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By email to: TransferPricing@oecd.org

February 6, 2015

Dear Mr Hickman,

Comments on the Organization for Economic Cooperation and Development ("OECD") discussion draft on the use of profit splits in the context of global value chains

Thank you for the opportunity to provide comments on the Public Discussion Draft on BEPS Action 10: *Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains* dated 16 December 2014.

PricewaterhouseCoopers LLP (PwC), on behalf of its international network of Member Firms, welcomes the consideration given by the OECD to provide additional commentary on the use of profit splits in the context of global value chains.

The Discussion Draft uses high-level scenarios to pose questions concerning the potential application of the transactional profit split method and considerations that should be analyzed in more detail before further guidance is provided. These scenarios and accompanying questions cover many of the most controversial areas of transfer pricing and pose many questions with differing, reasonable (and sometimes contradictory) opinions as to how to best approach them. Before answering those questions, however, we believe there must be acknowledgement of fundamental principles as the basis for the OECD's actions under BEPS. These fundamental concepts form the basis of sound transfer pricing policy and we believe that summarizing these principles within the Discussion Draft may be more useful than, or should be read in conjunction with, the point-by-point analysis of each open-ended question posed in the Discussion Draft.

- The arm's length standard is meant to provide broad parity of tax treatment for members of MNE groups and independent enterprises. By placing associated and independent enterprises on a more equal footing for tax purposes, the arm's length standard avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. PwC is concerned that consistency of the arm's length standard may be compromised if jurisdictions begin to weigh factors differently or lose sight of the overarching rationale for the arm's length standard - to place associated and independent enterprises on a tax parity. To a certain extent, the Discussion Draft seems to use concepts such as "integration" and "global value chains" to make it easier for tax administrations to apply the profit split method rather than to improve the guidance on choosing the most reliable transfer pricing method. The profit split method has previously been described as a "method of last resort"; the Discussion Draft contains elements that may in certain situations permit taxing authorities to, in effect, apply it as a default method. Agreement needs to be reached on the objective of this Discussion Draft, and we believe that it should be to improve the guidance on use of profit split methods, not simply to make use of profit splits more widespread. Placing too much emphasis on employing transactional profit split analyses may lead tax authorities to request or prefer profit split analyses in scenarios where such analyses do not assist in the goal of achieving tax parity between associated and independent enterprises.

- Functional analyses and a thorough understanding of the functions undertaken, assets owned and risks borne by all entities involved are critical in appropriately remunerating parties in a related party transaction. A thorough functional analysis resolves many of the issues identified in the Discussion Draft and we believe more emphasis on undertaking a thorough functional analysis may be more useful than emphasizing the use of corroborative profit split analyses as suggested in the Discussion Draft.

We would like to reiterate that the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("Transfer Pricing Guidelines") already address profit split analyses and the selection of the most appropriate method. Use of the profit split method is only appropriate where it is the most reliable method. That will be the case where there is a lack of reliable comparables to apply a one-sided method or, expressed alternatively, where both parties make "unique and valuable" (i.e., non-benchmarkable) contributions. It is not clear what, if any, further guidance offers in providing a basis for taxing authorities to apply the arm's length standard. We recommend that sufficient time for deliberation and consideration be utilized to properly consider any change to the guidance on use of profit split methods. Changes to the existing guidance should only be made where they improve the application and reliability of profit split methods and, as noted, in a coordinated and consistent manner with other BEPS Action Items.

- The Discussion Draft recommends the use of transactional profit split methods in a number of scenarios and as a corroborative method. We would like to point out that in many situations, one-sided analyses are appropriate and reliable. In scenarios where one-sided methods are appropriate and reliable based on a thorough functional analysis, we feel corroborative profit split methods may be a precursor to formulary apportionment, as they may improperly suggest higher returns to entities performing routine functions that can be reliably benchmarked. To this end, we would like to emphasize that a value chain analysis and a profit split are not, and should not be considered to be, synonymous.

- PwC recommends the revisions to the Discussion Draft focus on providing objective advice to MNEs. We believe the Discussion Draft includes many subjective terms that may be pejorative and therefore interpreted differently by rational decision makers.

- PwC recommends that the OECD view the revisions to the Discussion Draft in the context of the BEPS action plan as a whole. Other Action items may alleviate some of the concerns surrounding transfer pricing issues. The work to address base erosion and profit shifting should be viewed holistically, and other workstreams may address transfer pricing issues sufficiently enough that the arm's length principle and the guidance on use of profit split methods does not need to be radically altered.

- Overall, PwC recommends that the OECD devote sufficient time for deliberation and consideration in considering any change to the guidance on use of profit split methods. To this end, we emphasize that the Transfer Pricing Guidelines already address profit split analyses and the selection of the most appropriate method. Lastly, any changes in guidance on profit splits should reflect the principle that functional analyses are critical to transfer pricing analysis.

In the Appendix to this letter we have identified a number of items for further consideration by the OECD, mainly in response to the questions posited, in its next version of the document.

On behalf of the global network of PwC Member Firms, with the contribution of our colleagues David Ernick, Patrick Boone, Ian Dykes, Andrew Casley and Jonas Van de Gucht, we respectfully submit our response to the Discussion Draft on BEPS Action 10: Discussion Draft on the use of profit splits in the context of global value chains. For any clarification of this response, please contact the undersigned or any of the contacts below.

Yours faithfully,

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Appendix - Detailed Comments

1. We commend the Discussion Draft's reaffirmation of the importance of detailed functional analyses in determining the appropriate transfer pricing method. While the Discussion Draft notes that functional analyses cannot be performed in isolation but must consider the broader context of the MNE business operations, we question how this will be interpreted by tax authorities. We note that functional analyses are meant to identify functions undertaken, risks assumed and assets utilized in an intercompany transaction to better understand how to compare a related party transaction to what would have occurred in an unrelated party context. As such, we recommend the OECD note that profit splits are only useful to the extent that the results match the pricing that would have occurred in unrelated-party transactions based on the knowledge gained in the functional analysis.

2. The Discussion Draft considers a number of scenarios where it may be appropriate to apply a transactional profit split method to align transfer pricing with value creation. Nevertheless, the Discussion Draft notes in paragraph 6 "[i]n many cases, the structure of [an] MNE group's value chain will allow the identification of relatively discrete, stand-alone elements which can be reliably priced using one-sided methods." We recommend that the Discussion Draft emphasize the fact that one-sided methods are often appropriate and that many situations do not require a profit split to confirm the results of the one-sided method.

   The Discussion Draft acknowledges that in many cases, the structure of an MNE's value chain permits one-sided methods and transactional profit splits are not appropriate merely because an MNE's value chain covers multiple jurisdictions. However, the Discussion Draft recommends transactional profit splits may be more reliable than one-sided methods where there is pooling of entrepreneurial functions and risks and the success of the business depends on integration of related parties. It is not clear how it could ever be shown that that type of "pooling" and "integration" do not exist; MNEs exist precisely to take advantage of operating in a coordinated, integrated manner across jurisdictions. The result of the Discussion Draft may be that tax authorities will request taxpayers to prepare a profit split analysis in any scenario where the tax authority does not agree with the result of a one-sided analysis. Thus, we recommend that the OECD make clear that one-sided methods are often appropriate and tax authorities should not always default into requesting profit split methods to corroborate the results of one-sided analyses when such analyses are appropriate.

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

   Transactional profit split methods only provide a solution to the extent they provide a more reliable arm's length result than one-sided analyses. Even if the Leadership Board is assumed to consist only of representatives of the three OEMs (a fact not specifically stated, and a necessary prerequisite to considering application of a transactional profit split method to the OEMs in this fact pattern) we still question the ability to apply a transactional profit split method reliably.

   As noted in Paragraph 3.132, the criteria or allocation key to divide the combined profits should be supported by data, whether from independent comparables or internal sources.

The likelihood of data being available from either source that could reliably attribute profits to the various activities of the OEM participants on the Leadership Board is exceedingly low. As such, any application of a transactional profit split method is likely to result in an arbitrary division of profits among the OEMs, such that the division of profits has no relation to the division that would result in a true arm's length scenario.

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

   A more detailed analysis of the comparable companies and the value drivers of the business is necessary to understand whether a transactional profit split would be more reliable than a one-sided method.

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

   Transactional profit split methods are not inherently any more useful for dealing with particular aspects of value chains. We are concerned that the approach may be used to treat an MNE as a "single firm", and that too much reliance on transactional profit split methods in complex factual scenarios will lead to an inappropriate "rebuttable presumption" that a transactional profit split is the best method in such circumstances. Such primacy of the transactional profit split method impinges on the most appropriate method analysis and disregards the fact that even in complex factual scenarios, other methods may be more appropriate than a transactional profit split.

   We also note that our concern regarding potential for over-reliance on transactional profit split methods is, in many ways, connected to the definition of the controlled transaction at issue and the principles of aggregation in paragraphs 3.9-3.12. We are concerned that tax authorities will, when faced with a complex fact pattern involving several transactions that are tested with one-sided methods, conclude without proper analysis that they are so closely linked that they should be combined for purposes of analysis. Any conclusion that an aggregated approach is appropriate should be based on thorough consideration and analysis of the separate transactions and methods applied thereto.

6. *Question 4 – What guidance should be provided to address application of transactional profit split methods to deal with these aspects of value chains?*

   In many cases, a transaction profit split method may be the most reliable method where there is a lack of reliable comparables to apply a one-sided method or, expressed alternatively, where both parties make "unique and valuable" (i.e., non-benchmarkable) contributions. However, the functional analysis and broader comparability process should result in the selection of the most appropriate method. We are also concerned that the "global value chain" concept may be inappropriately used to treat an MNE as really being a single firm and to allocate income to the group members on a formulaic basis. The Discussion Draft notes that transactional profit splits may be preferable where an integrated business model reflecting a global value chain allows various entities to carry out interdependent functions. Such broad, sweeping statements offer little practical advice to taxpayers as there is nothing inherent about a multi-sided business model that results in a profit split being preferable. We worry that this preference for profit splits in the context of multisided business models may provide tax authorities reason to expect or request a profit split analysis rather than focusing on a most appropriate/best method analysis of why a particular method offers the best approximation at an arm's length result.

7. *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?*

   A profit split may be one of many ways to provide an appropriate transfer pricing solution to the case of Scenario 2, depending on the facts of the transaction and whether similar activities are undertaken by unrelated parties.

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

   The nature and extent of the activities undertaken by the local subsidiaries and whether these services exist in the market place would need to be elaborated. If these activities are undertaken by independent third parties, it may be possible to remunerate them appropriately via comparable returns of unrelated parties.

9. *Question 7 – Does the way in which "unique and valuable" is defined for intangibles assist in defining the term "unique and valuable contributions"*

   As noted in the Discussion Draft, the phrase "unique and valuable contributions" is utilized in the amendments to Chapter VI contained in the 2014 Report, Guidance on the Transfer Pricing Aspects of Intangibles suggesting "unique and valuable contributions" involve contributions constituting a key source of competitive advantage for the business and create difficulties in finding reliable comparable companies. Identifying competitive advantages in a business involves some subjectivity and there is room for reasonable disagreement as to the weights of competitive advantage. We believe "unique" refers to a situation where good comparables are not available. Use of undefined, subjective terms like "unique" and "competitive advantage" may confuse rather than clarify. It would be much simpler if objective rules were used; we believe it would be sufficient to say that a profit split method will be the most reliable method where there is a lack of reliable comparables to apply a one-sided method. As previously stated, a lack of reliable comparables should be determined based on a thorough functional analysis and broader comparability analysis.

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

    The nature of the activities undertaken by the competitors of S in Country S need to be elaborated, as does the relative weight customers give to technology and branding vis-a-vis the services and support provided by Company S.

11. *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?*

    If the nature of the activities undertaken by the competitors of S are similar to those undertaken by S, including the customer relationships, a method such as the TNMM may be the most appropriate method. If the activities undertaken by Company S differ in ways that cannot be reliably adjusted, a transactional profit split method may be the most appropriate method. Rather than specifying how a transactional profit split method would best be applied in a circumstance without full facts, we note that the transactional profit split would be appropriate so long as it provides for arm's length remuneration to both entities for their respective functions undertaken, assets owned and risks borne.

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

See response to Question 9.

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

The Discussion Draft notes that transactional profit splits may be appropriate where an MNE's business is highly integrated and strategic risks may be jointly managed and controlled by more than one entity. Such an analysis therefore requires an appropriate consideration of strategic risk, further confirming the OECD's continued reliance on detailed functional analyses. We recommend that the OECD reaffirm that not all risks are the same and different risks may have significantly different risk-reward trade-offs. We also recommend the OECD reaffirm that contractual allocations of risk will be respected. Identifying the risks borne by the tested party is a key aspect of a functional analysis and identifying comparable companies with a similar risk profile is a key task of an economic analysis.

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

If reliable comparables to a particular party to the transaction, or for a particular element to the transaction's pricing, can be identified a one-sided method would produce more reliable results.

15. *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?*

Information to be further analysed includes: the nature of the development and production process to better understand the value of the activities undertaken by Companies B and C, the knowledge or know-how developed by Company A that may have been provided to Companies B and C in developing the new generation of equipment, and whether reliable comparables exist for the activities undertaken by Companies B and C.

16. *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?*

No. The paragraphs in the intangibles report that are referenced here (6.57-6.58) are grayed out in that report, meaning there is internal disagreement within the working party. It would not be appropriate to revise the guidance on the scope of transactional profit split methods before that disagreement is worked out, otherwise there is nothing upon which to base any changes with respect to profit split methods. Additionally, those paragraphs seem to be based on the assumption that there are some functions that are so important that they can never appropriately be priced based on comparables and that some functions would never be outsourced by enterprises behaving in a commercially rational manner and therefore can never be priced at all, even under a profit split method. It is likely that some members of the working party believe those paragraphs are flawed in a fundamental (not minor) manner and inconsistent with the arm's length principle. That is another reason why it would be inappropriate at this time to revise the guidance on profit splits based on those paragraphs.

17. *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?*

Many MNEs split functions within a value chain whereby certain entities undertake only limited, specific functions (e.g., logistics, marketing etc.). Due to fragmentation, the Discussion Draft argues that finding comparable companies that are similarly limited to comparable specific and discrete functions may be difficult. As such, the Discussion Draft notes that it may be preferable to undertake a transactional profit split approach as a corroborative method, identifying comparable companies that combine multiple functions and utilizing the principles of a contribution analysis to divide the benchmarked profit. We are uncertain as to the need for such a statement and believe that such an analysis is undertaken in determining the reliability of the comparable set in relation to the functions undertaken, risks assumed and assets owned of the comparable companies in a one-sided analysis. Thus, such analysis should be performed in the process of determining the best comparable companies in the marketplace to be used as benchmarks and need not imply a profit split be used as a corroborative method. While we are not opposed to the profit split method being used as a corroborative method when appropriate, we believe that mere fragmentation is not reason enough to warrant the suggestion of a corroborative profit split when a reliable method has been utilized. We believe that the draft places unwarranted emphasis on the new concept of "fragmentation", and we are concerned that it may be used inappropriately to disregard separate legal entities. It should not be used to treat all MNEs as a "single firm" and to enable arbitrary application of a profit split method. We note that corroborative profit split analyses are costly and time consuming to taxpayers.

18. *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?*

A proper functional analysis which takes account of the availability and quality of information is the only way to determine the appropriate method. When reliable comparables are not available, a profit split method may be the most reliable method (or an income method or an unspecified method). The Discussion Draft does not present any persuasive arguments as to how "fragmentation" will help in determining the most appropriate method.

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

Comparables can be found and applied in Scenario 5 by performing a functional and comparability analysis. We do not see any facts discussed in this scenario that would necessitate any sort of prescriptive guidance being given regarding use of profit split methods under these facts. As such, we reiterate the fundamental concepts related to functional analyses and selection of the most appropriate method discussed in the beginning of this document.

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

We believe this question is best answered by reaffirming the fundamental concepts discussed in the beginning of this document.

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

Scenario 5 does not outline the key value drivers of the group's business and the members of the MNE group which perform those functions, bear those risks, or employ those assets. Without that contextual background, it is not possible to evaluate what method might be most appropriate.

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

We note than by definition any point within the range is arm's length, and we believe that the result in the last sentence of paragraph 32 could more appropriately be achieved by making a comparability adjustment to reflect the level of functions or risk in the tested party, instead of trying to combine two different transfer pricing methods.

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

We continue to emphasize the importance of relying on a proper functional analysis to make a determination as to what method is most appropriate. The concept in the Transfer Pricing Guidelines of having a "best" or "most appropriate" method necessarily implies that one transfer pricing method is better than all others and should be used to their exclusion. Paragraph 2.11 of the existing Transfer Pricing Guidelines is sufficient as to the use of more than one method. Again, we caution against using this Discussion Draft simply to make it easier to apply profit split methods; that should not be the objective of this paper.

24. *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?*

Value creation factors should be identified in any functional analysis and it is therefore not clear why such suggested factors or weights may be useful on an *ex ante* basis. In fact, we believe that suggested factors or weights may lead to the unintended results of forcing taxpayers and tax authorities to expend greater effort questioning why the presumed items may not be appropriate in certain scenarios when such analysis would otherwise be clear from the functional analysis. It is also noted that under Action Item 13, the Masterfile already requires the MNE to list the important drivers of business profit.

25. *Question 23. What guidance is needed on weighting of factors?*

See response to Question 22.

26. *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)?*

We believe that a proper functional analysis which analyses the functions, assets, and risks of each party is the appropriate approach to determining the most appropriate transfer pricing method. There is no shortcut for doing this type of detailed analysis and we do not feel that the concepts mentioned in question 24 add anything that is not already accounted for in a proper functional analysis.

27. *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 MNE operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate?*

We believe this question is best answered by reaffirming the fundamental concepts discussed in the beginning of this document.

28. *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?*

With hard-to-value intangibles, key among the considerations in the application of a transactional profit split method would be the relationship between the value contribution associated with a given measure and the overall value created. The ability to perform such an analysis within the context of a transactional profit split method also requires that the contribution to value of a given factor, such as assets or the bearing of risks, be fully understood as compared to the contribution to value of other factors.

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

No special guidance with respect to the most appropriate transfer pricing method is necessary or appropriate to deal with unanticipated results. At arm's length, unrelated parties often strike a deal based solely upon information known *ex ante*, and then live with the results of that deal, whether anticipated or unanticipated. The Transfer Pricing Guidelines already include guidance on commensurate with income type rules; consequently, no specific guidance regarding transactional profit split methods is appropriate.

30. *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?*

We believe this question is best answered by reaffirming the fundamental concepts discussed in the beginning of this document.

31. *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?*

We believe this question is best answered by reaffirming the fundamental concepts discussed in the beginning of this document.

32. *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?*

The arm's length principle would generally require a participant in a profit split method to also share losses. One can recognize certain situations in which a start-up enterprise or other unique set of facts may initially place greater risk of losses to the parent or homecountry entity. In such cases however the transfer pricing model should include risk-adjusted factors such as a profit limit or “clawback” to ensure the parties are compensated in a manner consistent with the arm’s length principle.

33. *Question 31. Paragraph 2.114 of the [Transfer Pricing] 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?*

We believe this question is best answered by reaffirming the fundamental concepts discussed in the beginning of this document.

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

We believe this question is best answered by reaffirming the fundamental concepts discussed in the beginning of this document.