The **BEPS**

Monitoring

Group

Comments on the Public Discussion Draft on

REVISED GUIDANCE ON PROFIT SPLITS

These comments have been prepared by the BEPS Monitoring Group (BMG). The BMG is a network 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. These comments have 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. They have been drafted by Jeffery Kadet, with contributions and comments from Tommaso Faccio and Sol Picciotto.

GENERAL REMARKS AND SUMMARY

We applaud the continued interest of the OECD and Working Party 6 in its work to make the profit-split approach a more viable and important tool in intercompany pricing.

In this submission we propose the development and use of defined allocation keys and weights to apply the profit-split method to actual profits of common business models (see Appendix). In our comments to the specific questions we point out that the examples in the discussion draft assume, without explicitly saying it, that the various business units of a multinational enterprise (MNE) are normally independently managed, albeit with common ownership and some top-level management over policy and direction. In contrast to this assumption, we believe that most MNEs operate as centrally-managed unitary businesses performing core functions and using intangible property in multiple countries. We therefore suggest that it is appropriate to apply the profit-split method to actual profits in these cases. Nevertheless, if Working Party 6 takes a different view, due to their belief that some level of integrated risk sharing is required for application to actual profits, the profit-split method with defined allocation keys and weights could be applied to anticipated gross profits or other measure appropriate for the specific business model. Whether our recommended approach or this alternative is chosen and inserted into the Guidelines, it would greatly simplify things for taxpayers and tax authorities alike.

SPECIFIC COMMENTS

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

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

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

Response:

We believe that the section C.1. draft explains very well the background and rationale for the actual versus projected profit approaches. The discussion is both clear and useful.

As is described later in our comments, we consider that many MNEs use common business models that generally involve central management coordinating key functions and the development and exploitation of intangibles, which actually take place through the MNE's various entities in multiple countries. In these cases, if Working Party 6 were to provide within the Guidelines concrete allocation keys and weightings for these common business models, then the profit-split method could provide a true simplification for both taxpayers and tax authorities. The Working Party could also articulate the principles on which concrete allocation keys and weightings should be determined so that appropriate allocation keys and weightings can be determined for new business models as they are developed and used in the future.

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

Response:

We agree with the logic of focusing on the link between integration of business activities (and thus the sharing of risks) and the appropriate application of a transactional profit split of actual profits.

Although we agree with the concept, we believe that many MNE situations do not involve independent businesses, though commonly owned, but rather a set of centrally directed and managed integrated operations that have been attributed to various legal entities not due to compelling operational reasons, but often primarily for tax-motivated planning purposes. It would be particularly helpful in discouraging MNE BEPS planning and in providing useful guidance to tax authorities to include examples in this discussion of situations where a centrally managed business has organised itself through a number of separate legal entities, each of which may be performing a defined function, but where each is a part of a unitary business. In such cases, application of the profit-split approach on an actual profit basis would be an acceptable approach, or indeed the most appropriate method.

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

Response:

We understand and agree with the principle that a profit-split of actual profits requires a high level of integration of activities. The examples in the discussion draft are good in illustrating this. However, these examples assume, without explicitly saying it, that the various business units are independently managed, albeit with common ownership and some top-level management policy and direction.

MNEs generally do not operate in this manner, so that this assumption for them is simply not valid. Rather, they operate as a set of centrally directed and managed integrated operations, with core functions being conducted and intangibles being used and exploited in multiple countries. The organisation of this operation into separate legal entities is often not due to compelling operational reasons, but rather for tax-motivated planning purposes.

For example, many companies have value chains spanning multiple locations and countries, including many core functions such as R&D, raw material and product sourcing, production, marketing and sales, customer support, etc. Each entity for its portion of the whole conducts itself based on centrally coordinated decisions regarding business opportunities and risks, and deploys applicable portions of the MNE's intangibles. This is not just common ownership and some top-level management over policy and direction. Rather, it is central management and decision-making coordinating how the business is to be conducted (e.g. the specific products and services, production processes, sources of raw materials, production quantities, marketing approaches, customer support, etc.). For such MNEs that operate what is effectively a unitary business, the profit-split method as applied to actual profits is not only appropriate, it is normally the most appropriate method.

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

Response:

From page 7: "14. [2.114] A weakness of the transactional profit split method relates to difficulties in its application. On first review, the transactional profit split method may appear readily accessible to both taxpayers and tax administrations because it tends to rely less on information about independent enterprises. However, associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates. In addition, it may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions, which would require identifying from the financial records of the parties to the transaction the revenues, costs, and profits arising from the transaction and separating them from the parties' other activities."

In today's world of centrally managed MNEs with highly integrated and computerized accounting and control systems, true difficulty in accessing information from foreign affiliates or in obtaining combined revenue and costs will be rare. Most instances of claimed difficulty will be taxpayer intransigence and should generally be given short shrift by tax authorities. In addition, one of the major achievements of the BEPS project is establishing common templates for Country-by-Country Reporting and Transfer Pricing Documentation. Implementation of these will be a great stride forward in remedying problems of access by tax authorities to adequate information about the MNE group as a whole and the relationships of its various parts. This stated "weakness" should either be eliminated from the Guidelines or its rarity should be noted with the burden of proof of such difficulties clearly on the shoulders of the MNE involved.

Paragraph 15 also comments on potential difficulties of calculating combined profits from the particular transaction or transactions concerned, finally noting: "The required financial information may be difficult to access, the required interpretation of the data can be difficult for the taxpayer to perform, the analysis of the data may require reasonable assumptions to be made based on knowledge of the business, and in most cases a tax administration will not be able to perform the analysis or verify the information without full co-operation from the taxpayer."

Judgment and careful work is required in any transfer pricing analysis. The calculation of combined profit is no different. In any case, again, with today's centrally managed MNEs with highly integrated and computerized accounting and control systems, the issue should normally be the application of sound judgment and not the difficulty of obtaining the information or making the analysis. We believe that this current language only encourages taxpayer intransigence and should be eliminated or appropriately changed so as to place the burden of proof of any difficulties clearly on the shoulders of the MNE involved.

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

Response:

A particularly important strength is that the profit-split method has the potential, especially with standardized allocation keys for common business models, of being a very easily implemented method for taxpayers and tax authorities, especially those tax authorities from developing countries. See further discussion later herein regarding standardized allocation keys and weightings for common business models.

A further point to make is that many of today's business models rely on proprietary technology and specialized knowledge of the MNE's products and services that make production and distribution activities qualitatively different from traditional businesses that manufactured a widget and then sold it through various distribution channels. In those traditional businesses, contract manufacturing and limited-risk distribution arrangements were practical possibilities due to the nature of the products. In today's high-tech environment, though, both production and distribution functions require personnel to have specialized knowledge of the MNE's products and services that go far beyond what was needed for the traditional production and sale of widgets. Hence, there will typically be no unrelated comparables for such specialized and proprietary activities. With this being the case, application of the profit-split method will often be the most appropriate method.

> *6. The discussion draft introduces the sharing of economically significant risks as a factor which may indicate that a transactional profit split of actual profits may be the most appropriate method.*
>
> > *1. Do commentators have any suggestions for clarifying the notion of risk sharing in this context?*
> >
> > *2. Do commentators find the draft helps to clarify the circumstances where the transactional profit split method is the most appropriate method? Please provide explanations and/or examples supporting your views.*

Response:

A number of today's business models rely on proprietary technology and specialized knowledge of the MNE's products and services that create an integrated worldwide business. This is very different from the traditional manufacture of a widget where the various production and distribution functions were more normal and did not vary much with the substitution of some other type of widget.

Most if not all MNEs now coordinate businesses through internet platforms. For example, a submission from BASF to an earlier BEPS consultation explained its system as follows:

> "Quality management and controls relating to the risks, functions and assets employed are to a wide extent part of corporate procedures which are generally valid group-wide and are fully integrated in the business processes. The research and development process is managed by electronic systems which track the allocation of projects to specific research centres, the adherence to budgets, the sign-off processes and the registration of IP rights. "Control" is therefore to a large extent built in to group-wide guidelines and operating systems, and can therefore be performed anywhere as such systems enable a decentralised, collaborative organisation."[1]

These MNEs may sell both hard and soft products and/or provide various services (e.g. sale of third party products, advertising, cloud services, taxi and limousine services, finding accommodations, etc.). Many of these MNEs must maintain in many countries where significant customers are found staff dealing with marketing and sales, operations, and local support. Because of the proprietary nature of the products and services and the highly trained local personnel whose knowledge of the MNE's products and services is a core part of the customer experience, a transactional profit-split method of actual profits is often likely to be the most appropriate method.

We recommend that section C.3. on Most Appropriate Method be expanded to include discussion of such business models.

Also, whilst we agree that a lack of comparables alone is insufficient to warrant the use of a transactional profit split under the arm's length principle, where significant assumptions are used in the adjustments and interpretation of the inexact comparables, we consider that the transactional profit split should be used as corroborative test to support the arm's length nature of the transaction. Where the outcomes of the transactional profit split and the adjusted inexact comparables are significantly different, the difference should be analysed in arriving at the arm's length outcome.

7. The discussion draft notes that a transactional profit split of anticipated profits can be used in conjunction with certain valuation techniques. Examples showing the application of a transactional profit split of anticipated profits are sought.

Response:

Where the assumption inherent in the various discussion draft examples exists (i.e., that an MNE's business units are independently managed, albeit with common ownership and some top-level management over policy and direction), then we agree that the profit-split method as applied to actual profits should be limited to those situations where a sufficient level of integration or risk sharing exists. However, this assumption inherent in the discussion draft is simply not true for most MNEs. As such, this focus on a sufficient level of integration or risk sharing is no longer appropriate for these MNEs.

Accordingly, we recommend that the Guidelines distinguish these MNEs and provide that it is not necessary to demonstrate this integration/risk sharing for an application of the profit-split method to actual profits, as it can be assumed in such cases.

In addition, we recommend that the Guidelines include concrete allocation keys and weightings for common business models (see Appendix), a number of which would include these types of MNEs. If Working Party 6 believes that some level of integration and/or risk sharing is still required to be demonstrated even for these MNEs before there can be application of the profit-split method to actual profits, then the profit-split method with

[1] BASF Submission to the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, September 2013.

defined allocation keys and weights could be applied to anticipated gross profits or another measure appropriate for the specific business model. Whether our primary recommended approach or this alternative is chosen and inserted into the Guidelines, it would greatly simplify things for taxpayers and tax authorities alike.

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

Response:

We agree that this distinction is appropriate for many traditional businesses and that new paragraph 21 provides excellent guidance. However, as explained in our response to question 6, we believe that many more recent business models involve highly integrated operations that have characteristics different from the traditional vertical and horizontal integration that paragraph 21 discusses. We suggest that this section C.3.1. be expanded to cover this integration in such new business models where the transactional profit-split method will be the most appropriate method.

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

Response:

See response to question 8.

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

Response:

The example in this paragraph 22 assumes, without explicitly stating it, that the developer and manufacturer of one key component together with the developer and manufacturer of the rest of the products are independently managed, albeit with common ownership and some top-level management over policy and direction. (This assumption also seems to be made in other examples throughout the discussion draft.) This, however, is not how most MNEs operate. Rather, they operate as a set of centrally directed and managed integrated operations with core functions being conducted and intangibles being used and exploited in multiple countries.

We recommend that this Section 3.2.2 be expanded to explain that these other MNE business models will also be examples of the contribution of unique and valuable contributions by all parties.

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

Response:

To continue our response to question 10, we believe that many MNEs, especially those that have value chain structures, operate with core functions being conducted and intangibles being used and exploited in multiple countries, although centrally directed and controlled. Often in such cases, intercompany contract manufacturing arrangements and limited-risk service arrangements will understate the value added by the activities conducted and intangibles used within the countries where these entities are located. The highly trained personnel who conduct their work using proprietary business models, trade names, technology, etc. are seriously undervalued under these stripped risk models. The same will often be true of cases involving entrepreneur MNE group members that contract with customers, but also work with other operating group members for not only R&D services and staff support functions (e.g. finance, legal, accounting, tax, etc.), but also for basic business operational needs (product procurement, management of contract manufacturing, inventory control, etc.), without which the entrepreneurial member could not conduct business.

We recommend that the Guidelines make clear that the profit-split method may be the most appropriate method for business models exhibiting these sorts of arrangements.

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

Response:

We agree with this point that group synergies alone will not support application of the profit-split method. Having said that, though, we do believe that some newer business models create significant group synergies through their centrally managed structures that involve proprietary products, services, and technology. These other factors will often mean that the profit-split method should be the most appropriate method.

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

Response:

We agree that this section properly describes a value chain analysis as a tool in helping to delineate the actual transaction and in identifying features relevant in determining whether the transactional profit-split method is appropriate. Having said this, though, we believe that the serious difficulties for both taxpayers and resource-constrained tax authorities of establishing arm's length prices under one of the traditional transaction methods, and the typical inapplicability in many value chains of the transactional net margin method, mean that the profit-split method should be clearly recognised within the Guidelines as a practical and frequently applicable approach. Especially if our simplifying approach to establishing concrete allocation keys with specified weightings for common business models were accepted and put into effect, the profit-split method could become a truly viable and often used method that would be appreciated by MNEs and tax authorities alike. We stated the following in our 6 February 2015 "Comments on BEPS Action 10: The Use of Profit Splits in the Context of Global Value Chains":

> 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'.

In this 2015 submission, we recognized that there must be a trade-off between the fine-tuning of the transfer pricing result in each specific case with simplicity of application. 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.

The expression "value chain" is often a nice way of saying that an MNE has legally fragmented its activities across various countries, typically with tax minimization and profit-shifting being the primary motivator for the specific legal and contractual structure chosen. With this in mind, Part I, Paragraph 85 of the "BEPS Action 8, 9 and 10: Discussion Draft on Revisions to Chapter 1", stated:

> 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.

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 and application of one or more of the traditional transaction methods will, due to its inherently subjective nature, only result in a very wide range of possible profit allocations. Transfer pricing practitioners are very aware that this is often the case. The use of simple-to-apply concrete allocation keys and weightings 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.

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

Response:

We do absolutely see a greater purpose and role for the profit-split method. Following the submission on 6 February 2015 of our "Comments on BEPS Action 10: The Use of Profit Splits in the Context of Global Value Chains", one of the authors of those comments went into more detail with specific examples in the article that is attached as an Appendix to this submission. This article, "Expansion of the Profit-Split Method: The Wave of the Future", dated 30 March 2015, was published in Tax Notes International (77 TI 1183). It is also available at: http://ssrn.com/abstract=2593548

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

Response:

Paragraph 28 appropriately states, in part:

> Application of the method will depend on the accurate delineation of the actual transaction, including the assumption of economically significant risks, the nature of the contributions of the parties, how those contributions drive profit outcomes, and the identification of the profits to be split, but the overriding objective should be to approximate as closely as possible the split of profits that would have been realised had the parties been independent enterprises. If the economically significant risks have not been specified, if the nature of the contributions of the parties has not been accurately determined, if an evaluation of how those contribution drive profit outcomes has not been made, if the profits to be split have not been reliably identified, or if the basis for splitting the profits has not been reliably determined (as discussed below), then it is doubtful that the overriding objective can be achieved and the application of the transactional profit split method would be unreliable.

This is no doubt true. What is also true, though, is that the analysis described in the second sentence is even more essential for any of the traditional transaction methods and the transactional net margin method.

We of course believe as described herein and in the Appendix that a concrete profit-split method approach should be mandated in the Guidelines for all common business models and that it should be the burden of the MNE to establish that another method is more appropriate. Recognizing that Working Party No. 6 might not choose to go this far, we suggest as a compromise of sorts that the Working Party identify common business models used by MNEs and include in the Guidelines for these models concrete allocation keys and weightings. Then, in any case where one or more tax authorities believe that a taxpayer has not sufficiently presented the above-described analysis that supports an accurate delineation of the transaction and application of the pricing used by the taxpayer, the tax authority could apply the profit-split method using the concrete keys and weightings.

Not including concrete allocation keys and weightings will only encourage MNE to set the allocation keys and weightings to their advantage. To limit arbitrariness, we consider that the Working Party should set specified allocation keys and weightings for a number of common business models, with the burden of proof on the MNE to prove that the use of different allocation keys or weightings would be more appropriate to its business model.

Section C.4.2 discusses issues regarding the determination of profits to be split. We of course agree that various judgment and computational issues will have to be faced in any case where less than the total activities of each of the parties are the subject of the profit split. However, this Section C.4.2 over-exaggerates the difficulties. In today’s reality of centrally managed and integrated accounting systems that take into account financial accounting, management accounting (including cost accounting), and statutory/tax accounting, concerns expressed by MNEs about the difficulty of obtaining information from affiliates should be disregarded. MNEs and the applicable tax authorities can discuss and agree on the various judgment issues that will affect the determination of profits to be split (including those described in Section C.4.3). The tenor of Section C.4.2 should be rewritten to change this stress on the difficulties and to direct taxpayers and tax authorities to work together to seek appropriate results.

16. The discussion of profit splitting factors sets a requirement that the factors must be capable of being measured in a reliable and verifiable manner. Do commentators believe that useful ways of splitting profits have been excluded? If so, please describe these factors and explain how they meet the requirement of reliable and verifiable measurement.

Response:

See the simplified concrete factor approach described in the Appendix.

17. What further guidance would be useful in this section relating to identifying and measuring profit splitting factors? Please illustrate your response with examples.

Response:

Paragraph 50 in Section C.4.5.1 comments on intangibles. Paragraph 49 notes that asset-based or capital-based factors can include intangibles.

Intangibles are terribly hard to value; the potential for disputes between taxpayers and tax authorities, and between tax authorities, is high. As such, including the value of intangibles as a possible allocation factor in a centrally managed MNE is simply making the process difficult to implement and a lightning rod for disputes. Also, in practice development, enhancement and exploitation of a firm's know-how takes place as both a continuous and dispersed process, with many contributions from different parts of the business. Attributing value to a specific legal right is just a reification of this process, and facilitates BEPS behaviour.

As an example, 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 (i.e. not including the value of intangibles) 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.

Say that the transferee is an associated enterprise that truly carries on its own activities through its own competent and capable personnel so that the transferor is only minimally involved or even no longer involved (and therefore would not have activities picked up by the applicable concrete allocation keys). In this situation, paragraphs 52 and 53 note the ability to use accumulated expenditures in appropriate cases. As a last resort, so to speak, the country of the transferor is also protected by new Section D.4. in Chapter VI in the event that the original transfer of the intangibles was undervalued.

18. More generally, examples are requested of scenarios where a transactional profit split of actual profits or of anticipated profits are applied, together with a brief explanation as to why the method and the approach to applying the method, is considered to be the most appropriate in the circumstances of the case.

Response:

See the Appendix to this submission.

APPENDIX

Expansion of the Profit Shift Method: The Wave of the Future

Jeffery M. Kadet

Tax Notes International, 77TI1183, 30 March 2015[2]

December 2014 saw the OECD issuing a number of BEPS (Base Erosion and Profit Shifting) discussion drafts, one of which was titled: *BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains* ("DD10"). Issued on 16 December, DD10 is a response to both BEPS concerns about "value chain" planning articulated in Action 10 of the 2013 BEPS *Action Plan* and transfer pricing issues raised in *Addressing the Tax Challenges of the Digital Economy*, issued on 16 September 2014 in connection with Action 1 of the BEPS *Action Plan*. As a discussion draft, DD10 of course is not a final document and only invites responses about how current transfer pricing guidance might be amended. The guiding principle of DD10 is how the profit split method can achieve the G20 mandate, which states: "Profits should be taxed where economic activities deriving the profits are performed and where value is created."

This article first provides background on why expanded use of the profit split method is needed. It next provides some description of the method. Finally, it suggests a simplified approach to applying the method. As is covered below, resource-constrained tax authorities in most countries are normally unable to administer or intelligently analyze and contest transfer pricing results presented by multinational groups. The overriding need at the present juncture is for rules which are easily administered and that provide results for taxpayers and countries that all regard as fair.

BACKGROUND

Despite all the continuing rhetoric about how arm's length pricing and the separate entity principle are sacrosanct, there are compelling reasons why the OECD BEPS project has focused on the possible expanded use of the profit split method, a method which clearly flies in the face of these sacrosanct icons. In short (and definitely with pun intended), a principal reason is the extreme shortcomings of the separate entity principle and arm's length pricing of transactions as applied to the big picture effort to match transfer pricing outcomes with value creation. Recognizing this, DD10 in paragraph 3 comments, in a very understated manner:

> The integrated nature of many MNE groups and the ways in which they interact with each other means that finding comparables (or comparables for which reasonably reliable adjustments can be made) can give rise to practical difficulties. In some such cases, transactional profit split methods may provide an appropriate solution.

To provide more background, a combination of factors has strongly motivated the highly successful tax structures that have so significantly lowered the effective tax rates of multinational corporations ("MNCs") and eroded the tax bases of so many countries. The existence of these factors means that some of the transfers pricing methods are a part of the problem; they are not a part of the solution. These factors include:

[2] This MS Word version of the article as published in Tax Notes International (TNI) does not include stylistic changes made by the TNI editors.

- The Separate Entity Principle—Internationally, pretty much all countries accept each legal entity as being a separate legal person for tax purposes, independent of its owner(s) and related entities, including those who control it and direct its activities. It doesn't matter whether the country of formation is a major country, an island tax haven, or someplace in between.

- Fragmentation—Similar to an artist who starts with a blank canvas, an MNC's in-house tax personnel and its outside advisors start with a blank sheet of paper. On that sheet of paper, they can create whatever legal entities they choose to create and they can define exactly what functions and activities each entity will conduct, what assets each will own, and what risks each will bear. In so doing, they minimize profits in higher tax countries and maximize profits in low or zero-tax countries. The *Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures)* ("DD8-10"), issued 19 December 2014, recognizes this by saying in paragraph 21:

  > A particular feature relevant in a functional analysis is that an MNE group has the capability to fragment even highly integrated functions across several group companies to achieve efficiencies and specialization, secure in the knowledge that the fragmented activities are under common control for the long term and are coordinated by group management functions. …

  DD8-10 goes on to say in paragraph 85:

  > 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.

  With the grave respect given to the separate entity principle by tax authorities and courts worldwide, all this careful construction of an MNC's organization chart is treated as real and is the basis for taxation in each relevant country.

- Respect of Related Party Contracts—As a corollary to fragmentation, tax authorities and courts have for the most part fully respected related-party contracts, despite their having been carefully drafted to a large extent to achieve profit shifting goals.

- The Arms' Length Standard ("ALS")—The ALS, which has been for the past few decades the guiding principle in transfer pricing, has required that the pricing between related parties reflect the pricing that would occur between unrelated parties considering the functions, assets, and risks relevant to each group member. By its nature, and despite all the detailed discussion in the 2010 *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ("Guidelines"), transfer pricing analyses under the ASL approach normally only provide highly subjective ranges of acceptable pricing. So, in addition to using fragmentation to shift profits out of higher taxed countries, MNCs will also seek to set pricing within the subjectively-determined ranges that further skew profits into low or zero-tax countries.

- Inability to Effectively Audit MNC Transfer Pricing—The Guidelines require a serious analysis of matters that include (i) the various legal effects of forms of intangible property concerned, (ii) the various commercial and legal effects of any contractual terms concerning those intangibles, and (iii) 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 of most countries in this world, if not all countries, have neither the sophisticated specialists nor the budgetary resources to truly conduct the work necessary to critically review the integrated and complex structures of most MNCs. This is particularly true for the many developing countries in this world. 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 on-going transfer pricing review of Microsoft at a cost in the millions of dollars.

- What the Capital Markets Value—Capital markets reward successful reductions in an MNC's effective tax rate through higher share prices.
- Personal Motivation and Greed—MNC managements are highly motivated to minimize effective tax rates due to equity-based compensation based wholly or partly on share price.

THE PROFIT SPLIT METHOD

Expanded use of the profit split method would counteract and seriously discourage the profit shifting that has been so prevalent and successful, and which is so dependent on the separate entity principle. What is the profit split method and why would it discourage BEPS behaviour?

Paragraph 2.108 of the Guidelines gives a concise statement of what the profit split method is. It states:

> The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate…) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions. The transactional profit split method first identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged (the "combined profits"). … It then splits those combined profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. …

Additional guidance in the existing Guidelines (paragraphs 2.132*ff*) makes clear that the criteria or allocation keys on which the combined profits are split should be "…independent of transfer pricing policy formulation…". Hence, these criteria and allocation keys "…should be based on objective data (e.g. sales to independent parties), not on data relating to the remuneration of controlled transactions (e.g. sales to associated enterprises)…". Paragraph 2.135 makes this objective basis clear by stating:

> In practice, allocation keys based on assets/capital (operating assets, fixed assets, intangible assets, capital employed) or costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) are often used. Other allocation keys based for instance on incremental sales, headcounts (number of individuals involved in the key functions that generate value to the transaction), time spent by a certain group of employees if there is a strong correlation between the time

spent and the creation of the combined profits, number of servers, data storage, floor area of retail points, etc. may be appropriate depending on the facts and circumstances of the transactions.

Further discussion in the Guidelines provides various approaches to splitting the combined profits amongst the relevant group members. While these approaches need not be detailed here, the point to make is that the approaches set out and discussed required a facts and circumstances case-by-case analysis before they can be implemented.

A SIMPLIFIED APPROACH

The Guidelines require a facts and circumstances case-by-case analysis for determining the most appropriate transfer pricing method for any particular case. Once it is determined that the profit split method is the most appropriate method for a particular case, then again, a facts and circumstances case-by-case analysis is required to determine how the combined profits are to be split amongst the relevant group members.

The reader may recall the bullet point in the Background section above headed: "Inability to Effectively Audit MNC Transfer Pricing". Any time that transfer pricing rules require a facts and circumstances case-by-case analysis for a complicated MNC structure, the chances are very high that the relevant tax authorities will have neither the in-house expertise nor the budgetary resources to effectively analyze anything. As stated at the start of this article, there is an overriding need for transfer pricing rules that are easily administered and that provide results for taxpayers and countries that all regard as fair.

We believe the following approach answers the needs for simplicity, fairness and ease of administration. Further, given the investment of time of in-house personnel and the exorbitant costs of outside legal, tax, and economic consultants, it should as well be attractive to any MNC that chooses to focus more on its business and less on aggressive BEPS motivated tax structures.

The **first step** of this simplified approach is that the profit split approach will be deemed to be the most appropriate transfer pricing method for various categories of MNC businesses. Such categories would include:

- Any MNC operating a value chain involving multiple group entities conducting operations in multiple countries, and
- Any MNC involved in the digital economy that maintains supporting group members in various countries.

To provide concrete guidance, we suggest that the Guidelines include both a listing of these categories as they exist today and the principles on which such categories are determined so that as MNCs evolve new forms of business conduct and organization, these new forms can be added to this listing.

This presumption that the profit split method is the most appropriate method to apply would be rebuttable to the extent that an MNC establishes to the satisfaction of all relevant tax authorities the clearly superior applicability of one of the other methods.

The **second step** of this simplified approach is the allocation of combined profits amongst the relevant group members.

Specifically, we suggest that the Guidelines include clear guidance stating concrete objective allocation keys and relative 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 objective allocation keys and weightings should be determined. There would be no facts and circumstances case-by-case analysis.

Such a simple and clear approach would be easy 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: "Profits should be taxed where economic activities deriving the profits are performed and where value is created."

An obvious question is whether such a simplified allocation approach would achieve reasonable results that governments and taxpayers can be comfortable with. We strongly believe the answer to this is "yes".

It is clear that any allocation of profits of a complicated corporate structure that results from the current approach based on a detailed facts and circumstances case-by-case analysis 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 objective 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.

With tax authorities no longer hobbled by a need for detailed analyses, which they seldom have the resources or expertise to achieve, the adoption of such a simplified approach will greatly enhance their ability to actually administer and collect taxes. It will also reduce conflicts both between tax authorities and taxpayers and among tax authorities. In addition, the application of such rules should result in a reduction in complex BEPS motivated structures since all combined profits will be spread amongst the group members that actually conduct activities with little or none left within low-taxed group members that do not conduct economic activity and thereby contribute little if any to value creation. In sum, a simplified and standardized approach for each common business model will provide significant benefits as well as give results that are fair to MNCs and all relevant governments.

To provide an idea of how this simplified approach would work, the box beginning on page __ includes examples of allocation keys and weightings for two business models.

EXAMPLES OF ALLOCATION KEYS AND WEIGHTINGS FOR TWO COMMON BUSINESS MODELS

Example 1

This example is taken from DD10's Scenario 2.

"The RCo Group provides a number of internet services (e.g. search engines, email services, advertising, etc.) to customers worldwide. On one side of the business model, advertising services provided through an online platform are charged to clients for a fee that is generally based on the number of users who click on each advertisement. On the other side, online services are offered free of charge to users, whose use of the services provides the RCo Group with a substantial amount of data, including location-based data, data based on online behaviour, and data based on users' personal information. Over the course of years of data collection, refinement, processing, and analysis, the RCo Group has developed a sophisticated technology that enables it to offer to its clients the ability to target specific advertisements to certain users. The more extensive the online services, and the greater the extent of the associated data, the more valuable and attractive the other side of the business model becomes for clients wishing to advertise.

"The technology used in providing the internet advertising services, along with the various algorithms used to collect and process data in order to target potential customers, were originally developed and funded by Company R, the parent company of the RCo Group.

"For larger markets and in order to deal with key clients for advertising services, the group has established a number of local subsidiaries. These local subsidiaries perform two functions: they promote the use of online services provided free of charge to users, translate them into the local language, tailor them to the local market and culture, ensure that the services provided respect local regulatory requirements, and provide technical consulting to users. In addition, they generate demand for and adapt advertising services. In doing so, they also regularly interact with staff members in Company R in charge of developing the technology and make suggestions, notably on the algorithms and technologies used and their adaptation to local market features, and on new features that would be attractive to users in their market."

Simplified Allocation Keys

For the combined profits of this common business model, two equally weighted allocation keys are defined 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 seeking advertising services. 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.)

Example 2

This example is taken from DD10's Scenario 3.

"Company P, located in country P, is a manufacturer of high technology industrial equipment. Company S, a subsidiary of Company P, markets and distributes the equipment to unrelated customers in country S. Both companies are members of Group X. Company P conducts extensive R&D activities to develop and improve the technological features of its equipment. It funds and has legal ownership of all the technology intangibles it develops. Company P also owns the global trademark, and provides broad guidance to its subsidiaries around the world on its overall marketing strategy. There are several global competitors making equipment which is similar (in terms of functionality, performance, and reputation) to that made by Group X. These global competitors also operate in Country S, which is a large market for such equipment.

"Company S is responsible for sales of the equipment and undertakes marketing activities. Due to the nature of its business, this entails developing very close relationships with customers, including providing on-site services (often in remote locations), carrying an extensive stock of spare parts, and a highly proactive maintenance programme to detect likely problems before they arise. Company S also provides extensive advice to customers on equipment choice, makes modifications for particular local conditions, and for maximising performance efficiency and effectiveness. These activities provide a significant competitive advantage as customers place high value on the reliability and performance of the equipment. In this case, Company S is recognised as not merely a "routine" distributor, but its activities constitute a key source of competitive advantage for the Group."

<u>Simplified Allocation Keys</u>

For the combined profits of this common business model, three allocation keys with the indicated weighting are defined 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 further comment below concerning this sales allocation key.)

- Marketing and Distribution Expenses (weighted at 25%)

  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.)

There is no allocation key suggested for either property or inventory. Regarding property (including rented and leased property), the value and extent of facilities will most typically be reflected by the labor retained by each group member. This reliance on labor thus avoids all the difficult property valuation issues that inevitably arise if property is included as a direct allocation key. It also avoids the many varying methods, lives, and inconsistent treatments if depreciation (book or tax) were used. 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.

Note that neither risks nor intangibles (e.g. patents, manufacturing processes, trade names, knowledge of market channels, etc.) are directly included. Consistent with the guidance in the Guidelines regarding objective allocation keys and given the integrated nature of the associated companies' businesses and the fact that both parties are contributing their own unique and valuable intangibles, it is 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 (50%) for all expenses other than those for marketing and distribution will reflect them. Such expenses include on-going 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.

Finally, 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.