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Dear Sirs

DISCUSSION DRAFT ON THE REVISED GUIDANCE ON PROFIT SPLITS

BDO welcomes the opportunity to comment on the OECD's Public Discussion Draft on the Revised Guidance on Profit Splits issued on 22 June 2017 ('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 highly integrated operations conducted by multinational enterprises. We appreciate the consideration the OECD has given from the previous round of consultation on this matter.

We recognise that the use of the profit split method can increase the reliability of transfer pricing outcomes 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.

1. Profit split of anticipated or actual profits

Paragraph 6 et seq of C.2.1 of the Discussion Draft addresses the fact that the main strength of the transactional PSM is that it can offer a solution for cases where both parties to a transaction make 'unique and valuable' contributions (giving the example of 'valuable' intangible) to the transaction. There may, however, be circumstances where the application of the PSM may equally be appropriate where contributions are made by parties that are not necessarily 'unique and valuable' per se (and certainly where there are no particular 'valuable' intangibles that are being contributed) but the combination of contributions made (whether services, particular attributes etc) by the parties concerned are such that the business outcomes of that combination are greater than the 'sum of the parts' and of themselves generate new attributes/intangibles. The guidance should explicitly recognise this.

We appreciate that paragraph 46 of the Discussion Draft highlights that in general only information known or reasonably foreseeable by the associated enterprises at the time a transaction was entered into should be taken into account.

We still hold the view expressed in our comments of 5 September 2016 on the Revised Guidance on Profit Splits issued on 4 July 2016 (cf. pg. 17 (18) of the Comments Received on Public Discussion Draft BEPS Action 8-10 Revised Guidance on Profit Splits Part I of 8 September 2016) that in practice as far as ongoing relationships are concerned the profit split based on anticipated profits and the profit split based on actual profits appear more akin to two stages of a single method. In such situations of ongoing contributions by both parties and sharing in the assumption of the economically significant risks one would assume that unrelated parties as a rule include a price adjustment clause in the underlying agreement.

Any profit split which relies on anticipated profits will be vulnerable to the robustness of the forecasting and budgeting process of the particular enterprise. Significant variances of actuals versus budget need to be assessed. It is likely in a third party arrangement some contractual provision or contingency will exist to deal with significant differences between budget and actuals. Blind application of an anticipated profits approach could give rise to an unrealistic economic outcome.

To reflect arm's length circumstances, Tax Authorities should be encouraged to review the appropriateness and reasonableness of the underlying assumptions and the determination process of the pricing of the transaction at the time it was entered into using the valuation techniques described in Chapter VI of the OECD Guidelines (a hypothetical arm's length price). This would involve accepting and then considering the premise of how the pricing has been set, and not simply applying expectations by default (for example by expecting actual rather than anticipated profit to be used). Hence, from our point of view it would be favourable to add some wording in paragraph 45 of the Discussion Draft to guide Tax Authorities in this regard.

2. Profit splitting factors

Profit splitting factors are elaborated on in paragraphs 54 ff. of the Discussion Draft.

a) Loss years and use of multiple factors

The discussion draft makes clear that similar factors should be applied to both profits and losses. Particular consideration should be given to the appropriateness of an allocation factor to loss making years. This can assist in determining the appropriateness of an allocation factor and the degree to which that factor is a good indicator of profit.

The use of staff cost as a single allocation factor could give rise to anomalous results in loss years. For instance if staff receive any performance based remuneration allocating more losses to the location with the highest staff costs may not reflect the contributions of each related party.

To help eliminate or reduce the risk of anomalous allocations consideration should be given to the use of multiple allocation factors. For instance staff costs could be used combined with sales volume/transaction count.

b) Capital and capital employed

The objective of the application of any transfer pricing method is to ensure that profits of the associated enterprises are appropriately aligned with the value of their contributions. If the main contribution in a transaction is the provision of capital, the relevant capital attributable to the transaction (taking into account the facts and circumstances pertinent to that capital) might be an appropriate profit split factor. The use of capital-based profit splitting factors, such as capital employed, may be recommended when the parties undertake capital-intensive financial activities (e.g., leasing companies, banks, etc.).

c) Headcount of similarly skilled and competent employees

Headcount may be considered to be an appropriate profit splitting factor when employees are involved in the value creation activities and their contributions create the competitive advantage for the enterprise, e.g. where company A and company B both develop the same intangible (or different elements of the same intangible) for future commercialisation (and the relative value of the contributions of the employees involved can be reasonably evaluated and delineated). Care will be needed around the functional analysis to determine comparable levels of expertise and contributions to value creation, which may require some subjective judgement (e.g., routine contributions vs. unique and valuable contributions). Similarly, as set out in paragraph 56 of the Discussion Draft, costs may also be a helpful profit splitting factor but, again, it is important in our view to emphasise that staff costs will not always accurately reflect a suitable comparative measure of contribution to the particular transaction which may be subject to profit split and that this requires appropriate evaluation of where value is created by such staff, e.g. salaries of senior management team where the management team is split across two entities and the operations are highly integrated.

d) Adjustments for purchasing power parity

Adjustments for purchasing power parity may be appropriate, particularly where cost is used as a determining factor for a profit split. However it can be an involved process to determine relative market pricing levels with specificity. As such, while we support the inclusion of purchasing power parity as an option, its application should be restricted to cases of clear relevance to the facts and circumstances of the transaction.

e) Others

In many cases an asset or a cost based profit split factor seems to bring reasonable results. However, there are cases in which the key contribution does not align the profit share with the value of a contribution. In such cases a weighted function and risk analysis or a weighted contribution analysis could still be considered. If the relative importance of key management roles is a key factor of adding value to a business, RACI-style considerations may be useful. However, this analysis may contain a high degree of subjectivity and therefore it should be used where assets or costs based profit splitting factors cannot be used.

3. Additional examples

The OECD may want to consider to add an additional example for profit splits that is similar to Example 5 of the Discussion Draft where one group entity (Company A in country A) developed a software product, e.g. in the life insurance sector, for use in country A and allowed another group entity (Company B in country B) to distribute and modify it for the use in country B against a royalty. Company B keeps on modifying the software for use in another business segment, e.g. medical insurance, and distributes it in country B. Company A continues developing the underlying base technology and Company B utilises these developments in the modified software it distributes.

In this example Company A is not sharing in the assumption of the economically significant risks from the sale of the product in country B and, thus, following the logic expressed in paragraph 45 of the Discussion Draft, this example may from our point of view also serve as an example for a profit split based on anticipated profits.

Concluding remarks

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

The Discussion Draft provides helpful principles in support of the use and application of the transactional profit split. We appreciate the examples provided for illustration purposes in the revised draft. We have set out some suggestions above how these may be revised to add greater specificity.

From a taxpayer's point of view, it is important that both documentation requirements and the selection and application of the transfer pricing methodology employed are appropriate as regards the amount of work involved and its cost to the business.

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.

Please note that the responses presented above reflect the opinions of the authors and not necessarily the opinions of BDO as a whole. For clarification of any aspect of our responses presented above please contact:

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