation on the Discussion Draft scheduled for 11-12 October 2016 in Paris.

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](mailto:nickhasen@sbcglobal.net), or Benjamin R. Shreck of the Institute's legal staff, at +1 202 464 8353, [bshreck@tei.org](mailto:bshreck@tei.org).

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