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Andrew Hickman,
Head of Transfer Pricing Unit,
Centre for Tax Policy and Administration.
2, rue André Pascal
75775 Paris
France

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Submitted by email: TransferPricing@oecd.org

Comments on the OECD Public Discussion Draft on the use of profit splits in the context of global value chains - 16 December 2014 – 6 February 2015

Through its members, BUSINESSEUROPE represents 20 million European small, medium and large companies. BUSINESSEUROPE's members are 41 leading industrial and employers' federations from 35 European countries, working together since 1958 to achieve growth and competitiveness in Europe.

BUSINESSEUROPE is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft on the Use of profit splits in the context of global value chains - 1 December 2014 – 6 February 2015 (hereinafter referred to as the Draft).

General Comments

BUSINESSEUROPE welcomes the OECD's work on the use of profit splits in the context of global value chains.

In the current economic environment many MNEs are conceived as integrated businesses; relevant implications arise from this scheme as related party transactions conducted by group companies will not always be perfectly comparable to those conducted by independent parties. Although no clear answer can be provided by either Tax Administrations or international organizations for every situation and the priority of the arm's length principle is one of the fundamentals of transfer pricing, flexible approaches should be further analyzed in this regard.

Under this scenario, the limited functionality of one-sided transfer pricing methods has already been acknowledged by Tax Administrations, international organizations and taxpayers, being therefore needed further guidance to address functionality constraints within the use of one-sided methods or alternative approaches such as transactional profit split methods, which may prove extremely useful in the context of highly integrated or global intercompany relationships.

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Nevertheless, it should be noted that the application of the profit split should be (as the application of any other of the transfer pricing methods accepted by the OECD) properly supported in every situation, proving that it is the most appropriate methodology to test the arm's length nature of the remunerations agreed, given the facts and circumstances of the case. Thus, the application of the profit split should be based on a thorough functional analysis (functions, assets and risks) in order to determine the contributions of each party and the corresponding allocation of profits.

As a general rule, MNEs do not operate on a fully integrated basis. In fact, in practice, only a little proportion of the related party transactions are of such an integrated nature that only an aggregated analysis is possible and therefore, the use of the profit split is quite limited. However, there are some situations in which it is not possible to use traditional methods or the Transactional Net Margin Method. In these situations both taxpayers and Tax Authorities should be aware of the need to objectivize the application of the profit split, given its technical complexity and the reality of the business conducted. Absent of objectivizing the application of the profit split method and overcoming the hurdles of complexity, may lead to distinct application of the profit split method by tax authorities, hence increasing the risk of double taxation. Therefore, the use of the profit split methodology may be limited to scenarios where traditional transfer pricing methodologies do not provide reliable arm's length pricing.

If selected, Profit split methods should be applied transaction by transaction and not at a general level which will otherwise lead to a formulary apportionment approach. If this were the case, there would be a certain risk to see tax Administrations tempted by this trend to have a global approach, what could be easier for them to apply.

<u>Questions</u>

1. Can transactional profit split methods be used to provide a transfer pricing solution to this scenario? If so, how?

If highly integrated, yes, once the routine functions conducted by contract manufacturers and distributors are properly remunerated, together with the license of IP, the residual profit achieved by the Group could be shared among the three OEMs using appropriate criteria.

2. What aspects of Scenario 1 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?

A thorough functional analysis (functions, assets and risks) in order to determine de contributions of each OEM together with a detailed overview of the value chain; this will allow to determine whether the profit split method would be the most appropriate to share profits among Group members.

3. Is the application of a transactional profit split method more useful than other methods for dealing with particular aspects of value chains, such as highly integrated functions, and the sharing of risks?

In certain situations where contributions made by each group entity are highly integrated and it is not possible to segregate the contributions of the entities and find comparables, then yes.

4. What guidance should be provided to address the appropriate application of transactional profit split methods to deal with these aspects of value chains?

BUSINESSEUROPE would appreciate any efforts by the OECD on detailing those factual situations in which the use of profit split is appropriate: what the "significant integration" means, which allocation keys are recommended to share profits, etc.

5. Can transactional profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how?

Same as answered to Question 1. For those activities very specific and integrated where no reliable comparables could be found, the use of the profit split method could be advisable.

6. What aspects of Scenario 2 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?

Detailed functional analysis; it is crucial to determine where value is created along the value chain, which companies are responsible for value creation and to what extent.

7. Does the way in which "unique and valuable" is defined for intangibles assist in defining the term "unique and valuable contributions" in relation to the transactional profit split method?

Yes. However, further guidance would be helpful to clarify these concepts.

8. What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method?

As mentioned before, the overview of the whole value chain together with a complete functional analysis in order to determine whether the contributions made by each party are "unique and valuable" or routine and whether comparable transactions exist. If the contributions are found "unique and valuable" the most appropriate criteria to split profits according to such contributions.

9. Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm's length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?

For example, if the profit split method is found to be the most appropriate method, the overall profit achieved by the Group in connection with these transactions could be shared among the parties involved in the transactions using a residual profit split methodology; that would involve first, remunerating the routine activities (in the case of Company S, the distribution and marketing functions conducted) and once they are covered for all entities, the residual profit could be allocated to Company S (under the assumption that it is the only company performing "unique and valuable" functions.

10. What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3?

Advantages: proper allocation of profit among Group members according to value creation if the profit split methodology can be reliably applied .

Disadvantages: technical complexity.

11. In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks?

After conducting a comparability analysis, the risks assumed by each company should be determined. Afterwards, the application of the profit split method could be appropriate.

However, this question should be analyzed together with comments raised on action 9 on risk and capital.

12. Would a one-sided method produce more reliable results?

It depends on the circumstances. As long as the contribution of the Group companies are highly integrated and can be considered as "unique and valuable", the profit split method could be adequate. On the contrary, if contributions of entities can be segregated and comparables exist, one-sided methods to determine the arm's length profitability of each company/activity on a single tested-party basis would be adequate and preferable due to less complexity.

13. What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?

As mentioned before, the overview of the whole value chain together with a complete functional analysis in order to determine the real nature of the contributions made by each party.

14. Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how?

Any guidance provided related to the use of profit split methodology should be consistent and coherent with that of intangibles as part of a complete system.

15. Can transactional profit split methods be used to provide reliable arm's length transfer pricing solutions for fragmented functions? If so how? Can other methods address the issue of fragmentation, and, if so, how?

Yes, the use of the profit split may provide reliable results in the context of fragmented functions. In order to allocate adequately profit to each entity it is important to review in detail the functions and risks assumed by each entity so that remuneration is assigned in accordance with value creation. Alternatively, also one sided methods may provide reliable results in the case of reliable comparables as independent enterprises may operate under similar circumstances.

16. What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?

It is necessary to develop under what premises fragmentation is appropriate and when the use of one-sided methods is preferable.

17. How can comparables be found and applied in scenario 5? What method is likely to be appropriate for determining an arm's length remuneration for the activities of the group companies?

An analysis of the value chain together with a complete functional analysis will determine the most appropriate method. If after performing a functional analysis it is concluded that a one sided method is the most appropriate method, comparables will need to be identified using databases. Should the profit split be the most appropriate methodology, total profit achieved by the companies could be shared taking into account a reasonable allocation key, such as the turnover generated by each company over the total turnover generated by the Group. Alternatively, total profit can also be split using a residual approach by first remunerating routine distribution activities using external comparables (benchmark of independent distributors) and then sharing the residual profit according to the contribution made by each party.

18. How can comparables be found and applied in scenario 3 (or to any other relevant scenario in this discussion draft)?

The use of external comparable (external databases) would be, among others, appropriate to remunerate routine activities when the residual profit split is used.

19. What aspects of scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?

As mentioned before, the overview of the whole value chain together with a complete functional analysis in order to determine the real nature of the contributions made by each party.

20. In what circumstances, if any, might an approach described in the last sentence of paragraph 32 be appropriate?

We don't have comments in this regard

21. More generally, in what circumstances would a transactional profit split approach be useful in supporting the application of other transfer pricing methods, and what guidance would be useful to develop for the supporting use of such approaches?

We don't have comments on this.

22. In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?

This question should be analyzed on a case-by-case basis. Additional guidance on what factors would better reflect value creation would be very useful when using profit split methods. However is difficult to find common features for specific industries as they will mostly depend on the functional analysis and the contributions made by each party to value creation in each specific transactions. Nevertheless, listing examples could serve as guidance.

23. What guidance is needed on weighting of factors?

How to weight allocation criteria is a critical step when applying profit split methodologies. Developments in this regard might be very valuable for taxpayers in order to implement these methodologies such us what to value most, how to weight different factors, etc.

24. How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (for example approaches based on concepts of bargaining power,

options realistically available, or a RACI-type analysis of responsibilities and decision making)?

Alternative approaches can be very useful when traditional ones are not appropriate. Especially when dealing with highly integrated activities where, as mentioned before, it is very difficult to find independent comparables, additional explanations provided may provide further clarification on the arm's length nature of the remuneration agreed by the Group companies. Therefore, Tax Authorities should be open to these approaches as they will help taxpayers to prove the rationality of the transfer pricing policies adopted.

25. Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an MNE operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate?

A multifactor profit split analysis would be appropriate to test the arm's length nature of the remunerations agreed among Group companies when the activities conducted are very integrated. Under this scenario, the use of several factors would allow to align the value creation with the profit achieved by each party. The selection of the factors to use and their weight should be determined considering the facts and circumstances of each case, so that they reflect the function, risk and asset profile of the companies involved.

26. What specific aspects of transactional profit split approaches may be particularly relevant in determining arm's length outcomes for transactions involving hard-to-value intangibles?

In these situations a thorough functional analysis of the contributions made by each Group entity becomes even more important in order to determine to what extent they are entitled to perceive the potential profits generated by the developed IP.

Given the difficulties to use one-sided methods to value certain intangibles, transactional profit split methodologies could be appropriate when there are different entities performing relevant functions in connection with the development enhancement, maintenance, protection and exploitation of those intangibles.

However, this question should be analyzed together with comments raised on action 8.

27. How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?

In these situations it would be possible to use residual profit split methodologies in order to ensure a proper remuneration of the entities involved in the transactions under analysis. Once routine functions are remunerated, the residual profit/loss is shared among the Group entities according to their respective contributions. It is therefore needed a deep analysis on how to value the contributions made of each party, considering not only functions or costs, but also risks borne; further guidance on how to measure and weight risks for the purposes of sharing profit/losses would be very useful.

28. Is the application of a transactional profit split method to calculate the royalty in Scenario 8, or in other circumstances to set a price, helpful? What are the advantages and disadvantages?

The use of the profit split could be useful when the IP licensed is very specific and comparable are hard to find. Also when both parties have been engaged in developing, enhancing or maintaining such IP and therefore a fixed royalty rate on sales is not considered to reflect the arm's length contribution of the licensee.

However, this question should be analyzed together with comments raised on action 8.

29. In what circumstances might it be appropriate under the arm's length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss?

It should be carefully supported that different factors are used depending on whether the Group makes profits or losses in order to avoid subjectivity and any behaviours that would not be acceptable between independent parties. Proper explanation should be prepared in order to demonstrate that entities involved in the intercompany transactions under analysis would be entitled to different return as their contributions would vary depending on the final result (i.e. profit / losses).

30. Are there circumstances under the arm's length principle where parties which would share combined profits, would not be expected to take any share of combined losses?

It is difficult to think of such situation in a relationship between independent parties. In principle, only when it could be solidly proved that the entity contribution is not related to the generation of losses, it could be argued that such entity should not take part of them; on the contrary, if all the entities are considered as entrepreneurs (assuming key functions/risk in the value creation), all of them should be ready to share either profit or losses.

31. Paragraph 2.114 of the Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?

Indeed, practical difficulties highlighted in paragraph 2.114 still remain relevant and it is generally acknowledged that the application of the profit split method is of technical complexity. Nevertheless, in some cases it is the only approach that provides consistent results in line with the arm's length principle being thus necessary to facilitate its use by the MNEs. In this regard, simple approaches should be admissible in connection with the factors used or the weight given to each of them, so that the practical implementation of the method does not became very difficult to manage for taxpayers. More sophisticated models should be kept for those Groups where information needed to split profit/losses is easily available through its internal systems.

In light of the above, detailed guidelines on the definition of profit would be advisable since MNEs are complex and often encompass many different businesses. It is therefore necessary to segregate and to allocate costs till the bottom line. In this regard, the use of management accounts should probably be favored as a starting point to avoid MNEs to put in place a new set of information to answer to the tax Administration requests.

32. Finally, what further points would respondents wish to make about the application of transactional profit split methods not covered by previous questions?

Any guidance provided by the OECD in connection with the practical application of this methodology (e.g. definition of profit, factors to share profit/losses, how to weight them, etc.) would help taxpayers to implement it with more certainty as this method is very useful for testing the arm's length nature of certain transactions.

Since value chain might change over time, any developments on the need to update the allocation of profits would also be useful.

Consequently, we urge the OECD to carefully consider these aspects in the process ahead.

BUSINESSEUROPE would be willing to engage in a constructive dialogue with the OECD on use of profit splits in the context of global value chains.

On behalf of the BUSINESSEUROPE Tax Policy Group

Yours sincerely,

James Watson
Director
Economics Department