UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

February 5, 2015

VIA EMAIL
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Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 10: Discussion Draft on the use of Profit Splits in the Context of Global Value Chains

Dear Mr. Hickman,

USCIB appreciates the opportunity to comment on the discussion draft on the use of profit splits in the context of global value chains (the "discussion draft").

General Comments

Arm's length principle and separate entity accounting

USCIB believes that both the arm's length principle and the separate entity legal principle are fundamental to Article 9 of the OECD Model Income Tax Treaty and the current transfer pricing guidelines interpreting those provisions. We believe that the OECD should reaffirm its continuing support for these fundamental principles. We are making this request in light of BEPS discussion drafts that, taken together, seem to indicate a movement away from these standards to a formulary apportionment/systems profit allocation approach. This discussion draft as well as those addressing country-by-country reporting, the digital economy, intangibles, and risk and recharacterization raise these concerns.

Dispute resolution

Clarity on the transfer pricing standard is especially important given the lack of binding arbitration in the dispute resolution draft. As USCIB points out in our comment letter on dispute resolution, we expect disputes to proliferate as the BEPS outcomes are implemented. Disputes will be reduced if the Transfer Pricing Guidelines ("TPGs" or "guidelines") narrow the possible options rather than expanding them infinitely. Trying to value the "global value chain", measure the impact of "integration", or "fragmentation", will lead to various inconsistent results that the guidelines anticipate resolving by reference to profit splits. A vague standard that seems to promote profit splits in virtually any case will, however, only increase disputes. There should also be a recognition that not all businesses are

profitable, particularly those in a startup phase. As such, if profits are to be split then losses should be split as well.[1] Without agreed upon methods for determining profits and the allocation keys, there will be no substantive basis for resolving those disputes. This combined with a lack of binding dispute resolution will lead to more double taxation.

Even if disputes can be resolved, the time and expense to both taxpayers and tax administrations expended in reaching resolution is significant. Therefore, an important part of dispute resolution is dispute avoidance. To achieve that goal rules must be clear and certain of application. USCIB believes that the discussion draft is neither clear nor certain of application.

Best methods and comparability

USCIB believes that profit splits have a place in the overall transfer pricing framework. The standard for determining the applicable transfer pricing method should always be the best method and in some cases a profit split may be the best method but should never be the default option. USCIB believes that the current TPG provide workable rules and guidelines that guide both taxpayers and tax administrators to the best method for assessing intercompany transactions. This is illustrated by our responses to scenarios/questions attached as an appendix to this letter.

The current TPGs acknowledge that "methods based on profits can only be accepted insofar as they are compatible with Article 9 of the OECD Model Tax Convention especially with regard to comparability. USCIB is concerned – despite the language in paragraph 3 preserving the wider framework – that the discussion draft may be read as requiring the use of a profit split method if company operations include any degree of integration – which would affect all MNEs. USCIB continues to believe that appropriate comparables for individual entity activities can be found in most cases, that it is appropriate to distinguish between routine functions and those that make unique **and** valuable[2] contributions, and that one-sided methods continue to be appropriate for compensating routine functions. All companies are unique; they have different structures, people and cultures. That does not mean they are not comparable. To some degree, nearly all MNEs employ an integrated business model, usually in order to provide a better commercial value to their customers. Cross group integration does not mean that routine functions cannot be identified and priced. MNE integration can include unrelated entities (e.g., contract manufacturers and contract development centers) as well as related entities, so third party comparables will exist. If integration, however, becomes the standard for disregarding one-sided methods, then profit splits will become the de facto method for tax administrators.

The current transfer pricing guidelines contain an excellent description of the advantages and disadvantages of the profit split method. A profit split may be found to be the most appropriate method in cases where both parties make unique **and** valuable contributions.[3] A transactional profits split method would ordinarily not be used in cases where one party to the transaction performs only simple functions.[4] We note that part of the problem with this standard may be the notion of a simple function. For example, in the pharmaceutical industry the sales force usually comprises individuals with degrees in medical fields (e.g., nursing, pharmacology, and life sciences). Therefore, the individuals performing the

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[1] For ease of reference, all references to "profit" splits should be read to assume "loss" splits as well.
[2] All snowflakes are unique, but they are comparable and not particularly valuable.
[3] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, paragraph 2.109, page 93. (Hereinafter OECD TPGs.)
[4] OECD TPGs paragraph 2.109, page 94.

sales function are considered to be highly educated compared to other industry sales forces.[5] However, the sales functions are similar across companies, comparables can be found, and in fact a highly educated work force does not mean that the functions are complex or that a profit split is required. At the end of this letter we briefly respond to some of the scenarios/questions based on the guidance provided in the current TPGs. Those responses demonstrate that the current guidance can be applied to achieve reasonable results in the vast majority of cases.

<u>Current guidelines on formulary apportionment</u>

We also have serious concerns that the OECD is reversing the guidance that it issued as recently as 2010. In the 2010 update to the Transfer Pricing Guidelines, the OECD noted that advocates of global formulary apportionment argue:

> [T]hat an MNE group must be considered on a group-wide or consolidated basis to reflect the business realities of the relationships among the associated enterprises in the group. They assert that the separate accounting method is inappropriate for highly integrated groups because it is difficult to determine what contribution each associated enterprise makes to the overall profit of the MNE group.[6]

The "global value chain" analysis described in the discussion draft seems entirely consistent with the contention noted in paragraph 1.19 that an MNE group must be examined on a group-wide or consolidated basis. The argument that that MNE groups are now operating on a more "integrated" basis (consistent with the economist's conception of a single firm operating in a coordinated fashion) seems entirely consistent with the argument, rejected in 2010, that separate accounting is inappropriate, and that a unitary approach which erases the boxes on a legal entity organizational chart is appropriate. It is not at all clear how the arguments found in the discussion draft can be reconciled with the OECD's 2010 rejection of global formulary apportionment.

Formulary approaches were rejected for the sound reasons set out in the current Guidelines.[7] In particular the Guidelines note:

> The most significant concern with global formulary apportionment is the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation. To achieve this would require substantial international coordination and consensus on **predetermined formulae** to be used and on the composition of the group in question. For example, to avoid double taxation there would have to be common agreement to adopt the approach in the first instance, followed by agreement on the measurement of the **global tax base** of an MNE group, on the use of a common accounting system, on the factors that should be used to apportion the tax base among different countries (including among non-member countries) and on how to measure and weigh those factors. Reaching such an agreement would be time consuming and extremely difficult. It is far from clear that countries would be willing to agree to a universal formula.[8]

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[5] The sales function maybe complex, but it earns routine returns. Sales functions are widely available "commodities" for which there are known prices.
[6] OECD TPGs, paragraph 1.19, page 37.
[7] OECD TPGs paragraphs 1.21 -1.32, pages 38 through 41.
[8] OECD TPGs paragraph 1.22, page 38, emphasis added.

The example of the States of the United States is sometimes given as a successful application of formulary apportionment. In our view, the success of this model is over estimated. States have many different apportionment formulae, which can result in both double taxation and so-called "double non-taxation".

The discussion draft would increase these difficulties as the scenarios seem to be proposing a variety of different formulas with different apportionment factors and different weightings. It is difficult to envision how sovereign taxing jurisdictions could reach an agreement on multiple formulae including the profit to be split and the allocation keys in the BEPS time frames on topics raising the most difficult of pricing issues: multi-sided business models; unique and valuable contributions; and hard to value intangibles.

The current TPGs also note that:

> Global formulary apportionment cannot, as a practical matter, recognize important geographical differences, separate company efficiencies, and other factors specific to one company or subgrouping with the MNE group that legitimately play a role in determining the division of profits between enterprises in different tax jurisdictions.[9]

USCIB agrees with the conclusion of the OECD TPGs that global formulary apportionment should be rejected.[10]

<u>OECD move away from arm's length principle and separate legal entity</u>

We are particularly troubled that the OECD may propose a significant policy reversal in such a short amount of time, as stability and certainty are two of the traditional hallmarks of sound tax policy.

We also note our disappointment that the discussion draft follows closely the conceptual paradigm set forth in the earlier report on the tax challenges of the digital economy.[11] In our comments on that digital economy discussion draft , we noted several serious flaws including:

- Disregard of the distinction between an origin-based income tax and a destination based VAT,
- Used of inconsistent reasoning regarding the importance of "substance" in supporting income allocations depending on whether the allocation was proposed by the taxpayer or the tax authority,
- Movement away from the OECD's application of the arm's length principle substantially in the direction of formulary apportionment, and
- Risk of creating a hybrid transfer pricing system composed of both formulary and arm's length aspects that threatened the OECD's traditional role in furthering world trade and economic development by promoting uniform rules for taxing cross border transactions. [12]

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[9] OECD TPGs paragraph 1.29, page 40.
[10] OECD TPGs paragraph 1.32, page 41.
[11] Addressing the Tax Challenges of the Digital Economy, http://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf.
[12] The OECD also assumes that all internet or "cloud" based transactions are always profitable. This analysis ignores the significant costs for data center infrastructure and delivery costs that must be incurred in order to provide "SAAS" or "PAAS" to customers. In the physical delivery world these costs would be borne by the

In our view, this discussion draft exacerbates those flaws, rather than ameliorating them.

The movement towards formulary apportionment and a unitary approach to the taxation of multinational enterprises (MNEs) was perhaps most succinctly encapsulated in this paragraph from the digital economy report:

> When the arm's length principle was initially devised, it was common that each country in which an MNE group did business had its own fully integrated subsidiary to carry on the group's business in that country. This structure was dictated by a number of factors, including slow communications, currency exchange rules, customs duties, and relatively high transportation costs that made integrated global supply chains difficult to operate. With the advent of the development in ICT, reductions in many currency and custom barriers, and the move to digital products and a service based economy, these barriers to integration broke down and MNE groups began to operate much more as single global firms. **Corporate legal structures and individual legal entities became less important and MNE groups moved closer to the economist's conception of a single firm operating in a coordinated fashion to maximise opportunities in a global economy.** Attention should therefore be devoted to the implications of this increased integration in MNEs and evaluate the need for greater reliance on value chain analyses and profit split methods. This work should also address situations where comparables are not available because of the structures designed by taxpayers and could also include simpler and clearer guidance on the use of profit splits along the lines that have been successfully applied in connection with global trading and other integrated financial services businesses.[13]

That paragraph inappropriately confuses economic concepts with long-established international tax principles. It may be true that an MNE consisting of many legally separate entities is, for some economic purposes, a "single firm." However, structures have important legal and economic consequences, which companies consider carefully when setting up or changing their legal structures. The corporate form exists to encourage investors to pool their funds in risky ventures. Although the ultimate risk of success or failure of the combined firm rests with the ultimate shareholder,[14] as between separate legal entities within a firm, limited liability may protect the assets of one company, and therefore the ultimate shareholder, from the mistakes of another related company; legal entities are not merely separate pockets of the same person. The location of assets may also reflect the local legal system's ability to protect specific assets particularly intellectual property. Valuable intangibles will not be located in jurisdictions that do not offer protection for intellectual property rights.

Consistent with history of limited liability and separate corporate personality, the architecture of the international tax rules has for the last century been built upon the notion that separate legal entities are

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customer but in the cloud these costs must be borne by the provider. While some companies may in fact earn significant profits, the bulk of cloud service providers are heavily investing in the hope of profit at some point in the future.

[13] Id. at ¶166, emphasis added.

[14] The implication of the ultimate individual shareholder being the person ultimately at risk should create a drive towards the integration of corporation and personal income taxes rather than a formulary splitting of the profit of the corporation enterprise.

generally respected for tax purposes. This is both important and necessary. If a creditor of a corporation can only collect from the assets of that corporation[15], then it is important that the separate return to that corporation be appropriately determined under arm's length principles. If the profits of that entity are shifted to another entity then the ability of that creditor to collect against the corporate debtor would be impaired. Thus, the longstanding respect of corporate structure has legal, economic, commercial and tax consequences. If the result of the BEPS project is to overturn that architecture and move towards a more unitary approach (an approach with which we strongly disagree, and that we think would have enormous, negative consequences), then it should be done explicitly, but with considerable forethought into the consequences[16] and only with an enforceable agreement between governments to adopt a standardized profit allocation methodology. We believe that incremental change is far worse than an explicit and immediate change to a new standard like formulary apportionment. Incremental change creates uncertainty for business and could have broader economic consequences as corporate taxpayers might delay investment or expansion decisions while awaiting additional policy guidelines or would be subject to different treatment in different parts of the world.

MNEs exist precisely because of the benefits that come from operating in an integrated, interdependent, and synergistic manner. A parent company and its related entities share a common goal of maximizing profits, but how the local country business unit accomplishes this can vary from country-to-country given the need to localize and adapt to local country business practices and customs, which is of course done within the accountability and corporate governance principles adopted by the company's board and shareholders.

The term "fragmentation" is also used throughout the draft to cast doubt on the viability of proposed comparable transactions and one-sided transfer pricing methods. So while "integration" creates problems for use of one-sided transfer pricing methods, apparently the opposite of integration, "fragmentation," is also occurring and also causing problems with the use of one-side methods. In practice, it is often easier to find comparables when the entity performs fewer functions, thus so-called "fragmentation" should not create an obstacle to finding the right transfer price.

MNEs focus on what they do best and outsource non-core activities. Thus, MNEs routinely "fragment" their businesses in part to unrelated parties. For example, outsourcing of manufacturing is commonplace in the electronics business. Both computer hardware and consumer electronics are routinely manufactured by third parties. These decisions allow companies to free up capital and resources to focus on their strengths. If, on the other hand, an MNE decided to keep this activity within the group, but in a separate legal entity with only that limited function, should they be treated differently than another group that "fragmented" the activity by outsourcing it a third party? We believe that consistent with the arm'[s length principle they should not be treated differently. Outsourcing also provides comparables to help determine the appropriate compensation when these functions are performed by affiliates.

Outsourcing functions is common in many other industries, including the pharmaceutical and chemical industries as examples. Pharmaceutical companies can and do outsource different aspects of their business. Some might outsource (or partner with an unrelated party) on research and development.

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[15] Creditors frequently require conditions limiting the ability of corporations to transfer assets out of the corporation. Attributing the profit from a valuable asset out of one corporation to another related corporation may function like a transfer of that asset. The implications of such rules for creditors ought to be considered.
[16] For example, the UK's proposed "Diverted Profits Tax" may result in reduced foreign investment in the UK.

Marketing and sales may be outsourced, manufacturing may be outsourced. In the context of the global enterprise, different functions may be performed internally or outsourced, so that it is very likely that internal comparables exist. Putting different activities in different entities makes sense from a business perspective and is not tax avoidance.[17] These activities will be managed separately and a one-sided method will likely be the most appropriate method; however, in limited and complex cases a two-sided method may be appropriate.

The concept of uniqueness is relevant here. Even under the current rules, tax administrations routinely reject internal comparables because of slight differences in the transactions. Tax authorities demand essentially identical transactions (which of course do not exist) and inappropriately reject transactions with unrelated parties that are functionally equivalent to those with related parties. The notions of "integration", "fragmentation", and "global value chains" seem designed to give support to these unwarranted rejections of comparable transactions. The OECD seems to be arguing that a price within an integrated company is never comparable to one that is not part of an integrated group; therefore, the prices – even internal comparables with unrelated parties – cannot be comparable because of the fact of integration in the global value chain. Demanding perfect comparables, and rejecting their application with integrated MNEs is tantamount to a rejection of the arm's length principle. Consistent with the arm's length standard, this notion must be rejected.

The term "global value chain" is apparently taken from a 2013 report by several OECD committees[18] regarding the international "fragmentation" of production in global value chains and its effects on the global economy. It is defined as the "full range of firms' activities, from the conception of a product to its end use and beyond . . . . It includes activities such as design, production, marketing, distribution and support to the final consumer."[19]

It is difficult to see how examining a firm's "global value chain," including the full range of firms' activities, from the conception of a product to its end use and beyond" will be relevant or useful to the transfer pricing of the vast majority of related party transactions. It will certainly not be relevant to transactions involving limited-risk distribution, manufacturing, or R&D. In the absence of the international agreement identified in paragraph 1.22 of the OECD's TPG[20], analyzing the "global value chain" is likely to give rise to an infinite number of possible profit allocations. How are taxpayers to settle on a particular outcome? How are they to document their transfer price? How are tax authorities to audit and resolve the inevitable disputes (both with taxpayers and other concerned jurisdictions) concerning these profit allocations?

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[17] For example, within the EU MNEs are able to centralize distribution functions as a result of the removal of restrictions on the cross border movement of goods and the existence of explicit VAT rules. MNEs are able to save costs by avoiding duplicate operations and those savings may be passed on to customers in the form of reduced prices, making the MNE more competitive.

[18] Interconnected Economies: Benefiting from Global Value Chains, OECD Publishing. http://dx.doi.org/10.1787/9789264189560-en.

[19] We note that the discussion draft, in paragraphs 38-43, page 11, has also appropriated the "RACI" (Responsible, Accountable, Consulted, and Informed) matrix from the project management field. We will not comment extensively on this framework, and only note in passing that we are leery of incorporating the latest fads from the fields of management consulting and business administration into the Guidelines; their usefulness to a transfer pricing analysis is not readily apparent.

[20] There is no evidence that such an agreement can be reached within the BEPS timeframe. Indeed, there are no proposals on how profit splits should be split in this discussion draft.

It seems that many of the BEPS Action Items are aimed at giving countries both permission to use profits to achieve formulary outcomes and the tools necessary to implement these outcomes. The Actions that raise these concerns include: the digital economy report, the interest deductibility report, virtually all the transfer pricing work including the work on intangibles, risk and recharacterisation, and documentation, especially the country-by-country report.

Current use of profit splits

Profit splits have been used successfully in a limited number of bilateral APAs and in exceptional Competent Authority agreements. However, these are case-by-case determinations with a discrete set of participants to the negotiation. These agreements, therefore, do not present the same significant difficulties as a potential global agreement on one or more formulae.[21] In this regard, business was very supportive of the proposal to develop bilateral or multilateral MOUs to reflect transfer pricing methodologies that countries have agreed on in particular cases and extending those agreements more broadly. There has been no evidence of any progress on this front at the OECD. It appears that it would be far easier to reach agreement on these more limited cases before tackling global agreement on formulas for a variety of different and difficult issues. That is, if countries cannot reach agreement to extend previously agreed narrow solutions more broadly, then it will be impossible for them to reach agreement on the broad range of difficult issues raised by the discussion draft.

Conclusions

For all of these reasons, we believe that the conceptual framework set forth in the discussion draft should be carefully reconsidered by the OECD and the individuals who prepared this document. We believe it represents an unwarranted and flawed attack on the arm's length principle and separate entity accounting. Even if that were not the intent, we believe the risk of interpreting the discussion draft in that manner is high and can only lead to confusion and unprincipled approaches to transfer pricing assessments.[22]

We would also point out that the arm's length principle is based on Article 9 of the OECD Model Tax Convention, which respects separate entity accounting. The Transfer Pricing Guidelines, which are essentially the commentary to Article 9, must be consistent with it. To the extent revisions are made to the Guidelines as part of the BEPS project which are inconsistent with Article 9, as incorporated in thousands of existing bilateral tax treaties, it could create years of needless disputes. Given that the recent discussion draft on dispute resolution mechanisms proposed only modest improvements, this could contribute (along with other BEPS project recommendations) to a substantial expansion of unresolved tax disputes and the "global tax chaos marked by the massive re-emergence of double taxation" of which the BEPS Action Plan warned.[23]

[21] Consider an MNE with operations in 100 countries. It is unrealistic to assume that all countries concerned, or even a minority of the countries, could agree on a common base and allocation keys. The practical consideration of implementing a profit split point overwhelmingly toward maintenance and improvement of the arm's length standard.

[22] Many MNEs are already seeing unprincipled tax assessments on theories that have not been approved by the OECD or enacted into local law.

[23] We also note our support for the earlier work on safe harbors and bilateral or multilateral MOUs for the competent authorities to reflect agreement on a transfer pricing method that could be extended beyond the parties involved in that agreement (http://www.oecd.org/tax/transfer-pricing/50514053.pdf). We have seen no evidence of any progress on that front. We respectfully submit that that work could be very useful both in terms

USCIB appreciates the opportunity to comment on the discussion draft and looks forward to working with the OECD to achieve appropriate outcomes.

Sincerely,

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Chair, Taxation Committee
United States Council for International Business (USCIB)

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of clarifying application of the arm's length principle, consistent with its historic understanding, and in minimizing tax disputes and conserving precious competent authority resources. We strongly urge that resources be devoted to finalizing that work as soon as possible.

Appendix: Comments on specific scenarios/questions

USCIB has some responses to the scenarios/questions posed on the application of the current TPGs, in particular whether profit splits should be appropriately applied. We have preserved the numbering, by including a number without comment in cases in which we have no comments.

Scenario 1.

1. Transactional profit spit method could be used to provide a transfer pricing solution. First, the taxpayers could determine total operating profit in the European market as the difference between sales to end customer and the sum of fully-loaded production and selling/distribution costs. Second, the taxpayers could determine the routine return for the fully-loaded selling/distribution function, and subtract that amount from operating profit. The residual profit could be split between the OEMs. The split could depend on a number of factors, as discussed in (2) below.
2. The aspects that need further elaboration include the differences/similarities in OEMs operations, and their risk profiles.
   - If the OEMs are very similar in all respects except for the assortment of manufactured products, residual operating profit can be split in such a way as to equalize the return to OEMs' operating assets. The OEMs' royalty for technology IP can be split along the lines of the profit split to ensure that the royalty payment is commensurate with income.
   - The OEMs, however, might be different in respect of the use of specialized inputs and economies of scale. For example, one OEM might be able to use a batch process to manufacture the product with minimal utilization of labor whereas the other OEM may employ a process that is labor-intensive. The split of the residual on the basis of equal return on operating assets may under-allocate the profit to the labor-intensive OEM. In this case, the split can be based on the ratio of returns for unrelated companies that are, correspondingly, capital- or labor-intensive. Similarly, if one OEM employs a process that generates economies of scale, the effect of the economies of scale would need to be incorporated into the split.
   - One might also have to consider whether excess capacity exists at each OEM, and why. If the Leadership Board decided that putting in place the process with excess capacity was the only way to produce the necessary component utilized by all OEMs, then all OEMs should bear the cost; if, however, excess capacity is the result of poor management by the OEM, the cost should be borne by that OEM.
3. Overall, if all OEMs bear risks, play an entrepreneurial role, and have significant cross-selling activity, a transactional profit split method could be preferable to other methods provided that all countries involved have agreed to the appropriate allocation keys.
4. Additional guidance would describe how to approach disparate technologies, uneven risk profiles, and differences in scale among the parties to the transaction.

Scenario 2.

5. The use of transactional profit split method in this case depends on whether the local subsidiaries face material risks. The fact pattern in this scenario might be interpreted that "suggestions" on the algorithms and technologies provided by the subsidiaries to Company R, as well as translation, tailoring, and regulatory compliance functions, do not impose operating risks on the subs, in which case the subsidiaries' remuneration can be

provided on a cost-plus basis. This scenario ignores the costs associated with providing the service to external customers. For example, RCo Group would likely be required to create multiple data centers around the world to provide the advertising services to individuals. These data centers are very costly (in the hundreds of millions of US dollars to create and initially equip). In addition, the annual expenses of the data center would need to be properly accounted for in determining the profit split. These annual expenses include operating expenses, and update and replacement of the equipment. The OECD should recognize that once all costs are taken into account, there may be a loss that should be split among the relevant jurisdictions.

6. The transactional profit split method should only be considered if the subsidiaries have an entrepreneurial role with regard to their demand generating function, in which case the relative contributions of this function and technology owned by Company R would have to be considered in determining the split. The demand generating function has to be spelled out with regard to the actual risks that it imposes on the subsidiaries' operations.

Scenario 3.

7. [
8. The aspects that require further elaboration are as follows:
    - Whether Company S operates at risk.
    - Whether the functions performed by Company S could be purchased by Company P from 3rd parties.
    - Whether "competitive advantage" provided to the Group by Company S can be quantified.
    - The extent of "modifications" and "proactive maintenance" offered by Company S (full-fledged distributors often provide these services to their customers).
    - The extent of Company S's dependence on the marketing strategy developed by Company P.
    - The Company S contributions are overstated in importance. There are countless examples of a third party distributor providing these services today which provide comparables to determine appropriate compensation for these activities. The value in the equipment is in the intellectual property that created the technology. There is limited "value" in the functions that Company S performs.
9. Under the fact pattern of scenario 3, transactional profit split method might not be necessary. If Company S operates at risk, a Resale Price Method might be an option if appropriate comparable transactions can be found. If Company S provides significant marketing service, a TNMM with an operating margin, plus an additional marketing return, might be preferred.
10. Transactional profit split method might be appropriate if Company S's intangible contribution (e.g., the effect of modifications and proactive maintenance) were quantifiable. This would require concrete examples of how the competitive advantage is manifested and such examples would likely to be difficult to find and subjective.

Scenario 4.

11. Transactional profit split method might be an appropriate approach if the contributions of Companies B and C were unique and risky and if similar components could not be obtained from unrelated parties. The profit split method would also be appropriate if the total amount of profit generated from the manufacture and sale of this medical equipment (Companies A, B, and C combined) were smaller than the sum of individual

returns to Companies A, B, and C if such returns could be measured by reference to comparable companies. To elaborate, suppose that one could find suitable comparable companies whose data could be used to calculate the return on operating assets to be used as a benchmark for Companies A, B and C. When this benchmark is applied to the operating assets of Companies A, B and C, the sum of individual companies' profit components based on the benchmark can be higher than the total amount of profit generated from the manufacture and sale of this medical equipment. Under such circumstances, a split of the available profit could be necessary. It would only be an appropriate method if tax authorities in the relevant countries accept an appropriate allocation of costs associated with the risks to each entity concerned. The discussion draft appears to assume that costs are minimal and profits are both common and significant. Absent specific acceptance by all countries that costs can be allocated and deductions allowed for such allocations across borders, the transactional profit split method is incomplete.

12. A one-sided method might produce more reliable results if Company A can outsource the development and production of key components to unrelated parties. (The fact in this scenario that the components are unlikely to be useful in other types of products does not indicate that Company A is precluded from sourcing these components from unrelated parties.) If the components can be outsourced to 3rd parties, Company A's bargaining power will be significant over that of Companies B and C. The suitability of a one-sided method also depends on the degree of risk borne by each company with regard to the finished product. If Company A is ultimately responsible for the quality of the sold equipment, Company A might be more likely to compensate Companies B and C on an operating asset or cost-plus basis.
13. The degree of shared risks, options realistically available to the parties, availability of comparable companies.
14. [
15. Whether transactional profit split methods are appropriate for fragmented functions depends on these functions' uniqueness, complexity, risk, and value contribution to the overall supply chain. When the uniqueness, complexity, risk, and value contribution are limited, the remuneration of the function can be determined using one-sided methods. Even in cases where the tested party's functional composition is somewhat different from the functions performed by the comparables, the one-sided methods may be acceptable if the functional difference of the tested party is reflected in the cost base (for a cost-plus method).
16. The functions' uniqueness, complexity, risk, and value contribution to the overall supply chain need to be elaborated.

Scenario 5.

17. The overall profitability of the supplier of office stationery in a region should be in line with comparable distributors that operate in that industry and region.[24] Whether transactional profit split methods or one-sided methods are appropriate depends on the similarity of markets in which the companies operate. If the markets are similar – i.e., if the product composition and the associated functions have similar profit potential – then one can remunerate individual operators on the basis of the comparable

[24] This scenario outlines precisely why MNE's have moved to a centralized structure. Customers' desire for centralized billing and distribution causes MNEs to adopt centralized risks and functions. This structure also makes sense from an economic perspective; MNEs save money by avoiding duplication of functions across legal entities.

companies' results. However, this could effectively produce the results consistent with a profit split if, for example, the selected one-sided benchmark is an operating margin which, when applied to individual operating countries, would produce the total operating profit in the region. The profit in this case would be split on the basis of sales.

Where certain operating companies perform services for other members that exceed the scope of functions performed by other members, a profit split approach becomes more relevant because the direct application of the comparables' benchmarks might produce the sum of parts exceeding the total. In this case, such additional services can be compensated separately on the basis of a one-sided method, and the residual profit can then be split using an appropriate basis (e.g., sales, cost, or assets).

Whether the operating companies sell to local customers or fulfill orders placed with other group companies might be of minor importance if there is limited marketing to local customers which can be the case if the overall brand of the MNE group is the main driver of the business. In such a case, operating companies may function like logistics/warehousing service providers, and would be compensated on a cost-plus basis subject to the total profit cap.

If the markets are different – i.e., if the product composition and the associated functions have different profit potential, and require varying degrees of marketing effort – then the applicability of the profit split method might be necessary.

18. Publicly available financial statements are available in most countries and could potentially be used with appropriate adjustments to serve as comparables.
19. The aspects requiring further elaboration are the degree of difference/similarity across the markets, including product composition, functions performed by operating companies, whether unique assets are being employed, and what risks are being borne. It is unclear why an MNE group should be concerned about the buying activities of its unrelated customers. The fact that the customer may be buying on behalf of a regional entity is a transfer pricing issue for the customer, not the MNE group. The regional purchasing activities of the customers do not generate measurable compensable value for the MNE affiliates accepting regional orders. MNE affiliates are taking orders and fulfilling them whether on a regional or single jurisdiction basis. Even if the transaction was transparent such that the MNE was fully aware of its customers purchasing activities, it will be virtually impossible for the MNE group to be able to track and compute a separate transactional profit split for each customer as accounting systems are not capable of tracking and reporting this level of detail. Also, to the extent that the regional capability allows the group to make additional profit, this profit will be earned by all the members of the MNE group participating in these transactions and thus it should not be necessary to aggregate that profit and split it.
20. This approach could be applicable under a very specific set of facts and circumstances. The establishment of the floor and ceiling on the operating margin can suggest several things, including, among others, (i) that the operating performance of the party is linked to the profitability of the group (which does not have to be the case if the party is a routine service provider), or (ii) that the risk of the party varies only within the prescribed range and only when the group's performance changes. If the party in this example were a distributor, the ceiling on the OM can be interpreted as a performance

bonus whereas the floor can be viewed as price protection, both of which could be addressed through a one-sided method. Whether a one-sided method is used, or if the floor/ceiling range is incorporated into the profit split, the boundaries of the range should be established by reference to the risk profile of the party. Such an approach could be useful as long as there was consideration of an appropriate return for an industry. A blanket baseline return of 7%, for example, would be excessive in some industries and de minimis in others. As noted above, costs as well as profits of a particular company must be taken into consideration in arriving at an appropriate transfer price.

21. The current guidelines provide two circumstance in which the transactional profit split method may be the most appropriate method: (i) where both parties provide unique and valuable intangible assets to the transaction where the comparables are not available, and (ii) where the group operates on an integrated basis, comparable transactions can be identified, but the total operating profit of the group is higher or lower than the operating profit implied by the comparable benchmarks, in particular global trading is identified as case in which a profit split may be the best method[25].
22. The discussion draft would benefit from a discussion that value drivers can be industry- or sector-specific. In certain cases, the value of production might not be an appropriate value driver if it incorporates expensive inputs and very little added value. In other cases, combining production capacity and headcount through a weighting approach might be misleading if the production processes across enterprises are drastically different. If one is uncertain about the most reliable allocation key, the process for selecting one should start with the analysis of the relevant industry and market factors. Once the industry value drivers have been identified, the selection of the allocation key will be more reliable.
23. If factor weighting is necessary, one needs to review their relative contribution to value. For example, in a simple capital/labor framework, there could be the optimal ratio of capital and labor inputs into the production process, even if these factors are owned and operated by different entities. Such optimal ratios might become the foundation for determining the split. The factors ignore the value of intellectual property investments that each participant may have brought to the transaction. Because an asset is not reflected on a corporate balance sheet does not mean that it does not have value that ought to be compensated or accounted for in the allocation keys.

Scenario 6.

24. Paragraph 42 appears to suggest that personnel is the primary value driving factor that affects other value drivers but none of the other value drivers are mentioned.[26] The analysis of profit splitting factors can be supplemented by the analysis of market characteristics and organizational constraints which will help determine which factors play an active role in profit generation and which factors are a dead weight.

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[25] OECD TPG, paragraph 2.109, page 93. We agree that is some cases integration may be a factor in determining whether profit split is the best method. However, global trading is a highly integrated function and providing that the profit split method may be the best method in such a case is very different from providing that profit split is or may be the best method any time there is any benefit from integration in an MNE global value chain.

[26] This scenario seems inconsistent with the discussion draft on risk and recharacterisation which require carefully analysis of risk. That discussion draft would seem to prohibit the behavior described in paragraph 42, that is "risks and assets were not considered separately as they were considered by the MNE group to be embedded in the processed that managed them." Discussion draft, paragraph 43, page 11.

25. A framework for a multifactor profit split analysis can certainly be developed, but the reliability will decline with the complexity of the transaction. As the number of factors increases, certain factors might become endogenous to the process which means that parsing out individual factor effects for purposes of the split might become subjective. In scenario 6, Companies A and B operate within a set of constraints, and the ultimate profit pool depends on the decisions made by A and B, where the decisions are not necessarily concurrent. For example, the decision on business and development strategy by A may be made first, followed by B's development of the manufacturing process and procurement decisions. Company A's decision is made given the (potential) technological capability of B, whereas B's decision is made within the narrower choice set constrained by the previous A's decision. Theoretically, one could use real options valuation approach by employing binomial lattices, but each step in a decision tree will be affected by market characteristics and organizational constraints, and will suffer from data limitations.

    The way to approach a multifactor analysis is to keep it uncluttered. Do not use a factor unless absolutely necessary. Try to avoid the factors whose outcome is tied to another factor because the profit to that factor may be double-counted. For example, if one factor is management of IP whereas the other factor is sales, the sales factor is likely to be the outcome of the use of the management IP factor, and the allocation of profit based on both factors may inflate the management IP factor.

    For complex structures, break the operation into large sub-modules and analyze the profitability of each module as a stand-alone entity. Determine the value driver(s) within each module. Determine the best realistic alternative for each module. Compare the sum of profits for each module to the total operating profit of the transaction. If the sum of parts is larger, consider which module was most likely to underperform given the market characteristics. Determine whether the underperformance was due to the module's own actions or whether this was the result of the decisions made by other modules. Based on the determination, adjust either the underperforming module or the other modules involved in the decision. Clearly, this process will get very complicated.
26. Particularly relevant is the discussion in ¶2.133 regarding reliance on data from comparable uncontrolled transaction – specifically, that co-marketing and co-promotion agreements can be used for guidance – and Section C.3.4.4 on reliance on data from the taxpayer's own operations.

Scenario 7.

27. This fact pattern raises numerous questions: Is the development of the two components sequential or concurrent? What are the differences in technology embedded/used to manufacture each component? For example, one technology might be simple chemical batch production whereas the other is manufacturing product with very specific characteristics. The risk of failure/cost overrun will vary with the technology. Can any development work be outsourced to unrelated parties? Is any information on success/failure rates in this industry publicly available? If so, one might be able to use them to construct the risk-adjusted split.

    If the profit split agreed to by the parties is appropriate to the anticipated results, the profit split should also be appropriate for unanticipated results unless such results are due to information asymmetry. Having a look back rule to account for information asymmetry (such as commensurate with income) may be appropriate in limited

circumstances. However, such a rule should only apply if the actual results are outside of a band of reasonable returns and the taxpayer should have an opportunity to demonstrate that the unanticipated results were due to external factors beyond the taxpayer's control, in which case the negotiated profit split should be respected. Losses should also be split in the same manner as profits.

Scenario 8.

28. In this scenario, if the combined operating margin remains stable year after year, and if the ex ante 80/20 split is not challenged, then the royalty rate will remain constant. For example, if sales = 1000, operating profit = 100, OM=10%, 80/20 split = 80/20, and company P's royalty rate is 8%. If sales increase to 2000 while OM = 10%, OP = 200, 80/20 split = 160/40, and company P's royalty rate is still 8% (160/2000). If the sales/profit path is not constant but predictable, a fixed royalty rate can be calculated so that it produces the same income stream on a net present value basis. When the sales/profit path is not predictable with any degree of certainty, then that is when the fixed royalty rate will be problematic. However, the problem is not just with the royalty rate: the entire 80/20 split would have to be re-examined.

Scenario 9.

29. This might happen if the losses occur during a startup phase when the IP was not fully developed and the split can be done on the basis of contributed capital. Then once the IP becomes the primary value driver and is able to generate positive operating results, the split can be done on the basis of relative IP contribution. Profits and losses should be split on the same basis unless there are unusual factors weighing on either that would dictate a different result.
30. Yes – if the loss was the result of the actions of one party which actions were not incorporated into the ex ante split. For example, one party brings to the transaction patented technology whereas another party contributes marketing IP/customer relations. If the first party is found infringing on a patent causing severe deterioration of sales which results in operating losses, the ex ante split would have to be revisited because the marketing party to the transaction should not have to bear the losses caused by patent infringement.
31. Among other practical difficulties is that the transactions are becoming increasingly complex, the value drivers are commingled making it exceedingly difficult to determine their individual influence on profit generation. One of the (so far underused) tools at practitioners' disposal is regression analysis which can be applied to parse out individual value components. At times, several methods might have to be used to determine the correct income allocation. The profit split analysis similarly has to be scrutinized to determine that the specification of allocation keys is robust.