UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL
Jefferson VanderWolk
Head
Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2 rue Andre-Pascal
75775, Paris
Cedex 16
France
(TransferPricing@oecd.org)

Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 10 – Revised Guidance on Profit Splits ("Discussion Draft")

Dear Mr. VanderWolk,

USCIB[1] is pleased to provide comments on the OECD's Discussion Draft on BEPS Action 10 – Revised Guidance on Profit Splits ("revised discussion draft" or "discussion draft"). USCIB would be pleased to present comments at the public consultation.

General Comments

USCIB is concerned that the discussion draft moves in the direction of supporting routine application of the transactional profit split method to transactions without properly considering the other transfer pricing methods. Profit splits are highly complex and require numerous subjective judgments; they should seldom be the first – or even a common -- option.

USCIB believes that the guidance on profit splits should be high-level and not prescriptive because the realities of business are wide ranging, so the guidance needs to be flexible to accommodate the wide-ranging circumstances to which it might apply. The discussion draft generally avoids prescriptive guidance, so USCIB supports that general approach. To the extent

[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.

that the discussion draft uses languages such as “will” or “must”, that language should be revised to suggest more optionality. An appendix attached to this letter points out some of these cases and suggests alternative language that does not imply a prescriptive approach.

USCIB is concerned that the discussion draft undercuts the detailed guidance on the allocation of risk that was extensively debated as part of the BEPS project and recently finalized in the OECD’s 2017 Transfer Pricing Guidelines. We believe that paragraph 1.94 of Chapter I of that guidance, which is part of the general discussion of risk, provides that the contract should be respected as the accurate delineation of the transaction when the entity that is contractually allocated risk controls the risk and has the financial capacity to assume risk. As a consequence of respecting the transaction, the transaction should be priced as structured. That conclusion should not change merely because there may be other entities contributing to the control of risk. The point of allocating risk is to determine which entity is entitled to the upside (and downside) from the playing out of the risks of the transaction. Other entities may contribute to the control of that risk and should be appropriately compensated for those functions, but that should not change the allocation of the risk, and these risk control functions may be routine and will likely have comparables. Paragraph 1.105 should not override the proper allocation of the risk; rather, USCIB believes that paragraph 1.105 merely states that it may be appropriate to compensate another entity for its contribution to control of risk. That contribution to control does not entitle it to upside or downside, or to any assumption that the transactional profit split is the most appropriate method.

The discussion draft seems to expand the potential use of the profit split method from transactions in which risk is shared, which is a factor which may, with other factors, support the selection of profit split as the most appropriate method, to a broader category that would include closely related risks. This expansion is not appropriate. All businesses take on risk, some risks are controlled, some are accepted but not controlled. All business transactions expose the participants to some level of risk from the other party. To the extent that the risks relate to the overall business of an enterprise, risks might be considered “closely related”. Such a loose, undefined term could lead to the routine application of the profit split method. In any event, a well done TNMM analysis takes comparative risks into account without the need to resort to a profit split.

USCIB thinks the discussion draft is improved by some of the deletions from the prior discussion draft. These include: the discussion of value chain (although see the last sentence of paragraph 48, which we suggest below ought to be deleted); and the discussion of parallel vs. sequential integration.   In addition, we believe that further deletions (see detailed comments below) can improve the draft, in order to focus more closely on the key determinant of when the profit split method will be the most appropriate transfer pricing method – when both parties make “unique and valuable contributions” (i.e., when both parties make contributions for which reliable comparables are generally not available. In particular, USCIB is concerned that there is too much emphasis on high levels of integration. High levels of integration are not unusual (are not unique and comparables may be available), are poorly defined in the discussion draft, and are not a reliable indicator that the profit split method should apply.

USCIB believes that the final guidance on transactional profit splits should contain an explicit rejection of global formulary methods. Chapter 1 of the 2017 OECD Transfer Pricing Guidelines contains a robust defense of the arm's length standard and rejection of global formulary apportionment. That guidance should be cross-referenced in the transactional profit split subpart of the revised guidelines. USCIB is concerned that a poorly applied transactional profit split or an inappropriate use of the transactional profit split in a context where an alternative analysis would be more appropriate, may achieve results that resemble global formulary apportionment. We believe that it is important that such applications be clearly rejected and, therefore, a cross-reference to the Chapter 1 guidance is appropriate.

The discussion draft, as pointed out below in our detailed comments, looks to macro conditions, which while relevant are subsidiary to the functional analysis of the actual transaction. The draft needs to improve its focus on the actual transaction and make clearer the relationship between the transaction and macro conditions. A focus on macro conditions is much more likely to result in generic profit splits or formulary apportionment.

USCIB believes that it is important to distinguish between taxpayers' ability to arrange their own affairs and apply a transactional profit split method and the tax authorities' ability to compel the use of a profit split on audit. In the first case, if the transaction is structured such that both parties make unique and valuable contributions or share risk in ways that are difficult to unravel, then the taxpayer may appropriately consider whether the transactional profit split is the most appropriate method and if so apply it to the transaction. If, however, the transaction as structured by the taxpayer (and as accurately delineated) does not have characteristics that would lead to the conclusion that the profit split method is the most appropriate method, then tax authorities should not be able to effectively restructure the transaction by imposing a method that shares risk when risk is not in fact shared pursuant to the accurately delineated transaction. Restructuring of transactions is likely to create double taxation because the tax authority on the other side of the transaction may not accept that restructuring – particularly if the taxpayer's actions were consistent with the structure. In that case, tax authorities will be pricing two different transactions. When different transactions are priced, the result will likely be inconsistent and result in more controversies, which will be difficult to resolve because the tax authorities view the transaction differently.

Further, the practical obstacles associated with properly applying a transactional profit split method also make such a method difficult to apply on audit since the information on the profit to be split and the allocation keys may be extremely difficult to construct if the taxpayer applied a different method. This is not to say that tax authorities could not apply the transactional profit split method if the taxpayer did not use it initially, but it is important to ensure that tax authorities only apply the transactional profit split method when it is the most appropriate method and not as a default method or to achieve an outcome that inappropriately puts more profit in a jurisdiction when the factual analysis does not justify its use. Tax authorities should be held to the same high standard as taxpayers in determining whether a method, including the profit split method, is the most appropriate method.

The Platform for Collaboration on Tax recently finalized a toolkit[2] on addressing difficulties in accessing comparables, which is focused on the needs of developing countries and suggests possible approaches that may be used to address the lack of comparables. The transactional profit split method is one option that the report discusses. While the discussion of the profit split method is generally in line with the guidance that has been provided by the OECD and others, the toolkit, in our view, overemphasizes the ability to apply the profit split method in the absence of comparables – generally ignoring that many if not most profit splits are residual profit splits and therefore require comparables for the initial allocation of profit and that allocation keys may be based on comparables. The widespread use of the transactional profit split method because comparables are lacking will likely "result in a fundamentally different outcome to the one supported by the accurate delineation of the transaction."[3] We raise the toolkit because we believe the guidance in the toolkit may be having an impact on the discussion draft. This will be discussed further in the detailed comments section of this letter.

Detailed Comments

USCIB supports the statement in paragraph 1 that the transactional profit split method seeks to establish arm's length outcomes for controlled transactions. This would also be a good place to cross reference the robust rejection of the formulary apportionment.

Paragraph 1 of the discussion draft uses the term relevant profits, rather than combined profits as was used in the prior discussion draft and the 2010 version of the Transfer Pricing Guidelines. USCIB does not read this necessarily as a change, but rather as a method of referring to the different ways that profits can be combined, which are detailed in section C.4 (beginning at paragraph 39). To avoid any confusion, USCIB recommends adding a cross-reference to section C.4.

USCIB generally supports the statement in paragraph 2 that where the transactional profit split method is the most appropriate method, it should apply equally to profits and losses. We note, however, that contrary to the discussion draft's statement that asymmetrical splits of profits and losses are "rare" at arm's length, in some industries, they are quite common (e.g., private equity). The discussion draft should make clear that the appropriateness of an asymmetrical profit split, as of any profit split, should depend on the evidence of analogous arrangements at arm's length or other supportive facts and circumstances.

Paragraph 6 provides that in the case of unique and valuable contributions there will be no reliable comparables information. While it may be the case that there would not be reliable numerical comparables, comparability extends to methods and there may be other methods

[2] http://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf. USCIB is also concerned that the toolkit, which is merely a product of the staff of the platform organizations, will be seen as having as much weight as the OECD guidelines, which are approved by countries, or other more authoritative forms of guidance. Countries and taxpayers are not and should not be bound by such informal guidance.

[3] OECD Public Discussion Draft Revised Guidance on Profit Splits 4 July – 5 September 2016.

that would be appropriate to the transaction under review. So, even in the case of unique and valuable intangibles, the transactional profit split method should not be considered a default method.

Paragraph 8 provides that the ability to vary profits with the actual outcome of the risk is a strength of the profit split method. While the transactional profit split method may allow for the determination of profits that vary with the actual outcomes of risks, this is not unique to the transactional profit split method. So it is not clear this is a particular strength of the profit split method.

Paragraph 9 should refer to evaluating both sides of the transaction, rather than to evaluating both parties to the transaction.

Paragraph 10 refers to “gross profits” and “operating profits”. The glossary for the 2017 version of the OECD Transfer Pricing Guidelines defines “gross profits” but not “operating profits”. A definition of operating profits should be added to the glossary.

Paragraph 10 acknowledges that “a weakness of the transactional profit split method relates to difficulties in its application.” USCIB believes this understates the difficulties associated with the transactional profit split method, particularly if the tax authorities seek to impose it retroactively when the taxpayer did not consider it the most appropriate method and used another method. USCIB is also concerned that tax authorities’ desire to use the transactional profit split method in the perceived absence of appropriate comparables will result in application of the profit split method without the necessary information with respect to the “relevant profits” and without making the necessary adjustments to achieve an accurate transactional profit split. In such a case, the profit split may look much more like the application of a global formulary apportionment.

One way to address the concern expressed in the prior paragraph would be to modify paragraph 40. Paragraph 40 discusses the need to put relevant financial data on a common basis and how a taxpayer would approach that process. Paragraph 40 should also address how a tax authority would approach that process.

Paragraph 12 of the revised discussion draft corresponds in some respects to paragraph 17 of the July 2016 discussion draft. Paragraph 17, however, contained a cross-reference and a summary of Example 1 in Section D.1 of Chapter I (paragraph 1.83). Based on the facts of the example, old paragraph 17 concluded that the profit split method would not be the most appropriate method to apply. This discussion is deleted from the revised discussion draft but should be reinserted. The facts of the example clearly illustrate that Company B performed contract R&D and did not share in the development risk with respect to the intangible being developed and therefore Company B should not be entitled to a return related to the development risk with respect to that transaction. This is consistent with paragraph 1.101 of the 2017 Transfer Pricing Guidelines, so deleting the discussion contained in old paragraph 17 may create an inference that the example and analysis were incorrect. To avoid this inference, which must be incorrect since the example including the conclusion expressed in paragraph 1.101 remains in the 2017 Transfer Pricing Guidelines, the deleted portion of paragraph 17 should be added to paragraph 12 or an example based on the example in paragraph 1.83 could be included in the examples section of the guidance.

USCIB strongly supports the statement in paragraph 13 that "existence of unique and valuable contributions by each party to the controlled transaction is perhaps the clearest indicator that a transactional profit split may be appropriate." Even in this case, however, it is necessary to determine whether the profit split method is the most appropriate method.

USCIB objects to paragraph 13's expansion of "shared risks" to include the separate assumption of closely related economically significant risks. All MNEs and transactions bear risk. Because those risks relate to the same business, there may be a tendency for tax authorities to assume or assert that those risks are closely related. Such a broad standard could lead to the profit split method becoming a de facto default method.

Paragraph 14 addresses some of the same concepts that are addressed in paragraph 18 of the July 2016 discussion draft. In USCIB's view, this revised discussion draft is substantially weaker than the July 2016 discussion draft. The last two sentences of paragraph 18 read:

> In cases where the accurate delineation of the actual transaction indicates that one of the parties to the transaction assumes only limited risks, but reliable comparables data is scarce, it is likely that a more reliable arm's length outcome can be reached the adjustment … and interpretation … of inexact comparables data rather than through the inappropriate application of the transactional profit split method. Using a transactional profit split of actual profits in such a case would result in a fundamentally different economic outcome to the one supported by the accurate delineation of the actual transaction.

The deletion of the last sentence, which strongly supports pricing that comports with the "real deal", is inappropriate. If, in fact, one party performs simple functions, and risks are not shared, then a profit split is not appropriate and the guidance should clearly say that. USCIB is concerned that this has been revised to accommodate more expansive use of profit splits by some countries.

Paragraph 15 should be deleted because it incorrectly concludes that if unrelated parties use a profit split method that can be a "pointer" that it should be used in the related party context.

Paragraph 18 provides that the profit split method may be the most appropriate method in the case of transferred intangibles if there are not comparable uncontrolled transactions. The draft should also point out that comparable valuation methods may be considered for purposes of valuing transferred intangibles.

Paragraph 19 states that most MNE groups are integrated "to some extent," but that "a particularly high degree of integration in certain business operations is an indicator for the consideration of the transactional profit split method." Other paragraphs use a variety of similar adjectives, such as "interlinked," "highly inter-related," "inter-dependent," "a high degree of inter-dependency") to reach the same conclusion.

It is difficult to see why using several synonyms is helpful when no objective definition has been provided for the underlying term. Without explicit criteria outlining the difference between the integration which exists in "most" MNE groups and the "particularly high degree of integration" which makes the profit split method the best method, no useful guidance is provided and this section (paragraphs 19 through 24) should be deleted. Otherwise a tax authority can assert that there is a "high degree of integration" on an arbitrary basis to justify use of the profit split method in order to claim a larger share of an MNE's global profits. USCIB believes that large market jurisdictions may see high-integration as an avenue to achieve indirectly (a transactional profit split that allows the local affiliate to earn the return on the "unique and valuable intangible" of the market) what they could not achieve directly. The Transfer Pricing Guidelines do not treat a market as an intangible, although some countries argued for that position. Thus, the local affiliate in the market does not "own" an intangible, such that both sides to the transaction are contributing unique and valuable intangibles. If tax authorities in the market jurisdictions argue, however, that the manufacturing and sales functions are highly-integrated, then those tax authoriities may assert that that "indicates" that the transactional profit split is the most appropriate method. See example 3, paragraphs 77 through 82.

If these paragraphs are not deleted, they should be modified. The language to refer to a particularly high degree of integration should be standardized and better defined. Some of the situations described seem like they could be appropriately characterized as joint ventures.

Further, even if a definition of a highly-integrated business can be agreed upon, a particularly high-degree of integration should be a factor rather than an indicator. Integrated businesses may be engaged in activities – especially services – for which comparables are available, and one-sided methods may be appropriate.

USCIB agrees that the reference in paragraph 20 to the transactional profit split method for global trading of financial instruments is appropriate. However, taxation of the financial services industry frequently follows special rules, so the OECD should not extrapolate from the global trading rules to similar rules for other industries without first carefully considering whether the situations are similar.

Paragraph 21 illustrates a high-degree of interdependency with the example of long-term arrangements involving the contribution of assets. In some cases, these sorts of contributions may effectively create a joint venture and some form of profit split may be appropriate. In other cases, however, a contributed asset may have a known value and compensation for the use of that asset may be readily determined under a one-sided method.

Paragraph 23 contrasts situations in which the parties share risks to those in which the parties separately assume closely related risks. As noted above, USCIB believes that separately assuming closely related risks should not be an indicator that the profit split method is the most appropriate method. Assuming, however, that the profit split method is the most appropriate method in such a case, USCIB believes that a split of gross profit is likely to be more appropriate. Therefore, we suggest adding the following sentence at the end of paragraph 23: "A split of gross profit may be most appropriate in situations in which the parties separately assume closely related, economically significant risks."

Paragraph 24 raises the issue of the interaction of paragraphs 1.105 and 1.94. As discussed above, USCIB believes that paragraph 24 misconstrues how paragraphs 1.105 and 1.94 are intended to interact. In our view, the party who is contractually allocated the risk, controls the risk and has the financial capacity to bear the risk is entitled to the potential upside and downside from the realization of the risks. Other parties should be appropriately compensated for their functions, including those functions that relate to risk management, but are not entitled to share in the potential upside and downside associated with that risk. Therefore, paragraph 24 ought to be deleted. At a minimum, the paragraph should be more balanced. One way to achieve a more balanced approach would be to revise the second sentence of paragraph 24 to mirror the first sentence. The second sentence would then read: "However, the mere fact that an entity performs control functions in relation to a risk will not necessarily lead to the conclusion that the transactional profit split is the most appropriate method in the case ***or that the entity performing the control functions is entitled to upside or downside in the case."*** (Proposed language ***in bold and italicized.***)

Paragraphs 25 through 27 claim that the sharing of "economically significant risks" and the "separate assumption of closely related risk" are the appropriate criteria for determining whether actual or anticipated profits are to be split. The members of an MNE group as a general matter share all economically significant risks to a certain extent; it is not obvious what the asserted connection to any particular risk is. It appears that the concept of the sharing of risks between unrelated parties when they enter into a partnership is being confused with the reasons for using a profit split method as the most appropriate pricing method in related-party transactions. Consequently, we recommend deleting these paragraphs.

If these paragraphs are not deleted, paragraph 27 should be revised. Paragraph 27 suggests that if the parties share the assumption of economically significant risks or assume closely related economically significant risks, then splitting of actual profits is likely to better align with the accurate delineation of the transaction. This is not necessarily the case. A buyout – frequently seen in the area of development of technology, pharmaceuticals, and medical devices – may involve splitting of anticipated profits. Similarly, royalty arrangements are based in part on anticipated profits (the level at which the royalty rate is set) and in part on actual outcomes (the level of actual sales). The paragraph also ignores how the transaction allocates risks. A licensee will face more risk in a buyout than in a royalty transaction. In light of these concerns, USCIB believes that paragraph 27 ought to be revised to reflect that whether actual or anticipated profits should be split depends on how the transactions are actually structured.

Paragraph 28 seem to divide the world into two categories: one category includes those situations in which the profit split is the most appropriate method and the other category includes those methods that rely entirely on comparables. This oversimplifies the world. There are other methods that fall between these two poles and also ought to be considered, for example, methods that use regional databases. The distinguishing factor for the profit split method is the presence of unique and valuable contributions on both sides of the transaction.

USCIB agrees with the discussion draft's statement in paragraph 33 (first bullet) that if the profit split method is being applied ex ante then it would be reasonable to expect the life-time of the arrangement and the profit splitting factors to be agreed in advance. This assumes, however, that the relationship is static, while in practice relationships may be evolving. The bullet should, therefore, be revised to reflect that the factors should be revised to take into account subsequent changes to the relationship. The 2010 Transfer Pricing Guidelines were clearer on this point.

USCIB agrees with the discussion draft's statement in paragraph 33 (third bullet) that the determination of the relevant profits to be split and the profit splitting factors should generally be used consistently over the lifetime of a transactional profit split arrangement, unless the facts and circumstances support the use of different measures of relevant profits or profit splitting factors. In order to avoid ambiguity, the discussion draft should acknowledge that splitting profits on an asymmetrical basis (differently in profit and loss situations) does not contravene this rule if consistent with the parties' ex ante risk allocation and with analogous arrangements at arm's length. Again, the 2010 Transfer Pricing Guidelines were clearer on this point.

Section C.3.1 of the discussion draft (paragraphs 34 through 38) sets out two approaches to splitting profits: a contribution analysis and a residual analysis. Under the contribution analysis, relevant profits are divided on the basis of the relative value of the contributions by each of the associated enterprises participating in the controlled transactions. While the discussion draft notes that the division can be supported by external data where available, it allows use of "information internal to the MNE group" in the absence of such data. A contribution analysis that allows governments to rely solely on information "internal to the MNE group" to determine a split of profits invites governments to engage in formulary apportionment by asserting that certain types of factors should normally generate certain relative levels of profit. We believe a transfer pricing analysis must be based on information that shows either how independent enterprises actually price transactions or, in the absence of such information, on how they would price transactions in comparable circumstances.

Accordingly, we propose the following changes to paragraphs 35 and 36 (adding the bold italicized language and deleting the language shown in strike-through):

- "In the absence thereof, it should be based on the relative value of the contributions by each of the associated enterprises participating in the controlled transactions, determined using information internal to the MNE group ***that provides evidence of how independent parties would have divided the relevant profits*** (see section C.5.2)."

- "In cases where the relative value of the contributions can be measured directly***, based on methods used by independent enterprises divide relevant profits,*** it may not be necessary to estimate the actual market value of each party's contributions."
- "The determination might be made by comparing the nature and degree of each party's contribution of differing types (for example, provision of services, development expenses incurred, assets used or contributed, capital invested) and assigning a percentage based upon the relative comparison <u>using</u> ~~and~~ external market data."

We also note that, when parties share profits from a combined activity, a key determinant of how risk should be shared is the contractual allocation of risks. We suggest adding the following sentence at the end of paragraph 35: ***'<u>The contractual arrangements, and in particular how those arrangements (appropriately delineated) allocate risk among the associated enterprises, are key determinants for how independent enterprises would share profits in comparable transactions under comparable circumstances</u>.***'

We also suggest amending the following sentence by adding the bolded/italized language: "Under a contribution analysis, the relevant profits, which are the total profits from the controlled transactions under examination, are divided between the associated enterprises in order to arrive at a reasonable approximation of the division that independent enterprises would have achieved from engaging in comparable transactions ***under comparable circumstances***."

The parenthetical should be removed from the second sentence of paragraph 37. Although the parenthetical only provides examples of cases in which a one-sided method may be applied, it may create the implication that one-sided methods are not appropriate in other cases. This is especially problematic given the loose definition of low versus high-integration, and that all of these factors may be present in transactions for which comparables exist.

The first sentence of paragraph 39 should be deleted or substantially revised. As it is written now, "the relevant profits to be split … are the profits of the associated enterprises relating to the controlled transactions in the associated enterprises are engaged." This could include other profits in the value chain of which the particular transaction is a part. The third sentence is a more accurate expression of the profits to be split. In our view, nothing is lost in deleting the first sentence and an ambiguity would be removed.

The last sentence of paragraph 42 should be modified to include the word "reasonable", so that it would read as follows: "Experience suggests that this initial stage in performing a profit split can in some circumstance be extremely complex, and the method of identifying the profits relevant to the transaction and any assumptions made in doing so need to be ***reasonable*** and documented."

USCIB strongly supports the statement in paragraph 46 of the discussion draft that "care should be exercised to ensure that the method is applied on the basis of information known or reasonably foreseeable by the associated enterprises at the time the transactions were entered into, in order to avoid the use of hindsight." 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.

Paragraph 48 deals with the measure of the profits to be split. The last sentence of paragraph 48 ought to be deleted. The discussion draft has eliminated most references to the "value chain". This sentence is carried-over from paragraph 40 of the 2016 discussion draft and now ought to be deleted given other references to "value chain" have been deleted. A new final sentence summarizing the paragraph ought to be added as follows: "Generally, it is appropriate to use any reasonable, reliable measure of the profits to be split, so long as that measure reflects the accurate delineation of the transaction and is consistent with comparable methodologies used by unrelated taxpayers if that information is available."

Paragraph 49 of the discussion draft explains that in appropriate circumstances, "gross profits" rather than "operating profits" should be split. It is also true that independent enterprises sometimes split revenues rather than profits. Accordingly, the discussion draft should be amended to permit the splitting of revenues. If revenues may be split, the following changes should be made to the discussion draft:

- The following sentences should be added to paragraph 2: "References to "profits" in this Chapter should include "revenues" where the transfer pricing method appropriately splits revenues based on an allocation metric. Unrelated parties may agree to split revenues (and sometimes expenses), without reference to "profits."
- The following sentence should be added at the end of paragraph 8: "The appropriateness of variable outcomes may support the use of a split of revenues or gross profits rather than operating profits."
- Revise the fifth sentence in paragraph 10 be adding the following language (in bold and italics): "Further, when the transactional profit split method is applied to operating profits ***rather than gross profit or revenue,*** it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises' other activities.

Paragraph 54 provides that: "The functional analysis and an analysis of the context in which the transactions take place (e.g. the industry and environment) may be helpful in the process of determining the relevant factors…." The draft should make clear that in determining the correct transfer price, the focus should always be on the accurately delineated transaction. The macro environment is of secondary importance and can only inform the functional analysis of the accurately delineated transaction, not supersede that analysis.

USCIB is concerned that paragraph 58 references the Master File as a source of information under the heading of profit splitting factors. The value drivers that may be identified in the Master File are not transactional and therefore may have no relationship to the transactional profit to be split. Value drivers are also not necessarily measurable. The ability to use high-level value drivers to allocate transactional profit may, therefore, be limited.

Paragraph 59 discusses relying on internal data. USCIB suggests that if it is necessary to rely on internal data, then management's judgment concerning the relative value of contributions to the business ought to be taken into account. This could be accomplished by modifying the first sentence to read as follows (additions in bold and italics): "Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the relevant profits, consideration should be given to ***management's judgment about the relative value of contributions to the business, as well as to*** internal data, which may provide a reliable means of establishing or testing the arm's length nature of the division of profits.

Paragraph 60 references asset-based profit splitting factors and mentions that "some analytical work is needed … to draw up a transactional balance sheet". First, it should be emphasized that asset-based factors may not make sense if the assets cannot be clearly and readily valued. Second, drawing up a transactional balance sheet may be difficult, time consuming and expensive. It also may not, in the end, be accurate. USCIB would like to re-emphasize that because of these concerns, it is unlikely that a properly applied transactional profit split will be able to address the administrative concerns that are reflected in the recent toolkit on addressing difficulties in accessing comparables.

Paragraph 61 illustrates the complexity and difficulties of applying the profit split method even when using a profit splitting factor such as costs that seems more straightforward to apply. The profit split method should not be considered the primary method for determining transfer prices; tax administrations should generally evaluate other methodologies first and use the most appropriate method.

Paragraph 64 strongly supports the use of asset-based or capital-based profit splitting factors. As pointed out above in our comments on paragraph 60, asset-based factors may present substantial difficulties in application. USCIB supports the use of capital-based profit splitting factors in appropriate circumstances.

Paragraph 67 should be revised to delete the reference to the treatment of location savings. Location savings are not intangibles and the contribution of location savings to profits is not unique. The contribution of location savings to profits is mainly routine and local comparables are generally available. Singling out location savings in this way may imply that location savings should be routinely included in the profit to be split, rather than priced under a one-sided method.

Examples

USCIB believes the examples are generally unhelpful. The conclusions in the examples are based on descriptive language that presupposes the result rather than a factual analysis of a particular case. USCIB acknowledges that writing useful examples is very difficult and therefore the best result might be to delete the examples entirely.

If the decision is made not to delete all the examples, then the analytical process needs to be described in detail. It would also be appropriate to have more examples where profit split is not appropriate (eight of ten examples conclude the profit split method is the most appropriate method). We find that troubling as in practice the profit split method is rarely the best method; the examples seem to put a thumb on the scale in favor of use of the profit split method in most cases. One option would be to develop cases with “A” and “B” solutions, where profit split is appropriate and where it is not (examples 3 and 4 follow this format). Another option would be to include more examples where profit split is not appropriate (for example, example 1 in section D.1 (paragraph 1.83) could be included here).

Although the examples use anonymous descriptions of the related parties (“Company A” and “Company B”) the facts of several of the examples bear a striking resemblance to the business models and arrangements of well-known U.S. companies. We believe that is inappropriate, and that even the appearance that the discussion draft is targeting American companies should be removed.

The following are comments specific to each example:

Example 1: The example does not sufficiently explain why the “important” development and enhancement functions and management of regulatory authorization are “unique and valuable” contributions. By using vague descriptors such as “important” to describe the functions, the example presupposes the conclusion it is trying to reach. Without additional facts, it is also possible that Company S is performing routine contract R&D services, where information on comparables may exist and a different transfer pricing method would be more appropriate than a profit split. Finally, given the vague facts of this example, the assertion that the profit split is “likely” to be the most appropriate method is an overextended recommendation. USCIB recommends that such normative conclusions be removed from this example as well as other examples, given the general nature of the assumptions made and facts presented.

Example 2: Like Example 1, it is again not immediately clear why certain functions performed by A Co. and B Co. are unique or valuable, including the routine assembly, marketing, and distribution functions performed by B Co. The simple functions by B Co. may be more appropriately benchmarked using a one-sided transfer pricing method than using the profit split method. Additional details are included which have no well-defined meaning in the example and do not help clarify why the functions of Company B are unique or valuable, such as the descriptor "extensive" applied to three separate types of tangible/intangible property in paragraphs 72 and 73, and 75, and the "premium price" commanded by the tea product(s).

Example 3: Similar to Example 2, this example uses vague descriptors which do not point out why exactly a function is unique or valuable, such as "cutting-edge" global marketing activities in paragraph 79, "valuable" trademark and associate goodwill in paragraph 79, and "valuable" information for demand forecasting in paragraph 80.

Furthermore, the term “economic advantage” is not explained, but rather is an asserted characteristic about the activities performed by the Companies. Characterization of an entity as having economic advantage relies on a careful delineation of functions, risks, and assets, which require more assumptions than can be captured in this example.

Finally, this example also attempts to illustrate the interrelated and interdependent risk of the Companies, but the example provided is too broad. The division of R&D, marketing, and distribution functions across related parties where the performance of each party depends on the success of other parties is applicable to product supply chains in general. The example does not make clear which specific characteristics of the entities described make the entities strictly interdependent, other than the vague adjectives used to justify the “unique and valuable” contributions of the related entities.

Example 4: The example describes the marketing and distribution functions as "limited", "not a particular source of economic advantage", and "not economically significant", resulting in a conclusion that the profit split method is not the most appropriate method. As in Example 3, these vague descriptors presuppose the conclusion of this example, can take on different meanings depending on how a tax authority may interpret them, and fail to describe what characteristics of a transaction make the profit split a less appropriate method.

Example 5: Based on the facts provided, ScaleCo’s provision of “scaling-up” services are “unique and valuable” because the system would be unable to meet potential customer needs without them. While these services may be “valuable”, the facts are insufficient to conclude on whether the services are “unique.” In other words, it is also possible that the scaling-up services could be contracted to a third-party, and therefore the compensation to ScaleCo could be benchmarked against uncontrolled transactions.

Example 6: It is not clear from the facts presented why Company A and B are only “integrated to some degree” as well as why the risks assumed by Company B are not “economically significant.” Additional details in paragraph 91 indicate that Company B may own manufacturing intangibles, but these details are not considered in the conclusion that Company B does not make unique or valuable contributions to the transaction.

Example 7: Although comparables for the portfolio management services are available, the example does not explain why information on the comparables is unavailable to pursue a different transfer pricing method. Rather, the example only asserts that the information on the comparables does not provide a way to split profits between the Companies. This assumes that the profit split is the most appropriate method without looking at how the information on the comparables may be used under another transfer pricing method as a more appropriate method. USCIB recommends that the normative conclusion be removed from this example. The addition of the following sentence at the end of paragraph 98 would also enhance clarity: "ASSET Co's management views the members of Company A and Company B as contributing equally to the performance of the funds."

Example 8: Given the lack of detail in this example, the profit split is a possible transfer pricing method, but it is also entirely possible that there are comparable uncontrolled transactions where an entity is contracted to develop and manufacture one component of a final product.

Example 9: The delineation of anticipated profits and actual profits split should be removed from this example. In paragraph 104, it is assumed that the contributions of both companies are unique and valuable, but this is not justified by the use of vague descriptors such as "enhanced" trademark value, "intensive" marketing activities, and "innovative" marketing activities.

Example 10: The example assumes that Company A and Company B are highly integrated because they both undertake manufacturing activities. This assumption is unwarranted, as participation in the same activity does not necessarily mean a high degree of integration. In paragraph 113, the phrase "complex web of intragroup transactions" is unnecessary, as it does not add meaning or a new assumption to the example. Finally, the conclusion that a profit split is the most appropriate method is unwarranted, as the example simply asserts that the companies depend on the capacity of one another for components. This assertion is based on the earlier unwarranted assumption that the Companies each developed unique and valuable manufacturing in paragraph 112.

In addition, in paragraphs 75, 87, 101, and 113, it is not clear that the tested company is at risk for failures. Paragraph 81, in contrast, addresses this issue directly ("In accordance with the risk analysis framework described in Section D.1.2.1 of Chapter I of these Guidelines, it is determined that Company A assumes the risks relating to . . . ."). USCIB strongly recommends that similar language be incorporated into the other examples, to confirm that risk allocations remain tethered to the TPG framework.

<u>Specific Questions for Commentators</u>

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

Paragraphs 43 through 46 deal with this issue in a very general manner. Consistent with USCIB's positions that preserving flexibility is important and that the most appropriate profit split might be "bespoke", we do not have any suggestions on the considerations that should necessarily be taken into account for this purpose.

> *2. A number of profit splitting factors are addressed in the discussion draft. Comments are particularly invited on:*
>
> > *a. Whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained, and if so, what factors need to be taken into account for its selection and application as a reliable profit splitting factor.*

USCIB supports the continued use of capital as a potential profit splitting factor in appropriate circumstances. For example, some transactions are structured to provide a specific return to capital (e.g., the hedge fund model, as described in the OECD's Report on the Attribution of Profits to Permanent Establishments, Part III, Section c-2(iv)).

The cost of capital or capital employed is a reflection of the economically significant risk. The cost of capital is not, however, observable on a transactional basis, so proxies are necessary to measure this. 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 and risks taken by 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.

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

USCIB believes that headcount may be an appropriate allocation key, for example if companies are sharing expenses such as IT and human resources. It might also be appropriate to split profit using headcount if the profits are heavily driven by function, seniority, time spent on a business etc. A headcount factor might be weighted based on the particular circumstances of the business activity. For example, developing new business may be more important than expanding existing business so that personnel involved in promoting new business may receive greater weight; the business may wish to move its customers to online transaction, so that personnel with responsibility for marketing online transactions may be given greater weight; and in the financial services and like industries, decision-makers may contribute more materially than line personnel, so that headcount could be weighted by title. The essential point is that the allocation key should split profits "on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement at arm's length."[4]

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

Purchasing Power Parity ("PPP") is an economic concept that compares different countries' currencies through a market "basket of goods" approach. Under PPP, two currencies are in equilibrium or at par when a market basket of goods is priced identically in both countries after exchange rates are computed. As such, it is an alternative to exchange rates. USCIB does not believe that this concept is useful for determining profit splitting factors, as asked in question 2 c. There are several problems with this idea.

First, as mentioned above, PPP is an alternative to exchange rates. When reviewing a related party transaction between two currencies, IFRS and GAAP always use exchange rates, not PPP. Use of PPP in a profit split factor would also necessitate use of PPP for all costs and revenues associated with the transaction, a major change in global accounting and tax standards. Second, calculating PPP is complex and unreliable, as a wide range of goods and services must be considered. The amount of data that must be collected and the complexity of drawing comparisons makes this process difficult. Consequently, there is no consensus on how to compute a reliable PPP. Note that several organizations that compute PPP, such as University of Pennsylvania, World Bank and the United Nations, often derive substantially different estimates depending on methodology. Third, exchange rates are superior to PPP as they account for relevant factors often omitted from PPP analyses, such as transportation costs, taxes and tariffs, political uncertainty and monetary policy.

Lastly, we note that the references to "purchasing power" in the OECD Guidelines are particularly broad and not meant for a specific calculation such as profit splitting factors.

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

As emphasized above, USCIB believes that the guidance will be of most value if it avoids strict prescriptions. In particular, the list of profit splitting factors should be expressly illustrative rather than exclusive. Transactions for which a transactional profit split is most appropriate should involve unique and valuable contributions; accordingly, a bespoke allocation key, such as one based on measures used by the taxpayer internally to evaluate business performance, may better reflect relative value contributions than a single-factor key such as capital employed, headcount or compensation. Any such key must, of course, align with the accurate delineation of the transaction.

[4] Discussion draft, paragraph 32.

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

> USCIB does not believe that determining whether there is a "high level of integration" is relevant for determining when the profit split method is the most appropriate transfer pricing method; consequently, no examples are needed.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)

Washington Office
1400 K Street, N.W., Suite 525
Washington, DC 20005
202.371.1316 tel
202.371.8249 fax
www.uscib.org

Appendix A

Provisions Using Proscriptive Terminology and Potential Corrections

The following sentences would be made appropriately less prescriptive by adding the language in bold italics, deleting the language shown in strike-through. We also explain why these changes are appropriate.

Paragraph 6:

- Revised Language: "Furthermore, since those contributions are 'unique' and 'valuable' there ***often*** will be no reliable comparables information which could be used to price the entirety of the transaction in a more reliable way, through the application of another method."

- Comment: It may be the case that a party that owns and makes unique and value contributions to a business will license from a third party, in exchange for a royalty, other unique and valuable intangible property. In those circumstances, the CUP method may be used to "price the entirety of the transaction."

Paragraph 12:

- Revised Language: "That is, the accurate delineation of a transaction ***may require*** ~~requires~~ a two-sided analysis (or a multi-sided analysis of the contributions of more than two associated enterprises, where necessary) irrespective of which transfer pricing method is ultimately found to be the most appropriate."

- Comment: It is not the case that such a two-sided analysis is always required to delineate the transactions. Where a contract limits the functions, assets and risks of a service provider to those of independent comparables for which data is readily available, and no facts or circumstances suggest that the service provider performs functions, uses assets or bears risks other than as set forth in the contract, analysis of the counterparty to the arrangement is not necessary or helpful. Our concern is that this language offers license to governments to assume a profit split is the right method until proven otherwise.

Paragraph 16:

- Revised Language: "Contributions (for instance functions performed, or assets used or contributed) ***may*** ~~will~~ be 'unique and valuable' in cases where (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) their use in business operations represents a key source of actual or potential economic benefits."

- Comment: Some operations within a business may have unique operating procedures that are "key" to its place in the value chain but that do not contribute meaningfully to profitability for the covered business as a whole.

Paragraph 42:

- Revised Language: "Similarly, if the associated enterprise engaged in European marketing and distribution buys products from other sources, it ***may*** ~~will~~ need to segregate its financial data in a way that reflects the revenues, costs, and profits relating to the goods purchased from the associated product supplier in the profit split."

- Comment: Whether third-party sourcing requires segmentation of associated profits can depend on materiality, on the TPM used to value the particular facet of the business (e.g., an application of the TNMM as part of a residual profit analysis may in fact be made less reliable by attempting to segment outcomes from third-party purchases), and on the availability of reliable data and assumptions on which to base the segmentation.

Paragraph 60:

- Revised Language: "In addition, certain assets, such as self-developed intangibles, may not be reflected on the balance sheet at all, and accordingly ***may need to be*** ~~must~~ be separately evaluated."

- Comment: Self-developed intangibles exist for every business. They typically need to be separately evaluated only if they are unique and valuable, and are not otherwise addressed by the selected TPM.

In many cases the use of "will" in the examples is inappropriate. The examples frequently state that Company A or Company B will be responsible for an activity. If the examples are retained, much of this should be rewritten to reflect the contractual obligations and the accurate delineation of the transaction. "Will" blurs these distinctions. The analysis should start with the contractual obligations and determine whether the transactions as accurately delineated are consistent with the contractual obligations.