BEPS MONITORING GROUP

Comments on BEPS Action 10: The Use of Profit Splits in the Context of Global Value Chains

This report is published by the BEPS Monitoring Group (BMG). The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This paper has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

This paper has been prepared by Jeffery Kadet and Sol Picciotto, with comments and input from Richard Murphy, Attiya Waris, Francis Weyzig, Yansheng Zhu and other members of the Group.

We welcome this opportunity to comment on the Discussion Draft, and would also be willing to speak at the public consultation on the subject.

SUMMARY

The BMG welcomes this report from the OECD, which confirms that the time has arrived for expanded use of the profit split method, placed on a more regularised and systematic foundation. In our view there is a serious need to develop a simple-to-apply reliable approach to determining how profits will be apportioned amongst the members of a centrally managed multinational group. Specifically, we suggest that the Transfer Pricing Guidelines should include clear guidance stating concrete allocation keys and weightings for all business models now commonly being used. Anticipating the likely emergence of new business models, the Guidelines should also articulate the principles on which concrete allocation keys and weightings should be determined. Such simple and clear rules would be easier to administer, and greatly reduce conflicts both between tax authorities and companies, and among tax authorities. They would make an enormous step towards achieving the aim set by the G20 that multinationals should be taxed ‘where economic activities take place and value is created’.

1. GENERAL REMARKS

A. Clarifying the Basis of the Profit Split Method

1. Transfer pricing rules are based on article 9 of tax treaties, which gives a power to adjust the accounts of associated enterprises according to the independent entity principle. Hence, they have become the major mechanism for apportioning the tax base of multinationals. Indeed, they have been made to bear far too much weight, for two key and interrelated reasons. The main reason is that article 9 has increasingly been interpreted to require entities which are affiliates of a multinational corporate group to be treated as if they were independent of each other. We believe that this is a misinterpretation, since the purpose of article 9 is to permit the adjustment of accounts of related entities to ensure an appropriate profit allocation. The independent entity criterion
for such adjustments specified in article 9 dates back to 1935, but since then both practical experience and the economic theory of the firm have shown that it is unworkable, since associated entities are not in fact independent parties and generally do not in any way behave like separate parties that are negotiating their relationship and transactions at arm’s length. Relatedly, the rules for attributing revenues and costs (and hence income) to different entities have become increasingly subjective, unclear and contested. Unsurprisingly, multinationals have themselves exacerbated the problems, by taking advantage of the separate entity concept to restructure by fragmenting their activities so that different functions are assigned to various entities in ways that minimise tax liability and achieve their BEPS objectives.

2. The mandate from the G20 for the BEPS project offers an opportunity to reorient the system, with the aim of ensuring that multinationals are taxed ‘where economic activities take place and value is created’. The new orientation means replacing the fiction of separate legal personality in those situations where it does not reflect economic substance with a holistic approach which treats corporate groups in accordance with the business reality that they are run as integrated enterprises. This would provide a much sounder foundation for rules to attribute both costs and revenues which could be simpler and easier to administer. It is heartening that some of the proposals resulting from the Action Plan have adopted this approach, notably those under Action 4 on interest deduction, and the simplified method for apportioning central service costs proposed under Action 10.

3. Regrettably, some of the proposals are confused and contradictory, mainly because they lack a clear and coherent orientation. This seems particularly the case in relation to transfer pricing rules. The continual evocation of the mantra of the arm’s length principle seems aimed at reassuring traditionalists that no significant changes are intended. At the same time, many of the proposals now put forward, in particular for revision of Chapter 1 of the Guidelines, strongly suggest moving away from the legal fictions of corporate personality and contracts between related entities, and the increased use of the profit split method.

4. This ambivalence goes back at least two decades, to the early 1990s when the OECD first confronted the central problem of the unsuitability of the comparable uncontrolled price (CUP) method due to lack of suitable comparables. Although this led to acceptance of profit-split, which entails apportionment of aggregate profits, it has been described as a ‘transactional’ method and based on the arm’s length principle. Worse, it has been treated simply as a fall-back, and no serious attempt has been made to formalise or systematise it, so that its application remains arbitrary, or merely a basis for bargaining.

5. We are therefore encouraged by the present consideration being given to the profit split method, and that the Discussion Draft on the Use of Profit Splits makes clear that this
approach has a more important future. However, we consider that it should be made explicit that this method is not based on the separate entity concept. So far this is only hinted at in the reports. For example, present guidance in paragraph 2.108 of the Guidelines provides that the application of the profit split method must determine ‘the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions’. In contrast, paragraph 1 of this Discussion Draft begins by stating:

This document invites responses to questions that seek to gain insight about experiences and best practices in applying transactional profit splits, and views on how current guidance might be amended in order that transactional profit splits can assure that transfer pricing outcomes are in line with value creation. [Emphasis added.]

The term ‘transactional profit split’ is contradictory and confusing, and should not be used. It should be made explicit that profit split is a method of apportioning profits to ensure outcomes that are in line with the location of economic activities and value creation. This clarification should involve a more thorough revision of chapter 1 of the Transfer Pricing Guidelines, as we have recommended in our comments on the DD on Revisions to Chapter I of Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures).

6. To the extent that there is a guiding principle for the reforms proposed for transfer pricing rules, it is that profits should be attributed according to the functions performed, assets owned and risks borne by each entity. Unfortunately, this retains the fundamental ambivalence about how to treat the fictions of separate entities and contractual transfers within a corporate group. This can be seen perhaps most clearly in relation to the concept of ‘risk’. As we argue in greater detail in our separate submission on the proposals on Revisions to Chapter I of Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures), it should be clearly and explicitly recognised that any supposed transfer of risk within an integrated enterprise is fictitious and notional. To continue to accept the idea that risks can be borne by a particular affiliate is a recipe for encouraging elaborate BEPS motivated tax restructuring, and for continued conflicts between taxpayers and tax administrations, and between countries, over the inevitably subjective evaluations of risk and the appropriate return to risk. This cannot be what is meant by aligning taxation with the location of economic activities and value creation.

7. An explicit acknowledgment that profit split is a profit apportionment method should also be accompanied by an explanation in the Commentaries of the rationale for this approach. This is based on the understanding that for a MNC which operates on an integrated basis, attempting to treat its various affiliates as if they were independent makes no sense and is therefore unworkable in practice. In addition to the basic problem of lack of suitable comparables, the integrated nature of the activities of such a firm means that it is difficult or impossible to decide what proportion of the profits to attribute to particular functions, activities, or assets. To take a familiar example, that of a pharmaceutical company earning large profits from sales of proprietary medicines: it may be thought that these are mainly attributable to the laboratory research identifying the specific drugs concerned; but such discoveries only have value following an extensive
and expensive process of development, trials and regulatory approvals; and the resulting revenues also depend to a great extent on marketing efforts, on which far more can be spent than on the primary research. A profit apportionment method such as profit split avoids these problems by allocating profit using allocation keys which reflect the real economic presence of the firm in the countries concerned, usually based on employees, level of expenses, and revenues.

**B. The Need for simplified methods**

1. A second general point should be made before beginning our specific comments below. The feedback from developing countries on the BEPS project has stressed the importance for them of formulating solutions that are simple and easy to administer. This should indeed be a concern for all tax administrations, which everywhere are being expected to do more with fewer resources. The discussions of risk in Section D of Chapter I and of Intangibles in Chapter VI of the Transfer Pricing Guidelines provide an excellent illustration of the differing platforms from which MNCs and interested tax authorities are operating. The discussion makes clear the need for a detailed analysis that includes the various legal effects of the form of intangible property concerned, the various commercial and legal effects of any contractual terms concerning those intangibles, and the functions performed, assets owned and risk assumed by the various parties. Each MNC that has implemented BEPS structuring has a relative army of in-house legal, tax, and other specialty personnel whose jobs it is to understand and protect the MNC's interests. Most MNCs also engage outside counsel, tax advisors, economic analysts, and other specialists as well. On the other hand, the tax authorities in this world, especially in developing countries, have far fewer resources. This inequality of resources is a major disadvantage of transfer pricing methods which rely on detailed ‘facts and circumstances’ examination and ‘functions, assets and risks’ analysis of each corporate value chain. Under this approach it is difficult for tax authorities to challenge a company’s structures and policies, if they are fully explained and documented, without applying equivalent resources to analysing those structures and policies. It may be noted that recent reporting has indicated that even the United States tax authorities have hired outside counsel to help them with an ongoing transfer pricing review of Microsoft at a cost in the millions of dollars. No tax authority can afford to apply such resources to ensure a detailed audit of every multinational within its jurisdiction. This approach benefits only the large tax advisory firms who offer services of transfer pricing analysis and documentation, and the consultants who have made transfer pricing regulation a big business.

2. In our view a key answer to this problem in the short-term context of the 2015 BEPS deliverables is to significantly expand the use of the profit split method and to provide formulary guidance for concrete and objective, easy-to-compute allocation keys that makes it easy to administer by tax authorities in all countries. This may well involve a trade-off between the fine-tuning of the transfer pricing result in each specific case with simplicity of application. However, the present overwhelming need is to develop a system that will really work in practice. Fine-tuning should be limited to exceptional cases where large sums are involved, which may often need to be dealt with on an ad hoc basis, e.g. through Advance Price Agreements.
3. We endorse and support the formulations stating the goals of good tax policy in the Action 1 2014 Deliverable, *Addressing the Tax Challenges of the Digital Economy*, Section 2.1. Those listed are neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. Without undue sarcasm, it should be pointed out that these goals do not include creating a mentally challenging exercise that is fun for professional accountants and lawyers to pursue. On the other hand, a method which could be simple to understand and apply would be a profit split method that uses concrete allocation keys. This eliminates Solomon-like subjective decision making for both taxpayers and tax authorities alike, and would meet a number of these tax policy goals.

- **Neutrality**
  Since concrete allocation keys that focus on objective factors such as personnel, expense levels, revenue, customers, etc. will all be independent of the form of business activity used by any MNC, neutrality will be achieved. MNCs can choose their form of business organization based on business and legal objectives, independent of tax considerations. This should also result in fewer of the convoluted structures that so many MNCs now use to pursue their BEPS objectives.

- **Efficiency**
  Compliance costs to business and administration costs for governments will clearly be minimized.

- **Certainty and Simplicity**
  The use of concrete allocation keys clearly creates certainty and simplicity in comparison to seriously subjective analyses of relative risk and relative value of intangibles.
  
  The Action 1 2014 Deliverable in Section 2.1 also notes: ‘Complexity also favours aggressive tax planning, which may trigger deadweight losses for the economy’.

- **Effectiveness and Fairness**
  The resource imbalance between wealthy taxpayer MNC groups and tax authorities, many of which are seriously underfunded, will be reduced whilst smaller taxpayer entities will have a greater chance of achieving fair outcomes compared to the wealthy MNCs.

We could continue the above listing and note how this simpler-to-apply profit split method also contributes to flexibility. However, enough has been said.

**2. SPECIFIC COMMENTS**

**A. Scenario 1, Question 4:**

*What guidance should be provided to address the appropriate application of transactional profit split methods to deal with these aspects of value chains?*
1. First, a general comment regarding the background facts of this Scenario. A royalty is being paid to the non-EU parent of the group. The facts stipulate that aside from this royalty, ‘the European operation of the group is largely independent of the parent.’ Para 10 goes on to say:

In this scenario one-sided methods can reliably be used to determine arm’s length pricing for the royalty and for the contract manufacturing and distribution services.

If we look at many of the successful profit shifting groups, the convoluted intra-group structures and royalty streams that they create for group-developed IP, manufacturing, and distribution are integral parts of the profit shifting mechanisms. Further, IP in particular is typically unique such that there are normally no comparable unrelated party transactions that would allow a true arm’s length royalty to be determined. Hence, we strongly suggest that future example guidance for ‘value chain’ situations assume as background that the IP development is a part of the activities to which the profit-split method is to be applied. As for contract manufacturing and distribution services, we suggest that at least one example similarly include such activities and indicate as background a situation where the manufacturing and/or distribution functions are unique and are appropriately a part of the combined income subject to the profit split method.

2. Now to our specific response to Question 4. There are two aspects of this. First of course is how to measure the profits to be split. Second is how to split the combined profits amongst the associated companies.

3. In regard to the second aspect regarding how to split the combined profits, a particularly relevant point is that certain factors are pretty much all 100% within the control of group management. These include intra-group factors such as:

- Capital structuring of subsidiaries, both concerning the specific categories and types of shares or securities issued as well as the specific ownership of each group member by one or more other group members,
- Form of organization of each group member as a corporation, LLC, partnership, branch or other available form of organization,
- Financings both between associated companies and from third parties where pledges or guarantees have been made by associated companies,
- Contractual sharing of risk, e.g. which associated company will bear risk of inventory obsolescence, customer credit risk, etc., and
- IP-related agreements including, for example, R&D and software service contracts, cost sharing agreements, licenses and transfers.

A value chain will of course be based on many legitimate business and investment decisions regarding where to conduct R&D and software development, what R&D to conduct and what software to develop, what products to produce and how and where to produce them and later market them, where to inventory them, whether regional warehousing is required and if so where to place it, what internet presence is necessary and what personnel will be responsible to maintain it, etc. All of these business and
investment decisions will determine the real third-party facing functions, assets, and risks that the group conducts, owns and assumes throughout the value chain. These functions, assets and risks are reflected in the financial statements that purport to inform the public of the financial position and operating results of the group. Those financial statements eliminate all intra-group dealings and capital ownership since they are all internal and have no “reality” to the external world.

4. Where the profit split method is the most appropriate method, then all internal intra-group factors must be ignored with only the real third-party facing functions, assets, and risks being considered in the transfer pricing analysis. Such an analysis would take into account operational factors such as employees and their real responsibilities, revenue and customers, operational tangible assets, R&D functions, design functions, manufacturing, sales functions, expense levels, etc. It would ignore the effects of all intra-group agreements and capital ownership that shift revenue, expenses, and risk amongst the group members. This is absolutely necessary to achieve the goals of BEPS Action 9 on Risks and Capital, which states its aims in part as: ‘to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital’. This guidance must be incorporated into Section C.3 of Chapter II, Part III of the Guidelines.

B. Scenario 2, Question 5:

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

We recommend the use for this Scenario 2 business model of two equally weighted allocation keys as follows:

- **Users**

  Using users as an allocation key reflects the importance of each market and the value of Aco’s users to the global business of Aco and Aco’s fee paying third-party customers. The country is determined by the location of the user and not the legal terms of any contracts, licenses, or other documents with either users or the third-parties that pay Aco for advertising, aggregate user data, etc.

- **Operating Expenses**

  This allocation key recognizes all operational inputs. As such, it covers all research and development, website maintenance, sales, marketing, distribution, management, support functions, etc.

  This key would include categories of expenses such as:

  - Salaries and bonuses of all operations personnel (allocated by location of personnel)
  - All other direct and allocated operating expenses (allocated by location of personnel or facility to which the expenses relate)
  - Commissions and service fees paid to other parties for all operational functions (allocated by location where the other party provides the
services) (These payments economically include all personnel costs, office and manufacturing costs, etc. of the legal entity performing the relevant operational functions for the taxpayer. Payments to any related parties whose profits are included in the combined profits for the profit split would of course be excluded.)

C. Scenario 3, Question 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?*

1. Yes, it will assist in analyzing specific situations in relation to deciding whether the profit split method is the most appropriate transfer pricing method to apply.

2. In considering this determination of the most appropriate transfer pricing method to apply, it is more than fair to say that taxpayers will know their own intangibles and contributions intimately. On the other hand, tax authorities in all countries, whether developed or developing, will be at a disadvantage in understanding both a taxpayer’s specific situation regarding intangibles and contributions and those of other players in the taxpayer’s industry or trade segment. We suggest, therefore, that Paragraph 6.17 (or some other appropriate paragraph) include the following language: ‘In the event that any tax authority believes that any associated company holds unique and valuable intangibles or provides unique and valuable contributions, the burden of proof to establish the contrary will be on the applicable taxpayer.’

D. Scenario 3, Question 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?*

1. In this situation for Scenario 3, we recommend the use of three allocation keys to be applied to the combined profits of Companies P and S with the indicated weighting as follows:

   - **Sales (weighted at 25%)**
     
     The inclusion of sales as one of the allocation keys reflects the importance of each market and its customers to the global business of Companies P and S. The country of sale should be determined by the location of the customer and not the legal terms of the sales contract. (See concluding comment in this section concerning this sales allocation key.)

   - **Marketing and Distribution Expenses (weighted at 25%)**
     
     Para 2.138 of Transfer Pricing Guidelines provides, in part:

     > An allocation key based on expenses may be appropriate where it is possible to identify a strong correlation between relative expenses incurred and relative value added. For example, marketing expenses may be an appropriate key for distributors-marketers if advertising generates material
marketing intangibles, e.g. in consumer goods where the value of marketing intangibles is affected by advertising.

Total marketing and distribution expenses make an excellent allocation key that reflects the amount of resources that a taxpayer invests in each market. This key would include categories of expenses such as:

Salaries and bonuses of marketing and distribution personnel (allocated by location of personnel)

Advertising expenses (allocated by market that advertising targets)

All other direct and allocated expenses of marketing and distribution, not including transportation costs of inventory (allocated by location of personnel or facility to which the expenses relate)

Commissions and service fees paid to other parties for marketing, distribution, and after-sales services and support (allocated by location where the other party provides the services) (A taxpayer will often pay other legal entities, whether related or not, for sales activities, other sales support, and/or after-sales service and support activities. These payments economically include all personnel costs, office and warehouse costs, etc. of the legal entity performing the marketing and/or distribution functions for the taxpayer. Payments to any related parties whose profits are included in the combined profits for the profit split would of course be excluded.)

- Expenses Other than Marketing and Distribution Expenses (weighted at 50%)

This allocation key recognizes all inputs other than those for marketing and distribution. As such, it covers all manufacturing activities, research and development, management and support functions, etc.

This key would include categories of expenses such as:

Salaries and bonuses of all personnel other than those involved in marketing and distribution functions (allocated by location of personnel)

All other direct and allocated expenses other than those related to marketing and distribution functions, not including transportation costs of inventory (allocated by location of personnel or facility to which the expenses relate)

Commissions and service fees paid to other parties for all operational functions other than marketing, distribution, and after-sales services and support (allocated by location where the other party provides the services) (For example, this category includes situations where a taxpayer pay another legal entity, whether related or not, for contract manufacturing services. These payments economically include all personnel costs, office and manufacturing costs, etc. of the legal entity performing the relevant operational functions for the taxpayer. Payments to any related parties
whose profits are included in the combined profits for the profit split would of course be excluded.)

2. Note that there is no allocation key for property or inventory. Regarding property (including rented and leased property), we believe that the value and extent of facilities will most typically be reflected by the labour retained by each group member. This reliance on labour also avoids all the difficult property valuation issues that inevitably arise if property is included as a direct allocation key. If depreciation (book or tax) were to be used, the many varying methods, lives, and inconsistent treatments make these too subjective and subject to potential abuse. Regarding inventory, the sales allocation key measures the importance of the source market and suggests that inventory and inventory transportation costs could be duplicative, to some extent.

3. Note also that neither risks nor intangibles (e.g. patents, manufacturing processes, trade names, knowledge of market channels, etc.) are directly included. Given the integrated nature of the associated companies’ businesses and the fact that both parties are contributing their own unique and valuable intangibles, it seems both appropriate and simpler to ignore these risks and intangibles as separate allocation keys. Both are, however, indirectly included through the other factors. For example, to the extent that risks and intangibles are related to manufacturing that is solely conducted in the home country or elsewhere outside the source country, then the higher-weighted allocation key for all expenses other than those for marketing and distribution will reflect them. Such expenses include ongoing R&D, the bulk of which will be in country P. As for marketing risks and marketing intangibles, the marketing and distribution expenses factor will similarly reflect them. For example, if relatively higher paid marketing executives in country P make sales and credit decisions regarding buyers, then relatively more profit will be allocated to Company P and relatively less to Company S, thereby reflecting the risk that is being managed from Company P. On the other hand, if sales personnel in Company S are performing important functions such that they are paid bonuses based on their productivity, then the value they add will be reflected in their bonuses with relatively more profit allocated to Company S.

4. An alternative approach would be to eliminate the ‘sales’ allocation key and then equally weight the remaining two keys. This would leave the ‘sales’ key to be used only in cases where there has been a meaningful creation of value due to participation of local users and consumers. If the ‘sales’ key were eliminated, then consideration should be given to including a key for the value of inventory allocated by location where maintained.

E. Scenario 4, Question 11:

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

1. Within any group of associated companies, the assignment of the rewards of business success and the assumptions of business risk amongst the group members are totally within the control of the group’s management. They typically exercise this control through inter-affiliate contracts that are specifically structured to provide what they
perceive as the best tax result for the group. These contracts and agreements are in no way documents resulting from arm’s length negotiations between unrelated persons.

2. Given the serious and effective use that this control and the contractual mechanism has provided to multinational groups, we believe that business opportunity and risk cannot be an allocation key or otherwise be used in the process of applying the profit split method. Rather, the actual physical aspects of the conduct of business (location of employees, property, customers, etc.) must be the factors on which the profit split method is based. When this is done, factors such as personnel numbers and personnel costs will reflect the relative business benefits and risks that are spread amongst the countries in which the group operates. Such an allocation key approach will also be administratively much easier to apply than a person-by-person analysis and weighing of the exact relative management functions performed by each executive with often overlapping responsibilities.

F. Scenario 4, Question 12:

*Would a one-sided method produce more reliable results?*

A one-sided method would be totally inappropriate in Scenario 4. To be at all appropriate, a one-sided method assumes that the measured side will be performing activities that carry very little, if any, business opportunity or business risk. The facts specify that: ‘Companies A, B and C each control and perform their own research, development and production processes’.

G. Scenario 4, Question 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?*

The facts of Scenario 4 are sufficient. Nothing further needs to be elaborated to establish the need for use of the profit split method. The integrated nature of the group’s business of developing and selling medical equipment products using proprietary IP developed by each of the three identified group members makes this clear.

H. Fragmentation

*General Comments*

1. While we agree that there can be legitimate business and legal reasons why a multinational group might choose to organise certain of its activities and functions under distinct affiliates, we believe that the vast bulk of what can be described as fragmentation is motivated principally to achieve a better tax answer rather than to accomplish any important business or legal objective. The extent of the recent Luxembourg tax ruling leaks clearly demonstrates this. Fragmentation is an accepted and regularly conducted part of the tax planning/tax avoidance toolkit practiced by virtually all multinationals and definitely by all of their legal and tax advisors.

2. In our view, therefore, it is essential for the success of the BEPS project to make clear the necessity of moving away from the presumption of acceptance of the separate entity existence of associated enterprises. Without this recognition,
fragmentation would be sure to continue as an important tax planning/tax avoidance tool. For this reason our submission on Action 7 concerning PE Status recommends a reconsideration of article 5(7) of the Model Convention. Such a reversal of the presumption would much reduce the need for detailed analysis of corporate structures to decide whether and to what extent a particular affiliate or sub-group should be regarded as not part of the integrated business. Such an analysis requires a tax authority to identify all relevant group entities within any fragmented structure and truly understand their respective roles and the contractual and financial flows between them. Under current rules, it is only in this way that a tax authority can determine, for example:

- If each player’s separate existence should be respected (i.e., whether non-recognition or re-characterization should be considered),
- Whether any player’s activities cause it to have an unregistered branch (i.e. permanent establishment) that exists under current domestic rules or an applicable treaty or in the future under any expanded PE definition that emerges from the BEPS,
- The appropriate characterization for tax purposes of the various contractual relationships and financial flows, and
- Whether a transfer pricing review is appropriate for any such financial flows as appropriately characterized.

Typically, the MNC and its advisors will be well aware of the big picture and objectives of the planning as well as all the created entities and what functions, assets and risks each will conduct, own or assume, and will illustrate these for themselves in charts and diagrams. However, under current rules most tax authorities would never see these charts and diagrams. Under normal circumstances, the tax authorities in source countries, and often in home countries as well, will never be aware that careful and concise fragmentation planning has even occurred. All these tax authorities will see is what the MNC intends for them to see. This reality is at the heart of fragmentation planning: show the relevant tax authorities what you want them to see and no more. Since they are not aware of what they can’t see, tax authorities cannot ask appropriate questions that will allow them to carry out their functions and collect legally due taxes.

3. This situation should be transformed if the proposals under Action 13 on Country by Country Reporting and Transfer Pricing Documentation can be successfully implemented on a worldwide basis. The combination of the Country by Country Report and the Transfer Pricing Master File, which in our view should be directly and automatically supplied to all countries where the MNC may have a taxable presence, should give all tax authorities both an overview of the firm as a whole, and the detailed information on legal and ownership structure and geographical location. In addition, the new Local File will include much relevant information including a local organization chart, information on material controlled transactions, and copies of material intercompany agreements concluded by local group entities.

4. However, even where information on all participants in a fragmentation plan are included these three reports, the reports will not set out in any easily understandable...
manner the fragmentation planning that an MNC has undertaken. There will be no nicely prepared charts and diagrams showing for each fragmentation planning the participating group entities and the contractual relationships and financial flows amongst them. In short, as the tax authorities in both MNC home countries and source countries view the three reports, there will be no obvious indication of the existence of fragmentation planning focused on their respective countries.

5. Fragmentation planning isolates various functions, assets, and risks so that they will appear unconnected with various source countries to which they truly relate. Hence, in many if not most cases, group entities involved in fragmentation planning will not be included in the ‘local files’ of the countries to which significant portions of their operations relate. In addition, contractual relationships and payment flows will often be structured so that no source country entity is a direct counterparty. Where this is the case, the applicable ‘local files’ are unlikely to include any information suggesting even the existence of such group entities involved in fragmentation.

6. Hence, we suggest that the BEPS project in considering fragmentation, for both the transfer pricing rules as well as other special measures, provide clear guidance for both MNC home and source countries including:

- How to recognize the possible existence of fragmentation planning,
- The various implications regarding potential non-recognition and re-characterization of entities, contractual relationships and financial flows,
- The potential application of permanent establishment, CFC, and other applicable taxation mechanisms to counteract BEPS behaviour, and
- The application of the profit split method to MNC group entities involve in fragmentation planning.

I. Question 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?*

Guidance similar to what is provided above in our responses to Questions 5 and 9 should be given regarding allocation keys that should be used for varying types of MNC group transactions for which the profit split method is appropriate.

J. Question 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?*

1. The profit split method is normally the most appropriate one to be used in such cases. MNCs have total control to fragment by creating whatever organization chart they believe will result in the lowest effective tax rate on a worldwide basis. The following, which is from Part I, Para 85 of the *BEPS Action 8, 9 and 10: Discussion Draft on Revisions to Chapter 1*, clearly acknowledges this total control:
'Attributes of non-arm’s length arrangements can be facilitated by the ability of MNE groups to create multiple separate group companies, and to determine which companies own which assets, carry out which activities, assume which risks under contracts, and engage in transactions with one another accordingly, in the knowledge that the consequences of the allocation of assets, function, and risks to separate legal entities is overridden by control.'

2. Recognizing this total control to fragment functions, risks and assets, the best way to truly align value and profits is with profit split methods. These methods are the only ones that truly counteract and nullify the carefully crafted BEPS fragmentation planning that MNCs have so successfully conducted over the past several decades.

K. Question 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?*

No comments.

L. Aligning Taxation with Value Creation:

*General Comments*

1. We are very much encouraged by the suggestion in this section for the use of more concrete allocation keys. We believe that this is a very positive approach that will greatly simplify administration of transfer pricing and reduce potential conflicts. In particular, we especially applaud the approach of focusing on concrete factors such as production capacity, headcount, and value of production and ignoring the soft and subjective areas such as intangibles and risk. Perhaps ‘ignoring’ is not the best word to use since the reality is that abstract and hence nebulous factors like intangibles and risk will normally be adequately reflected by these more concrete factors. Hence, they are not being ignored; rather, they are being accounted for in a very much more concrete and practical manner.

2. Earlier within this submission in the responses to Questions 5 and 9, we set out several similar approaches to the use of concrete allocation keys. We strongly suggest that the Guidelines should include clear guidance stating concrete allocation keys and weightings for all business models now commonly being used. Anticipating the likely emergence of new business models, the Guidelines should also articulate the principles on which concrete allocation keys and weightings should be determined.

3. In support of this simplified approach, it is clear that any allocation of profits of a complicated corporate structure that results from the current approach based on a detailed assessment of functions, assets and risks will by its inherently subjective nature only result in a very wide range of possible profit allocations. The use of simple-to-apply concrete allocation keys that are appropriate for the particular business model used will result in profit allocations that will virtually always fall within this wide range. Adoption of such an approach will ensure a reduction in BEPS behaviour, greatly enhance the ability of tax authorities to actually administer and collect taxes, and reduce conflicts both between tax authorities and taxpayers and among tax authorities.
M. Question 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?*

1. As explained above, guidance should be modified to provide concrete allocation keys and weightings for each business model now being used and the principles on which concrete allocation keys and weightings should be determined for new business models that appear in the future.

2. For example, where an MNC uses a business model of developing, maintaining, and exploiting an internet platform that provides free service to customers and charges advertisers and others for access to that customer base, then the following concrete equally weighted allocation keys could be used:

   - The number of customers using the MNC’s services in each country, and
   - Operating expenses including all research and development, website maintenance, sales, marketing, distribution, management, support functions, etc.

Additional details are included in our response to Question 5 above, which concerns Scenario 2.

See also our response to Question 9 above, which concerns Scenario 3. This involves a business model where a manufacturer and its distributor subsidiary each hold important self-developed intangible property. The following concrete allocation keys could be used with the indicated weighting. There are additional details and discussion on this in our response to Question 9 above.

   - Sales (weighted at 25%)
   - Marketing and Distribution Expenses (weighted at 25%)
   - Expenses Other than Marketing and Distribution Expenses (weighted at 50%)

N. Question 23:

*What guidance is needed on weighting of factors?*

As indicated above, the guidance to be provided on the weighting of allocation keys for each type of business model should be specific set percentages. We strongly recommend including specific set percentages such as those included in our responses to Questions 5, 9, and 22 because that will provide administrative simplicity and many fewer disputes.

The only cost would be a little less specificity, and given the subjectivity of any theoretical arguments on the relative weighting of the allocation factors, this ‘cost’ is indeed very low.

O. Question 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)?

As indicated above, we strongly support the use of concrete approaches that will ease the transfer pricing process and reduce conflicts. We do not have practical experience with RACI-type analysis. If this is an approach that can be made with relative objectivity, then we fully support its use as an allocation key. If on the other hand it carries only slightly less subjectivity that dealing with Solomon-like judgments on issues of relative risk and the value of differing intangibles, then we recommend that RACI analysis not be used as an allocation key. Rather, easily measurable and objective keys such as personnel headcount and total compensation costs should be used. The latter of these two (total compensation costs) would normally be used within the analysis of any business model that involves relative risk and intangibles since compensation costs will reflect the higher paid personnel who typically make business risk and intangible decisions.

P. Question 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 MNC 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?*

1. It is certainly possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an MNC operates an integrated global value chain. As explained in more detail in our response to Question 9 above, the following allocation keys and weighting would provide a simple and easy-to-apply approach to allocating profits under the profit split method for an integrated global value chain model. There are considerable additional details and discussion on this in our response to Question 9 above.

   - Sales (weighted at 25%)
   - Marketing and Distribution Expenses (weighted at 25%)
   - Expenses Other than Marketing and Distribution Expenses (weighted at 50%)

2. Again, as noted in the above general comments, such a simplified approach will normally result in a profit allocation that is within the very wide range of outcomes that would result from a theoretically correct and terribly subjective assessment of functions, assets, and risks. The reduction in BEPS behaviour, the ability of tax authorities to actually administer and collect taxes, and the reduction in conflicts will be very much worth any reduction in specificity of the process itself.

Q. Hard-to-Value Intangibles

*General Comments*

1. We believe that using the profit split method on a mandatory basis and with concrete allocation keys will be the best approach to discouraging BEPS behaviour with respect to the transfer of partially developed intangibles.
2. BEPS tax avoidance planning often involves the transfer of partially developed intangibles to a low or zero-taxed associated enterprise. Commonly, these transferee enterprises have few if any operations of their own or capability to either conduct or even oversee the completion of the intangible project. In such cases, the application of a profit split method using appropriate concrete allocation keys for the particular business model would apportion profit to the associated enterprises where real activities take place and little, if any, within the low or zero-taxed associated enterprise that nominally owns the intangibles. Because in such situations the transferor usually continues to be involved in R&D efforts and maintenance/enhancement following the transfer of the partially developed intangible project as well as its exploitation, the transferor’s real activities will be reflected in the various concrete allocation keys. As long as the profit split method is consistently applied throughout the life of the intangible’s development and subsequent exploitation, taxation will align with value creation.

3. Assume next that the transferee, whether taxed within its countries of operation at normal rates or at low or zero rates, is an associated enterprise that truly carries on its own activities through its own competent and capable personnel so that the transferor is no longer involved (and therefore would not have activities picked up by the applicable concrete allocation keys). In this situation, an approach such as the special measure suggested in Part II, Option 1 of the BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter I would be appropriate to apply. We applaud the suggestion of this Option 1 and believe that it is a necessary addition to the Transfer Pricing Guidelines.

R. Question 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?

No further comments in addition to the above general comments.

S. Scenario 7, Question 27:

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

1. The focus of this scenario and question is on dealing with ex ante/ex post result differences. A first important point is that the two associated enterprises have common ownership and common control. Is this common ownership and control 100%? This will typically be the case in most MNC situations. Assume for this initial discussion that there is no significant level of minority ownership.

2. Even though two associated enterprises have 100% common ownership and control, there can be legitimate reasons why they might make an agreement such as described in Scenario 7. For example, they could have completely separate managements and operations that are each judged for employee compensation and bonus purposes based on the relevant company’s operating results. This of course is fine as it presumably helps the common owner motivate and compensate appropriately the personnel of each company. While the common owner chooses to organize its affairs in this multiple management group manner, this owner alone will ultimately bear the economic costs of the taxation of
the two associated enterprises. Our overall tax policy goal is to see that the overall tax costs are fair to both this owner and the relevant countries in which these two associated enterprises operate. As further tax policy goals, the approach used to determine the profits of each company must be easily administrable and not an undue burden to either the companies or the tax authorities.

3. The transfer pricing method to be used must consider the tax policy goals discussed in Section 1B above (i.e. fairness, ease of administration, etc.) as well as the factual uncertainty regarding whether one or both of the companies might incur cost overruns that will affect economic outcome. In this case, the simplicity and ease of using a profit split method with concrete allocation keys on an ex post results basis is compelling. The owner is free to organize his activities as he chooses, but this much simpler approach to determining the portion of profit to be reflected in each enterprise will in fact better align taxation with value creation. Whether a cost overrun was caused by some unforeseen circumstances or merely from a bad initial cost estimate will not be a concern to the tax authorities. The work was still required and contributed value to the eventual profits that are earned by the two enterprises from the sale of the one product.

4. Now assume a situation where there is a significant minority interest in one of the two associated enterprises. In this case, there is a real economic issue regarding the bearing of taxes by the two enterprises. Despite this real economic issue, we believe that the above approach to using a profit split method with concrete allocation keys on an ex post basis is the more appropriate approach to adopt in order to best achieve the desired tax policy goals. The controlling owner and the significant minority interest have the choice, if they desire, to agree on how they will allocate tax costs amongst group members.

T. Scenario 8, Question 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?**

Yes, we believe that this is a helpful approach, but only in combination with the implementation of the special measure for ‘hard-to-value intangibles’ suggested in Part II, Option 1 of the BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter 1. This special measure would provide for a contingent adjustment mechanism that would have the economic effect of continuing the 80/20 sharing relationship that has been determined under the facts of Scenario 8 if actual sales divert from anticipated sales.

U. Scenario 9, Question 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?**

1. As has been indicated throughout this response, we strongly recommend applying the profit split method in a simple-to-administer fashion that involves the use of concrete allocation keys. We have also suggested above that the Guidelines should include specified concrete allocation keys and weightings for all business models now commonly being used. In order to provide guidance for the new business models that will be
developed in the future, the Guidelines should articulate the principles on which concrete allocation keys and weightings should be determined.

2. We believe that it is very appropriate to vary the allocation keys and their relative weighting in gain and loss situations where called for in any particular business model. Hence, for any such business model (e.g. the one used by the global trading organization in Scenario 9) that has a common and logical special treatment for losses, the guidance we have suggested for the use of concrete allocation keys and their relative weighting should be appropriate.

V. Scenario 9, Question 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?*

We have no specific comments on this. However, if there are one or more common business models in use where this makes sense, we have no objections to such specific guidance being included in the Guidelines. As noted earlier, we have suggested that the Guidelines be expanded to include stated concrete allocation keys and weightings for all business models now commonly being. Such a treatment where there are combined losses could be included in this guidance.

W. Question 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?

1. Certainly, these practical difficulties will remain. But additions can be made to the Guidelines that will lessen these difficulties. We will briefly discuss each of the issues raised in Question 31.

2. The first issue is:

   *[A]ssociated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates.*

We do not doubt that this may sometimes be true in reality. To minimize this in the future, we strongly suggest that the Guidelines reiterate in appropriate places (such as within the detailed profit split method guidance) what was recently included regarding penalties in paragraph 42 of the Action 13: 2014 Deliverable *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*. This paragraph reads, in part:

   ‘Moreover, an assertion by a local entity that other group members are responsible for transfer pricing compliance is not a sufficient reason for that entity to fail to provide required documentation, nor should such an assertion prevent the imposition of documentation-related penalties for failure to comply with documentation rules where the necessary information is not forthcoming.’

3. Associated companies are associated because there is a high percentage of common ownership. The common owner or owners have control and must take these obligations
seriously. If not, then local tax authorities should have the authority to make adjustments and impose penalties with the burden of proof regarding changes to be on the shoulders of the applicable taxpayers. This should cause the owners to respond to their obligations more readily.

4. The second issue is:

   \[\text{It may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies.}\]

In the case of MNCs, they are annually making necessary material adjustments from local accounting so that their consolidated accounts are reported for financial statement purposes on a consistent basis. Despite this, of course, there could be potential adjustments that might be material from a local country perspective but which are not material from a consolidated perspective so that no adjustments for such items are made.

5. Despite MNCs choosing not to make some or all of these adjustments for financial statement purposes, they still must go through a serious review process to look for potential adjustments and to document them. Even if they decide in the end that those adjustments are not material enough to make, they have records of these potential adjustments. With this in mind, MNC claims of difficulty in obtaining common basis combined revenue and costs should be ignored. We recommend that the Guidelines make perfectly clear that the burden of producing combined revenue and costs data is on the relevant associated enterprises and that penalties to enforce this are appropriate. MNCs have themselves chosen the form in which they operate and producing proper combined income or loss information on which the profit split method can be applied is on their shoulders.

6. In a longer time-frame it would be desirable, in order to further systematise and regularise the application of the profit split method, to develop harmonised tax accounting standards. In virtually all countries, tax authorities require significant adjustment to financial accounts to make them suitable for tax purposes. This includes significant adjustments to key concepts such as the recognition of income. Hence, although MNCs already produce consolidated financial accounts on a group-wide basis, these can only provide an approximate basis for defining aggregate profits for tax purposes. We recognise that there are not sufficient resources or time in the BEPS project to do significant work on this issue. However, considerable work has been done, and is continuing, in the framework of the EU’s project for a Common Consolidated Tax Base, to establish a harmonised tax base definition. We recommend that the current work on profit split, which has rightly focused on other aspects such as appropriate allocation keys, should be followed up by work on tax base definition, which could build on the CCCTB proposals.

7. The third issue is:

   \[\text{When the transactional profit split method is applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the}\]
transactions and to allocate costs between the transactions and the associated enterprises' other activities.

The principal issue is one of consistency in calculation. We believe it fair to say that MNCs must maintain accounting systems that allow them to easily identify direct expenses applicable to their various categories of income. Hence, there should be no difficulty identifying such expenses.

8. It is reasonable that different group members might apply differing approaches and bases for allocating indirect expenses that are not directly allocable to any category of income. If this is the case, then it would be fine for the combined profit or loss to be calculated on a consistent basis only recognizing revenue and direct expenses. We suggest that the Guidelines provide guidance for such flexibility in the absence of any unusual situation where one or more group members have material indirect expenses relative to other relevant members that would make combined profits or losses on this basis inappropriate.

X. Question 32:

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

No specific comments. We would just like to say that we appreciate greatly and strongly support the current focus on an expanded use of the profit split method. With greater use of the concrete allocation keys and set weighting for different business models that we suggest herein, we believe that the BEPS Project’s objectives and the use of the profit split method will be more achievable for all countries. In our view, such a simplified profit split method would be far easier to administer especially in developing countries than the other transfer pricing methods which require ad hoc evaluations of facts and circumstances, and a pointless search for comparables which do not exist. It should also establish a more stable and predictable framework for business, and ensure that taxes are paid ‘where economic activities take place and value is created’.