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Dear Sirs

Discussion draft on revised guidance on profit splits

BDO welcomes the opportunity to comment on the OECD's Discussion Draft on the Revised Guidance on Profit Splits issued on 4 July 2016 ('the Discussion Draft').

We support the OECD's efforts to develop rules to achieve effective guidance on the application of profit split methods. We believe this will be helpful to address situations where other methods do not appropriately reflect the integrated nature of the functions, assets and shared risks arising in business conducted by multinational enterprises. We appreciate the consideration the OECD has given from the previous round of consultation on this matter.

We recognize that the profit split is a useful tool that can increase transparency and result in transfer pricing which more closely aligns to commercial reality. It is also important to weigh the practicalities and administrative costs for businesses in implementing transactional profit split methods. We present below our comments and responses to questions posed in the Discussion Draft. To prevent repetition we have set these out thematically.

General comments

The increasingly interdependent nature of the value drivers and core business activities of multinational enterprises means that it becomes more likely that the transactional profit split will be determined to be the most appropriate method following an analysis of the functions, assets and risks of a transaction. As such, it will be important for the OECD's Transfer Pricing Guidelines ('the Guidelines') to clearly set out and support:

- The conditions which might lead to the application of the transactional profit split method;
- The reasonableness of the use of the transactional profit split method under these conditions; and
- Acceptable parameters for the effective application of the transactional profit split.

The Discussion Draft goes a long way to addressing these requirements. Of all the transfer pricing methods set out in the Guidelines, the transactional profit split method is likely to be the most challenging to fully delineate and potentially the most subjective to apply. As such we agree that the principles-based approach to its application currently adopted by the Discussion Draft is considered to be the most practical and robust means to present effective guidance.

In this context, areas which the OECD may wish to consider in further detail to increase the effectiveness of this guidance might include:

- The practical application of the transactional profit split of anticipated profits and whether a distinction between a split of anticipated profits and actual profits is helpful;
- The types of activities whose functions, assets and risks might fall within the transactional profit split parameters;
- Whether royalties are a helpful illustration in this context;
- The importance of residual profit split in practice and whether this may be emphasised more strongly;
- The level of guidance provided around the mechanism for splitting profit, including the most appropriate profit level at which a split may be made, for example gross profit compared to operating profit; and
- Numerical examples to illustrate the application of the profit split in various scenarios.

We discuss these areas in more detail below.

Transactional profit splits of anticipated profits

At a theoretical level, the distinction between the two profit split approaches is clear in that the transactional profit split of anticipated profits relies upon a calculation based wholly on information known at the time the policy is determined, while the transactional profit split of actual profits may upon implementation rely on hindsight in its calculation once the outcome of the transaction is known.

Where the relationship between the parties is ongoing, this distinction becomes less clear in practice. When considering how each approach might be implemented our observation is that the approaches appear more akin to two stages of a single method.

The Discussion Draft acknowledges that both approaches would set their profit split policy *ex ante* (paragraph 5 and paragraph 30, third bullet). As such, in either case the policy would be expected to be determined based on financial and other information available at that time. In their policy setting decisions, both approaches follow the model of the transactional profit split of anticipated profits.

The entities within the transactional profit split will determine the profit position at the end of a given period by reference to the actual results of the relevant business. This will be the case for a transactional profit split based on anticipated results or a split of actual results using profit splitting factors set out in C.4.5.

An ongoing transaction based on anticipated profits still requires reference to actual amounts. It is unlikely that third parties entering into a transaction based on anticipated profits would not review the outcomes periodically for reasonableness and, if necessary, seek to renegotiate or exit the arrangements. There will always be variances against forecasts which parties must accommodate, either in shortfall of revenue or profit or the perception that the other party benefits disproportionately. This is acknowledged under Chapter VI where it is recognised third parties may include price adjustment clauses or re-negotiate in circumstances where unforeseen subsequent developments arise in the pricing of intangibles.

It is also likely that many actual profit calculations continue to contain elements of the anticipated profits approach. Estimated accruals and some provisions will be recognised on an anticipated basis and could well reverse the following year. This further blurs the usefulness of the distinction.

It's common for joint venture arrangements to have clauses for variations to take account of actual outcomes being different to anticipated. Variations (both positive and negative) are generally borne by the joint venture partner contributing to that aspect of the project. So the concept of variation clauses similarly could be built into a profit split arrangement.

As such, in the calculation of the result and payments to be made both approaches rely on the actual amounts, or at the very least at arm's length would refer to these actual amounts periodically.

As every transactional profit split would be prepared based on anticipated profits and implemented based on actual results, the OECD may wish to consider whether it might be most appropriate to present the transactional profit split as a single approach with key stages:

- Policy setting, based on anticipated profits;
- Payment at the end of a given period – at a maximum an accounting period – based on actual results;
- Periodic consideration of the ongoing appropriateness of the policy.

It is difficult to identify examples of when a transactional profit split based wholly on anticipated profits (i.e. with no later reference to actual outturn) might arise. This would involve the parties to the transaction placing significant trust in the effectiveness of forecasts. If one party is likely to be less active in the transaction, for example if it contributes intellectual property, it could be dependent on the cost control of its counterparty over which it would have no influence. It would be helpful for the guidance to provide clarity on how variances would be treated; we presume that these would be ignored and the anticipated arrangements upheld in any payments to be made.

It may be that a transactional profit split of anticipated profit is intended primarily to set a price for a one-off transaction, for example the disposal or long term alienation of hard to value intangibles. This is alluded to by the Discussion Draft, for example in its consideration of valuation techniques in paragraph 5, although in a context which leaves open the potential for an ongoing relationship between the parties.

This may be valid in the case of a one-off transaction, as there may be no opportunity at arm's length for subsequent review or alternation of arrangements. If this is the OECD's expectation, then it would be helpful to state this explicitly. Doing so would add clarity to when it is most appropriate to rely on anticipated profits and so illustrate the distinction between transactional profit splits based on anticipated and actual profits. References to other potentially relevant guidelines, for example Chapter IX, might also be included. The OECD may also wish to consider whether this kind of pricing might be best addressed in its discussion of intangibles in Chapter VI.

If the pricing of one-off transactions is the intention of the OECD in this instance, consideration should be given to how the requirements of the Guidelines might interact with national legislation around the valuation of assets on disposal to ensure either that consistent principles are applied or that guidance is provided on how best to address any differences which may arise.

The OECD may also consider including guidelines to address circumstances in which a significant variation to anticipated profits arises.

Activities where a transactional profit split might be most expected

A determination that the transactional profit split is the most appropriate method is more subjective than for other transfer pricing methods. This is essentially as it can be a negative decision – the relevant activities of parties involved must not be routine or somehow identifiable as comparatively 'simpler' – rather than a positive selection. As such, this creates a higher risk of controversy as the same conclusion may not be reached by the taxpayer and all of the relevant taxing authorities with respect to the transaction. It will therefore be important for the Guidelines to be as clear as possible regarding when a profit split might be appropriate and how this decision might be expected to be supported.

The principles-based approach adopted by the Discussion Draft is helpful, and likely to be the only effective way to address what will be highly specific facts and circumstances. The provision of some examples would nonetheless be useful to manage the expectations of both taxpayers and taxing authorities and provide a starting point for policy setting or enquiries.

We support the OECD's focus on a robust analysis of the value chain and the functions, assets and risks undertaken as a basis for determining whether a transactional profit split is appropriate. In this, the markers set out by the OECD in the Discussion Draft provide signposts for the application of a profit split, but these may be expanded upon:

- The integration of business risks, and so the sharing of "the same economically significant risks associated with the business opportunity…", as an appropriate indicator for the application of a transactional profit split method effectively casts the transactional profit split more widely than purely a means of addressing the presence of intangibles on both sides to the transaction. This is consistent with business models we are seeing, for example, where management models are dispersed between entities and location.

- The integration of business activities, either sequential or parallel; although to this might be added the 'umbrella' of senior management activities discussed above.

- The balanced interdependence of activities across locations, for example in the parallel integration between entities which combine software and algorithms with customer and market data to form a new value driver which would not otherwise be able to exist.

- The sharing of business risks should not be conclusive to the decision as to when to apply a profit split arrangements. Franchise arrangements are a well-known practice and have risk sharing between the franchisor and franchisee. However, in this situation it is usually only one party (the franchisor that is making a unique and valuable contribution). A contribution can be made in a more passive or routine sense, for example by a licensor of intellectual property whose return is subject to the sales of the licensee with often little management of that risk beyond a floor to the royalty payment. The sharing of economically significant risks suggests a position where both upside and downside risks can be transmitted to all parties, and where the management of those risks is similarly shared. Again, this ties in with the presence of common management, which is itself an indicator that the business activities are highly integrated, and so can serve as a useful pointer towards the transactional profit split method.

Providing additional illustration adds practicality when making and supporting policy decisions. This might also address:

- Providing guidance on whether such sharing (or the assumption of closely related risks) must be explicit or if it could legitimately be interpreted by a tax authority as taking place implicitly; what kind of evidence would be required if explicit sharing of risks is required?

- Illustrating the limits of this kind of sharing, for example by developing the discussion in paragraph 15 around a global manufacturer (which might operate as a principal) and a regional distributor; with distinct roles, would these entities necessarily prompt a transactional profit split or could their activities and associated risks be sufficiently distinct that other methods may be more appropriate?

Where the Discussion Draft refers to economically significant risks or value chain analysis, reference might be made to those parts of the Guidelines which set out their meaning and intention in detail. This may prevent confusion between a full discussion and the brief summary currently incorporated within the transactional profit split paragraphs.

Use of royalties as an example

Regarding the example in paragraph 6 of a royalty as an illustration of a transactional profit split, the OECD may wish to consider whether this is the most appropriate concept to use in this instance. Royalties for the provision of intellectual property between third parties are typically set as a percentage of relevant sales, rather than a profit level which is affected by a cost base that the licensor cannot easily influence. Royalty rates are often set and supported based on CUP or CUT data, drawn either from internal or external sources, and rely primarily on that method rather than the transactional profit split. While there are examples in case law which consider how much profit a licensee might forgo in return for the benefits of the right to the asset, at best these provide a rule of thumb and so would not normally be expected to drive the transfer pricing analysis of a transaction.

Residual profit split

In practice it is very rare to see a transactional profit split applied to the whole profit of a transaction. Generally, there are at least some aspects for which an appropriate comparable may be found.

For example, in a software business an appropriate return may be identified for:

- The local sales team
- The contract R&D centre
- Back office support
- License fee for the software intellectual property

A balance of profit or loss will generally remain to be allocated after this point where the management of the business is not confined to one entity or location, for which a transactional profit split can be appropriate.

The Discussion Draft currently deals briefly with residual amounts. This might usefully be expanded to validate the use of the transactional profit split to appropriately attribute amounts that remain after other transactions have been identified and priced. Examples along the lines of that shown above might be provided.

Group synergies

We agree and acknowledge that in general, group synergies should be shared based on contributions to creation of the synergy and it is not necessary to split total profits. However, it is noted that in certain situations, the concerted group actions are the driving factor for deriving a benefit. For example, cash pooling arrangements are arrangements that only exist within groups, and the benefit gained by setting up a cash pool arrangement is the result of the concerted group action and group synergies. A transactional (residual) profit split approach may often be the best way to allocate this benefit taking the contributions of various group members into account. It may be useful to identify examples where splitting a system profit is more appropriate.

Mechanisms for splitting profit

We agree that a value chain analysis should be the starting point to both determine whether a transactional profit split is appropriate and the factors influencing how that profit is divided.

Clarity would be helpful regarding how an allocation might best be determined, for example based on:

- Functional analysis of the importance of different activities, for example if the management of intellectual property is split across locations the relevant share of profit attributable to that asset might itself be divided based on the relative importance of the DEMPE functions and where each is performed;
- A weighting based on relative importance to the business of key management roles, based again on functional analysis and RACI-style considerations;
- A similar weighting but using salaries (and bonuses) or equivalent staff costs as a proxy for value to the business.

A profit split methodology is likely to be more subjective than using a TNMM methodology which could create more disputes between the taxpayer and tax authorities. Clarity would be helpful on how this subjectivity could be reduced and consensus reached between both parties.

The level of profit to be split should also be a focus. For example how might a business distinguish between less- and more-integrated transactions? Some transactions might best split profit at the gross margin level (such as where there is discretionary marketing spend by each party that should fall below the line) and others where the level of common cost (or cost control) is greater where the split should be made at the net margin level.

The attention paid by the Discussion Draft in paragraph 40 to the selection of profit measure is welcome. This is important as while parties may sign up to share profits from a venture they will be reluctant for their reward to be subject to factors beyond their control, for example if one party to the transaction overspends through lax cost control then the other party would be penalised. There is the risk of moral hazard where the downside risk of overspending is partially offset for one party by its impact on the profit share of another.

Paragraph 41 currently illustrates this helpfully. It could go further to show that the point at which profits are split need not be limited to the gross and net profit levels, but could be at a point in between to be determined through the functional analysis. Costs under common oversight or control would be ‘above the line’, while costs which are not would fall ‘below the line’. To obtain more clarity in this respect, a numerical example would be helpful to illustrate the impact of picking either the gross or net profit levels as the point to split.

The OECD should consider expanding C.4.5 Profit splitting factors with some additional discussion on the merits of using a multi factor approach. Reliance on a single factor could give rise to an inappropriate allocation. For example in the event of losses arising applying a singular sales remuneration factor would not result in a commercially realistic outcome. Similarly using only sales volumes could give rise to an inequitable allocation where one location simply achieves higher sales as a result of charging a lower margin. Consideration should be given to a multi factor approach where situations can be envisaged that an individual factor will not always be a profit level indicator.

Concluding remarks – supporting the use of the transactional profit split

Broadly, the Discussion Draft provides helpful principles in support of the use and application of the transactional profit split. We have set out above how these may be expanded upon to add greater specificity in the expectations of both taxpayers and taxing authorities to align expectations.

As these expectations will come together over the transfer pricing documentation, the OECD might also wish to consider:

- Placing the comments around potential difficulties regarding measuring combined revenue and costs (paragraph 14) in the context of the new documentation guidance, including expectations of what might need to be provided in a financial analysis to show both the assumptions or expectations behind the policy and the calculation of the amounts involved;

- Making reference to what information tax authorities might reasonably expect to obtain to assess a transactional profit split method, and how this information might be requested and shared between tax authorities (paragraph 15). This will be helpful to manage the expectations of business regarding materials which should be produced and maintained, and prevent excessive demands for information from tax authorities (either directly or through sharing of information) in relation to the audit of prior periods.

We support the OECD's efforts to provide clarity on the application of the transactional profit split method.

We would like to thank the OECD again for this opportunity to comment and would be happy to expand on our responses and contribute to further stages of this discussion draft if required.

For clarification of any aspect of our responses presented above please contact:

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