



September 2, 2016

VIA EMAIL

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Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Actions 8-10 – Revised Guidance on Profits Splits (“discussion draft”)

Dear Mr. VanderWolk,

USCIB¹ appreciates the opportunity to comment on the Revised Guidance on Profits Splits Discussion Draft (“discussion draft”). We understand the importance of having a meaningful two-sided method such as the transactional profit split method to support the other transactional methods listed in the OECD Guidelines. We understand, per page 1, that this is not a consensus view of the CFA and hope our comments and the public consultation in October will help the OECD achieve guidance supporting cross-border investment and minimize double taxation by providing a consistent and administrable set of rules on this important topic.

Executive Summary

We agree with the overall tone and content of the discussion draft. In particular, we agree with the discussion draft:

¹ USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

- On the need for the transactional profit split method (“TPSM”) to be consistent with arm’s length principles and reflect the arrangements that unrelated parties would likely enter into under similar circumstances;
- That a key indicator of the appropriateness of a profit split of actual profits is that the parties continue to share in the outcomes and manage the business activities and risks associated with those subsequent outcomes (they act more like partners);
- That lack of comparables alone is insufficient to warrant the use of a transactional profit split under the arm’s length principle;
- That group synergies alone are insufficient to warrant the use of a transactional profit split under the arm’s length principle;
- That the transactional profit split method may be the most appropriate method if unique and valuable intangibles are contributed by both parties to the transaction(s) under consideration;
- That the most appropriate method criteria requires significant integration of functions and risks among related parties, in addition to the presence of unique and valuable intangibles, before the TPSM would be considered the most appropriate method;
- That profit splits are more common and appropriate in some industries than in others;
- That defining the level of profits (or losses) to be split is often a complex and difficult exercise;
- That profit split factors should be measurable, verifiable, and related to the profits that are to be split; that is, there must be a causal relationship between the measure of the contributions that give rise to the economically significant risks (the profit split factor) and the definition of the profits to be split which must be the return on these economically significant risks; and
- That a value chain analysis can be useful as a diagnostic tool to assess the relative contributions of both parties to a transaction and identify potential split factors, but should not be required to support taxpayers’ determination of the most appropriate method.

USCIB believes that in most cases a transactional profit split method will not be the most appropriate method and the introduction to this section of the Transfer Pricing Guidelines should recognize that. In addition, it would be useful to include additional statements concerning what the transactional profit split method is not. USCIB is concerned that some countries use profit splits that are not based on the principles articulated in the discussion draft and set forth above. That is, for example, some countries rely on profits splits when they find it difficult to find comparables even though the transactional profit split is not otherwise appropriate. In some of these countries the profit split method looks more like formulary apportionment, which has been repeatedly rejected by the countries participating in the BEPS project. Despite recognizing that a value chain analysis can be a useful tool, USCIB is also concerned that countries that support a formulary type profit split intend to use the value chain analysis to justify profit splitting factors that achieve global formulary apportionment, rather than a transactional profit split of profits. In a transactional profit split, profits outside of the transaction between the two parties to transaction are not relevant. Therefore, the

information provided by the value chain analysis might be more relevant to risk assessment than actual splitting of the profit from the transaction at issue and therefore discussion of value chain analysis would more properly be included in Chapter I.

It is therefore important for the OECD – perhaps by adding an introduction that could remain a permanent part of the Transfer Pricing Guidelines -- to state that the transactional profit split method is not formulary apportionment, is not intended to achieve results consistent with formulary methods, and should not be used for this purpose. An executive summary should also highlight the complexities of the TPSM, and the difficulties in obtaining appropriate financial reporting information and other relevant data, as discussed in detail in the body of the discussion draft. We believe these issues are the most important factors to consider in evaluating the TPSM and will generally result in a conclusion that the transactional profit split method is not the most appropriate method.

While we understand that the discussion draft is meant to provide general guidance rather than specific instruction on the selection and application of the transactional profit split method, we do think greater clarity is required on a number of topics listed below. Greater clarity will help reduce confusion on evaluation, selection and application of the transactional profit split method by both taxpayers and tax authorities.

Comments

Section C.1 – In general

USCIB requests greater clarity on the differences between a split of anticipated profits and a split of actual profits. In particular, we are unclear if there are significant differences in risk profile or selection of method between anticipatory and actual. With respect to risk, we agree with paragraph 10 that “It would be contrary to the guidance of Section D of Chapter 1 to apply a transactional profit split of actual profits where the functional analysis demonstrates that one party does not exercise any degree of control over those risks, since to do so would assign to that party the impact of risks it does not control.” We think this standard applies to anticipated profit splits as well because if one party does not control any risks it should only be entitled to a routine return that should be determined under a one-sided method. The discussion draft should make clear that control of risk by both parties to the transaction is also necessary to the proper application of an anticipatory profit split.

While risk sharing should be a necessary precondition to the use of the transactional profit split method, sharing of risk alone is not sufficient to justify its application. Risk is real and is taken on anytime a company does business. The existence of risk does not mean that comparables are not available. Many risks taken on by related parties are similar to risks that exist between unrelated parties and can be priced appropriately using other methods. It is USCIB’s view, therefore, that in most cases risk can be priced accurately without resorting to the transactional profit split method unless both parties make unique and valuable contributions. The existence

of unique and valuable contributions, in virtually all cases implies the use of non-routine intangibles.

Paragraph 3 states that “profit splitting factors...must be determined ex ante on the basis of information known or reasonable foreseeable by the parties at the time the transactions were entered into.” USCIB agrees that the *framework* must be determined ex ante. However, USCIB would like to point out that profit split factors are often based on annual results, especially if the transaction is more of a service than an asset. An example of this could be barrels of oil pumped from a joint venture or billable hours by a service company. Additionally, in a transactional profit split of actual results, the profit splitting factors are often updated on an annual basis. An example would be a capitalized cost method that rolls forward the additional expense and amortization annually. So while the profit split framework may be established ex ante, the annual application will change as the taxpayer’s underlying business inputs change.

We note that the comment in paragraph 8 that distributors do not bear risk in underlying product price movements (e.g., chocolate bars) is at odds with the practice of many distributors of commodities who do pass along price increases. Gasoline stations, grocery stores (produce) are examples of such pricing behavior. The example might need to be narrowed, so that it is not misinterpreted.

C.1 - Commentator Questions

The guidance in the 2010 Transfer Pricing Guidelines on the application of the transactional profit split method envisages its application to either projected or actual profits (see 2.127). This discussion draft proposes to explore these distinctions further and provide clearer guidance on the different applications of the two approaches.

1. Comments are invited on the usefulness of the explanation of and of the guidance on transactional profit splits of anticipated profits. In particular:

1. Is the distinction between transactional profit splits of anticipated profits and transactional profit splits of actual profits clear?

As noted above, USCIB thinks greater clarity is needed on the differences between an actual vs. anticipatory profit split. In particular, how does the anticipatory profit split differ from a conventional CUP royalty analysis? That is, in order to apply a transactional profit split method to anticipated profits, the relative shares might have to be converted into royalty rates. Furthermore, anticipated profit cannot be split by assigning a royalty rate to both parties to a transaction, because the effect of such an assignment would be to split actual profits – for example as the actual base varies from the projected base. At arm’s length, when the parties seem to be applying a transactional profit split of anticipated profits (by determining a royalty rate for one of the parties to the transaction) there are often adjustment clauses based on performance or milestone payments that bring the transactional profit split of anticipated profits closer to a transactional profit split of actual profits.

Although paragraph 2 of the discussion draft states that references to a transactional profit split method cover both applications of the method, it is sometimes not clear whether the discussion draft is referring to the transactional profit split generally or only the split of anticipated profits or only the split of actual profits. The discussion draft should be revised to make this clear throughout.

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

The distinction is useful but requires additional clarification. The guidelines also need to address the reliability of financial data on which the transactional profit split method is based. In the case of a profit split based on actual profits, the splitting factor is the key. In the case of a profit split based on anticipatory profits, both the allocation keys and the base to split are determined ex ante and therefore depend on financial data that must be reliable to achieve an appropriate answer. Clarification is required to define the appropriate level for the ex ante determination to be applied – while the framework may be determined ex ante it seems highly likely that the annual computations required will change as the underlying business inputs change. In addition, the role of risk should be clarified in an anticipatory profit split.

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

USCIB agrees that close integration between both parties to the transaction is required if the transactional profit split method is to be considered the most appropriate method. We believe this integration includes both the sharing and the management of the risks in question. However, operations do not necessarily have to be integrated. In addition, highly integrated businesses (a baseline requirement to succeed in today's business world) may earn routine profits and comparables may be available to determine the appropriate price. So integration, without the presence of unique and valuable intangibles earning non-routine profits on both sides of the transaction, should not be a sufficient condition to support the use of the transactional profit split method as the most appropriate method.

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

See examples section below

Section C.2 – Summary of strengths and weaknesses

As detailed above, USCIB agrees that for highly integrated businesses with unique and valuable intangibles the transactional profit split method may provide a reliable method to determine the arm's length price. Similarly, we agree that it can provide flexibility and can mitigate extreme results. We also agree with the challenges in defining, implementing and administering the transactional profit split method. As noted later in this letter, we also agree that delineating the profit to be shared and the profit split factors are complex exercises that if performed incorrectly can greatly compromise the reliability of the pricing method.

C.2 - Commentator Questions

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

USCIB generally agrees with the summary of the strengths and weaknesses in this section. We are concerned, however, that the difficulty of applying the transactional profit split method is not emphasized enough. Companies do not generally keep financial records that track the relevant transactions. Therefore, these records will need to be created on a case-by-case basis and it is also likely that the creating the records for one year does not necessarily provide a framework for subsequent years. Creating financial information separate and different from the taxpayer's normal operating financial reporting will require subjective judgments with respect to cost allocation and segmentation issues, leading to higher risk for controversy and double taxation.

It is not clear what the "benchmarked profit" in paragraph 13 of the discussion draft is referring to. If this refers to one-sided testing based on comparables, then transfer pricing methods based on benchmarked profits will, in fact, be the most appropriate method in the majority of cases. Most companies in a MNE do not earn premium returns and the routine profit attributable to those activities can, in fact, be "benchmarked".

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

A critical weakness of the transactional profit split method as formulated with the distinction between actual and anticipated profits, is that, in practice, it will be difficult to distinguish whether actual or anticipated profits ought to be used. USCIB is also concerned that tax authorities will be evaluating the results after-the-fact when outcomes are known and will use hindsight to determine which method produces better results and require the taxpayer to use that method.

Another weakness of an anticipatory profit split is that it requires the use of forecasts concerning the profitability of the transaction. Factors that determine the reliability of valuation techniques also apply to the anticipatory profit split. These include: reliability of forecasts, reliability of the estimated useful life of the product or service offering, and the reliability of the appropriate discount rate. Inability to accurately specify any of these variables would limit the use of an anticipatory profit split.

The transactional profit split of anticipated profits may, therefore, be most useful when there is a single contributing factor that is not expected to be volatile, which can be isolated and valued. For example, if one party to a transaction contributes a brand name and the other party contributes in-process R&D, the brand value might not be expected to vary significantly which might mean that it is relatively easy to convert to a royalty rate. In this case the role of the

transactional profit split would be to determine the relative value of the two intangibles. Determining the relative value of intangibles may be a complex and subjective exercise and may mean that the transactional profit split of anticipated profits is unreliable.

At a first glance, it appears that a strength of the transactional profit split of anticipated profits is that it would allow one to correctly capture the risk of each party: if A grows the market through own efforts, splitting the actual profit between A and B would allow B to free-ride on A's effort. But this assumes that the actual profit would necessarily have to be split based on pre-determined percentages. Unrelated parties often incorporate performance clauses that allow them to align actual performance with anticipated performance – there is a truing up at year-end. This also can be and is done in related-party transactions.

As mentioned above, the main weakness of the transactional profit split of actual profits is the difficulty of identifying the profit to be split, as well as quantifying the profit splitting factors, because the books and records of the companies are very unlikely to provide this information without substantial adjustments. This weakness should not be underestimated.

Section C.3 – Most appropriate method

USCIB agrees with paragraphs 16 and 18 that lack of comparables is not a valid basis for selecting the transactional profit split method, but rather significant business integration as described in section C.3.1 and unique and valuable intangibles as discussed in C.3.2 are required. Concerning the sharing of risks as discussed in paragraph 19, USCIB believes the criteria for control of risk as applied in Chapter IX is appropriate. For the transactional profit split method to be considered the most reliable method, both parties to the transaction must have management responsibility over their respective risks, not simply the bearing of the risks.

C.3 - Commentator Questions

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

- 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*

USCIB believes that, consistent with Chapter IX, that risks should only be included in a transfer pricing analysis if they are controlled by the relevant party. We are uncomfortable with the selection of the transactional profit split method in a fact pattern where one party bore risk but did not have a high level of integration in business activities with its transactional partner or where the transaction does not involve the contribution and use of unique and valuable intangibles by both parties to the transaction.

It would also be helpful to analyze which party bears the ex ante “common risk”. Suppose companies A and B engage in a project where the risks are sequential. A engages in R&D, B engages in marketing. Suppose the product is successfully marketed during year 1. In year 2 another company enters the marketplace with a competing product leading to a decline of combined profit of A and B. Which party should be responsible for the decline of profit? If the risk is shared, how should the relative exposure to this risk be evaluated?

Section C.3.1 – Highly integrated operations

C.3.1 - Commentator Questions

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

The distinction between parallel and sequential integration of business operations may be useful. It would appear that parallel integration lends itself more readily to a transactional profit split of actual profits, whereas a transactional profit split of anticipated profits would be more appropriate in the case of sequential profits. In both cases, however, the integrated business may only generate routine profits and comparables may exist, so another method may be the most appropriate method.

While the distinction between parallel integration and sequential integration may be useful, it may also be more useful conceptually than in practice because most companies will have both parallel and sequential integration. USCIB is concerned that attempting to define an activity as part of parallel versus sequential integration could become an area of dispute, if tax authorities believe that applying the label of “parallel integration” would permit them to apply the transactional profit split method, while labeling something “sequential integration” would not. This might be of particular concern in the area of intangibles. The tax authorities may argue that taken together development, enhancement, maintenance, protection and exploitation of an intangible are a unified activity that if done by different entities would result in the activities being considered parallel integration. While this might be the case, it also might not. In particular, exploitation of an intangible would frequently be a sequential step, rather than a parallel step to development, enhancement, maintenance and protection. Rather than depending on whether the label “parallel or sequential” is applied, the application of the transactional profit split method should depend on a careful functional analysis and the determination that the transactional profit split method is the most appropriate method.

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

USCIB agrees with the statement in paragraph 21 that “the parties may each contribute intangibles, share functions in jointly developing products, and exploit the marketing of those products together. In cases of parallel integration, it may be the case that the accurate delineation of the actual transaction determines that each party shares economically significant

risks, and a transactional profit split, using an approach which splits actual profits, may be found to be the most appropriate method.” With parallel integration it is clearer that the level of integration between the parties will limit the effectiveness of one-sided pricing methods. Additionally, parallel integration also makes deriving relative allocation keys easier. For instance, compare a company A performing similar R&D and marketing functions in both countries with company B performing R&D in one country and marketing in another. It is more reliable to create profit split factors based on attributes of R&D and marketing where they are performed in both countries. For company B, development of a reliable transactional profit split factor is more difficult.

However, even with the parallel integration, there is no explicit assumption of one party’s risk by another party. For example, if the parties are the same in all respects, but one party experiences supply disruption which leads to a decline in profit, should the parties split the actual profit based on ex ante-determined shares because there is parallel integration of business? In addition, the parallel integrated businesses may not involve unique and valuable intangibles, may generate routine profits, and comparables may exist such that transfer pricing methods are more appropriate than the transactional profit split method.

It would be helpful to discuss whether/how the risks are shared in the case of parallel integration. The reason is that, even with parallel integration, the risks may differ, for example, were the parties bring separate component IP into the supply chain.

Section C.3.2 – Unique and valuable contributions

C.3.2 - Commentator Questions

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

In cases of unique and valuable contributions, USCIB believes that the transactional profit split of actual profits may be more reliable. For example, consider a case where the two parties contribute separate patents, A and B, which together have to be used in the finished product. If the product performs as expected, the profit split would be based on the relative contributions of the parties which can be established ex-ante, and both parties would bear the risks to which they are jointly exposed, such as the market risks. If the product malfunctions because of one of the patented components does not perform correctly, the transactional profit split of actual profits may still be the most appropriate method, but the split, determined ex-ante, would have to provide for the probability of failure of one or both of the patented products or provide for ex post true-ups to the profit split based on actual results (e.g., differences outside of an agreed-upon range).

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

Paragraph 22 recognizes that: “Another situation in which the transactional profit split method may be the most appropriate method is where multiple parties to the transaction make unique and valuable contributions, such as unique and valuable intangibles.” Intangibles are important to the determination of the most appropriate method and selection of the transactional profit split and the creation of reliable profit split factors. However, the mere presence of intangibles does not indicate that the transactional profit split method is necessarily the most appropriate method as intangibles can often be addressed more reliably by other methods. Examples include the CUP method for trademarks, and the resale price method for technology where external evidence exists. The key factors in determining whether the transactional profit split method is the most appropriate method for splitting the intangible non-routine profit are the level of integration among the related parties, joint management of the unique and valuable contributions, and sharing of the economically significant risks.

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

USCIB strongly agrees with the approach taken by the discussion draft that group synergies alone would not support the combining and splitting of “total system profits.” USCIB is especially concerned with the use of the phrase “total system profits” since that seems to be a reference to a global profit split. As discussed above, the discussion draft pertains to transactional profit splits, which is not “total system profits”. Even without this caveat, applying a transactional profit split method any time there are synergies would likely result in the transactional profit split method becoming the default method, which is fundamentally inconsistent with the Transfer Pricing Guidelines as a whole.

Section C.3.4 - Value Chain Analysis

USCIB believes a value chain analysis may be a valuable tool in the functional profile stage of the assessment of any intercompany transaction, although it is not clear to USCIB how a value chain analysis differs from a standard functional analysis. As discussed in paragraph 24, a value chain analysis can play an important role in assessing the contributions of both parties to a transaction and helping establish the most reliable method. USCIB agrees that the purpose of a value chain analysis is to “...assist in delineating the controlled transaction...and determining the most appropriate transfer pricing methodology.” As such, we agree with the discussion draft that a value chain analysis “alone does not imply that the transactional profit split method should be applied.” (Para. 25) As a diagnostic tool used in the functional profile, USCIB believes this section may be better placed in Chapter 1, Section D, where it would be clear that the value chain analysis, if relevant, should apply to all pricing methods.

USCIB also believes that it is important to recognize that the value chain analysis is merely a tool and use of a value chain analysis, if it somehow differs from a standard functional analysis, is not and should not be required. In many MNEs most of the entities are engaged in routine transactions that are amenable to one-sided pricing and therefore a value chain analysis is not required to determine the best method or the arm's length price. As noted above, USCIB is concerned that the routine use of value chain analysis and its use to determine profit splitting factors will result in profit split methods that are based on global formulary apportionment and are not consistent with the arm's length principle.

C.3.4 - Commentator Questions

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

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

USCIB believes that a value chain analysis may be a useful tool for all pricing methods and may be helpful in the identification of profit split factors. As the transactional profit split method does not rely primarily on external evidence, it is important that the method be grounded in the industry and market factors that determine financial success or failure. Typically, these success factors (value drivers) will differ by industry and market. Therefore, a value chain analysis can be effective in identifying the specific candidate factors that determine success and therefore are candidate measures to attribute profit under all pricing methods.

C.4 Guidance for application

USCIB agrees with the tone of this section that the application of the transactional profit split method can be complex, and the method may be unreliable. In particular, the profit split method maybe unreliable if: the economically significant risks have not been specified; if the nature of the parties' contributions has not been accurately determined; if an evaluation of how those contributions drive profits has not been made; if the profits to be split have not been reliably identified, or if the basis for splitting profits has not been reliably determined. Failure to specify the economically significant risks, accurately delineate the level of profit or the profit split factor can render the method unreliable. (Para. 28) These restrictions on the use of the profit split should be emphasized. USCIB members have been subject to adjustments that do not consider these factors and simply assume that global profits should be split in a manner that attributes substantially all profits to a particular jurisdiction. Such use of the profit split method is inconsistent with the arm's length principle and will result in double taxation. It is important that the OECD guidance reject these sorts of approaches and specify all conditions necessary to support the transactional profit split method as the most appropriate method.

C.4.1.1 Contribution analysis

USCIB would point out that, as a practical matter, a contribution analysis (paragraph 32) is employed very rarely – most transactional profit splits are residual profit splits – as data on comparable profit splits is seldom available and the valuation analysis implied by a “relative value of the functions performed” is particularly difficult. If comparables are available, they should be used to price the transaction and profit split is less likely to be the most appropriate method. Use of this method is likely limited to a few industries.

C.4.2 Determining the profits to be split

USCIB strongly agrees with the statement that “the combined profits to be split in a transactional profit split method are the profits of the associated enterprises from the controlled transactions in which the associated enterprises are engaged.” (Para. 36) USCIB is concerned that some jurisdictions may ignore the transactional nature of the profit split method and instead apply a global profit split. It is very important that the OECD guidance clearly reject that approach.

USCIB agrees with paragraph 39 that determining the level and nature of profit to be split is often times complex and burdensome. Indeed, this is a major factor in limiting the broader use of the transactional profit split method. Often company financial systems do not allow the creation of transaction-specific financial profit and loss statements. If transaction specific financial profit and loss statements cannot be used, then attempting to apply the transactional profit split method might produce unreliable results. This would be the consequence of the use of unreliable cost allocations, identification of collateral income, difference in currencies and complex tax issues such as customs, duties and VAT.

C.4.2 Determining the profits to be split

C.4.3 Different measures of profits

Paragraph 40 correctly acknowledges that the measure of profit can vary by industry and by company-specific factors. Operating profit is the most common measure, both because the transactional profit split method is most naturally thought of in terms of operating profit, and because many value drivers that will create the profit split factors are focused on creating operating profit. Yet in some circumstances, a split of gross profit may be the method most likely to yield an arm’s length result. In particular, where each party controls the economically significant risks relevant to its own operating costs, a split of gross profit may be more appropriate than a split of operating profit because the latter would result in the sharing of risk outcomes with a party that does not control those risks.

On the use of operating profit vs. gross margin, the first example in paragraph 41 concerning the “two associated enterprises” is problematic. While this example is intended to show the benefits of gross margin as a measure of profit when sales and marketing functions are unintegrated, an alternative explanation can lead to the use of operating profit. The key

question is the reason for the differing sales and marketing expense between the two countries. If the higher level of sales and marketing is required to generate the forecast or actual revenue, then one should properly include both the level of revenue and the level of sales and marketing expense. By excluding marketing expense this example assumes the sales quantity or price is not enhanced by these additional expenses. In this case, use of operating profit, not gross margin, may be a more reliable measure of profits.

In contrast, the second example in paragraph 41, involving “associated enterprises that engage in highly integrated worldwide trading operations,” effectively illustrates when gross margin may be the more reliable measure of profits. In some industries, such as financial services, a business may be highly integrated for purposes of generating revenue and the direct costs incurred to produce that revenue (e.g., cost of goods sold), but each associated enterprise may independently control the economically significant risks relevant to its own operating costs. Further, unlike in the manufacturing context, forecast or actual revenue may not depend directly on the level of operating costs. In such a case, a gross profit split would avoid rewarding associated enterprises for risks they do not control, and gross margin would be the more reliable measure of profits.

C.4.3 - Commentator Questions

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

Gross margin should only be used if the excluded functions are separable and do not effect realized price, revenue, and cost of revenue. The standard should be that the level of profit must define the pool of jointly managed and controlled potential income, and must in turn be consistent with the profit split factor or factors.

Will the transactional profit split be a reliable method if the profit to be divided is generated in only one jurisdiction? This could be the case if both parties contribute valuable IP but the product is sold only in one party’s marketplace. The use of the CUT method might not be appropriate if both parties manage the intangibles and risks. But in this case, the profit to be split will be determined only in the market where the product is sold (taking into account the other party’s relevant costs).

A measure of profits to be split can be an intermediate measure between the gross profit and the operating profit. For example, the parties share all risks except R&D risks, and one party performs R while the other party performs D. In this case, all costs (except R&D) can be taken into account when arriving at the pre-R&D profit, and then the resulting amount will be split based on relative contributions of unique and valuable intangibles (which may not include routine development (D) services).

C.4.4 Splitting of profits

USCIB stresses that the ability to identify reliable and effective split factors is a key component of supporting the transactional profit split method as the most appropriate method.

The primary criteria for the selection of a profit split factor should be a direct relationship between the split factor and the profit being split. There must be a causal relationship between the measure of the contributions that give rise to the economically significant risks (the profit split factor) and the definition of the profits to be split which must be the return on these economically significant risks. That is, value drivers of routine profit should not be used to split residual income. We suggest the criterion described above be added to the list in paragraph 42.

USCIB generally agrees with the requirements of paragraph 42 [based on paragraph 2.132 of the existing transfer pricing guidelines] that the factors used to split profit be (1) reasonably independent of transfer pricing policy and based on objective data, (2) verifiable, and (3) supported by comparables data, internal data, or both. Moreover, USCIB agrees with the statement at paragraph 44 that “Thus, where there is no more direct evidence of how independent parties in comparable circumstances would have split the profits in comparable transactions, the allocation of profit may be based on the relative contributions of the parties, as measured by their functions, taking into account the assets used and risks assumed.” For example, the frequent use of relative capitalized development costs of two intangibles, as a residual profit split key, is meant to provide a reasonable measure of the relative contributions of the two parties. Indeed, it is well known that the ex-ante value of an intangible contribution is proportional to the level of fixed funding commitment required to develop the asset (because fixed costs commitments increase risk and increased risk means increased expected value). Therefore, measuring relative contributions of value by a relative measure of the capitalized development costs (as a proxy) is not only meaningful, it is grounded in a correct application of basic financial economics concepts.

‘Risk-weighting’ specified in paragraph 51 is not defined. The discussion draft should specify if this is the bearing of risk or the management of risk. In addition, a method to value risk for purposes of a transactional profit split method is both undeveloped in the discussion draft and complex as can be seen in the discussion of control in Chapter IX of the Transfer Pricing Guidelines.

USCIB wishes to point out that all of the issues and difficulties of using costs as a reliable estimate of an intangible asset value also apply to a profit split allocation key.

Examples of use of transactional profit method

Example A: Professional service firm

Example A: A professional services firm has operations in countries A and B. The firm delivers services based on jointly-staffed teams from both countries. A two-sided functional profile determines that the critical business activities of business development, service offering development, recruiting, training and development are all performed jointly by professionals from both country A and B. Additionally, senior management is also comprised of members of both countries. Here, the necessary criteria for functional integration are met and the profit split method may be the most appropriate method.

Example A1: Same as Example A above, except the firm also has operations in Country C that focused on project execution under the direction of professionals in Countries A and B. Here, it may be more appropriate to establish an arm's length price for Country C based on one-sided method. Therefore, Countries A and B would be included in the profit split but Country C would be excluded.

Example A2: In Example A above, if a profit split of the total operating profit of the firm is selected, then a profit split allocation key based on value driver of overall operating profit must be used. A potential allocation key might be total billable hours by staff. Conversely, if residual profit split is employed, the staff-based service delivery may be characterized as routine. Here residual income would exclude routine profit based on staff-based billable hours, and an allocation key more directly related to the driver of residual income would be more appropriate, such as business development, service line development, or senior management productivity.

Example B: Global manufacturer

Example B: A global manufacturer has R&D and manufacturing centers in countries A and B and manufacturing and sales companies in countries C and D. Countries A and B both have jointly develop projects, share technology and know-how, and the products are of similar profit potential. Both countries license finished technology for manufacture and sale to countries C and D. Here, it may be appropriate to employ a transactional profit split method between countries A and B. It would be inappropriate to include countries C & D that do not have direct ownership or control of the manufacturing intangibles. As countries A and B are also manufacturers, a residual profit split is likely most appropriate. A value driver specific to product technology and know-how, such as capitalized cost, may be a potential profit split factor.

Example B1: Same as example B, except here country A and B specialized in design and development of different products with different profit potentials (e.g., small cars vs. large trucks). Here, without the level of integration between the intangible development teams between country A and B the transactional profit split method is likely inappropriate. The

differing profit potential between the two bundles of technology preclude creating a common pool of profit required under the transactional profit split method. Other methods, such as the CUP, may be more appropriate.

Example B2: Same as B, except country A owns and manages the brand/trademark of the product. The trademark is separable from the product technology (i.e., is managed and developed independent of the product technology) and can be valued reliably under the CUP method. Here, the transactional profit split method may still be appropriate, but the residual income must exclude the value of the trademark owned by country A and the trademark profit allocated directly to country A.

Example B3: Same as B2, except the trademark and brand is integral with the product technology. It is developed jointly by countries A and B and cannot be reliably priced as a separable asset. In this scenario, the transactional profit split method may be the most appropriate method and the residual income includes all revenues and costs associated with trademark and brand development. Here the split factors would be based on technology development factors and would include brand development factors only if they could be reliably quantified.

Sincerely,



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