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BUSINESSEUROPE position on the Public Discussion Draft on BEPS Action 10: Revised Guidance on Profit Splits

Through its members, BUSINESSEUROPE represents 20 million European small, medium and large companies. BUSINESSEUROPE's members are 41 leading industrial and employers' federations from 35 European countries, working together since 1958 to achieve growth and competitiveness in Europe.

BUSINESSEUROPE is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft entitled "BEPS Action10: Revised Guidance on Profit Splits" (hereinafter referred to as the Draft).

BUSINESSEUROPE notes the OECD recognition that guidance on the transactional profit split method (TPSM) requires clarification and strengthening following the BEPS Actions 8-10 Final Report in 2015, and appreciates the efforts of WP 6 and the Inclusive Framework to produce relevant and useful updates to Section C of Chapter II of the 2010 Transfer Pricing Guidelines (TPG). However, to be effective as guidance for both taxpayers and tax administrations, particularly tax administrations who are members of the Inclusive Framework and have limited past direct exposure to the TPG, the guidance needs to be a consensus document that more clearly distinguishes the circumstances in which the TPSM is not an appropriate pricing method and that the TPSM should not be a default method in the absence of readily available comparable uncontrolled prices or transactions.

Recognising that there may be practical difficulties in achieving consensus on detailed guidance relating to the TPSM in a relatively short time frame, and that very high level consensus guidance may be of limited practical assistance in complex inter-company business scenarios, the OECD should perhaps consider whether this particularly contentious issue should be dealt with through a two-stream approach, with consensus on detailed practical guidance among OECD members and other countries who support the previous OECD position on the use of profit splits as documented in the 2010 TPG, and a higher level consensus, based on this draft, that all Inclusive Framework members could support.

The previous draft guidance, issued on July 4, 2016 included a clearer statement on the inappropriate use of the TPSM in the final sentence of paragraph 16:

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"The application of a transactional profit split of actual profits when not supported by the features derived from the functional analysis, for example in cases where other methods are difficult to apply because reliable comparables are scarce, is unlikely to produce an arm's length outcome since the appropriate use of a profit split is determined by the existence of a specific commercial relationship between the parties." BUSINESSEUROPE would recommend that this sentence is reinstated in the current draft as clear guidance to tax administrations that the absence of comparable data is not a valid reason for the use of the TPSM and that other pricing methodologies will be appropriate in most circumstances, whether or not directly comparable data on similar transactions is available.

It would be appropriate for the guidance to emphasise that, where the taxpayer does not use a TPSM, there are likely to be very considerable difficulties in creating, after the event, the level of detailed analysis that would be required to support or quantify the outcome of a TPSM. Tax administrations should be advised that the circumstances in which a tax administration could estimate the outcome of a TPSM, or require that a taxpayer should undertake the very significant work required to perform a reasonably accurate TPSM, are likely to be very limited. Paragraph 46 contains some confirmation that the method must be applied on the basis of information known or reasonably foreseeable at the time the transactions were entered into and that the method of calculation should be based on written contracts documenting the intentions of the parties, and should not be varied over the lifetime of the agreement: the implications of this guidance for any tax administration proposal to use TPSM after the event should be highlighted.

The Draft uses "operating profit" as a concept throughout, but this term is not defined in the 2017 TPG glossary. It would be helpful to include a definition, either in this draft or in the glossary of the TPG.

Throughout the draft the phrase "unique and valuable contributions" or "unique and valuable intangibles" and similar words are used, but "unique and valuable" is not defined. The draft should include a definition that is useful to taxpayers and tax administrations and which helps identify the threshold for a contribution or intangible to be considered "unique" and "valuable" in particular circumstances

Paragraph 7 identifies one of the strengths of the TPSM as a solution for highly integrated operations, with a reference to section C2.2.2. It would be relevant to include the wording in paragraph 19: "*Although most MNE groups are integrated to some extent a particularly high degree of integration…is an indicator*"

The draft, at paragraph 10, refers to the difficulty of obtaining relevant information as a weakness of the TPSM: this paragraph underestimates and understates the significant practical difficulties that many taxpayers would experience in gathering sufficient accurate information to carry out a reasonably accurate TPSM analysis.

Paragraph 32 of the discussion draft identifies two main factors TPSM should incorporate. The second factor refers to the ability of TPSM of "*Be capable of being measured in a reliable manner*". Although paragraphs 60-62 include some scenarios to support the measurement of the TPSM, the term "reliable manner" is not defined further and perhaps a clear definition of this in the guidance would assist MNEs in determining in what circumstances profit splits could be considered truly measurable. This is particularly relevant when other internal data rather than asset-based and cost-based profit splitting factors are used (e.g. weight of people).

Paragraphs 35-36 refer to contribution analysis, but with very little guidance being provided on the concepts and processes used in this analysis. BUSINESS EUROPE would recommend that more detailed guidance is provided, or that the draft includes a clearer caveat that contribution analysis is complex and requires detailed knowledge of the business processes of both parties.

Paragraph 24 of the Draft refers to control and assumption of risk and makes a reference to paragraph 1.105 of the TPG. To be consistent with the 6 steps process recommended in Chapter 1 of the TPG, this cross reference should be expanded to paragraphs 1.72 through to 1.106, not to a single paragraph that could be taken out of context. It is important that the guidance on the control of risk in a TPSM takes full account of the detailed guidance in Chapter 1 on the analysis and pricing of economically significant risks.

The Draft, at paragraphs 60-61, refers to the use of especially drawn-up transactional balance sheets. It should be recognised and explained in the guidance that there are likely to be very significant practical and financial system difficulties to be overcome in drawing up such balance sheets, even on a contemporary basis, and creating a transactional balance sheet for an audit sometime after the event would be particularly challenging.

Specific questions

1. The guidance already notes at paragraph 43 that the basis of a TPSM should be the accurately delineated transaction, based on written contracts (paragraph 46). Whether the TPSM should be based on anticipated or actual profits will therefore depend on the nature of the relationship between the parties and the investment or contribution that each makes, and the guidance should not encourage tax administrations or tax payers to rely on one or other in all circumstances. Certainly, as paragraph 45 suggests, where unique and valuable contributions are made and one party could not realise profit without the other, anticipated profits should be used. It does not, however, follow that where the business operations are highly integrated or each party makes unique and valuable contributions, that actual profits should be used in all cases. Paragraph 44 posits a scenario where business risks are shared and concludes that actual profits should be used in computing the split of profit: this may be appropriate where the relationship between the parties is close to a joint venture or partnership, but it should not be

concluded that in all cases where there is some sharing of risk that actual profits should be used.

2. Profit splitting factors: as a general comment, the accurate delineation of the transaction should facilitate the identification of profit splitting factors that are appropriate to the particular economic relationship between the parties, and creating a limited list of factors that appear to be endorsed by the OECD could restrict the use of economically appropriate factors or combinations of factors.

a. Capital and capital employed should be retained, not only because of relevance for financial transactions, but also for capital intensive industries and because the current value of assets reflected in a capital account that are contributed to a trading relationship can be an effective proxy for the arm's length value of the underlying assets.

b. Headcount: this could be a suitable factor, if used with care. It has the merit of being simple, practical and consistent with third party arrangements e.g. in the services sector. However, consideration should be given to applying weighting factors to headcount, and these weightings will often not be the same as payroll/employment costs.

c. Purchasing power parity: this would be very difficult to estimate and in practice is likely to be of limited use. For example, although labour cost could potentially be used as profit splitting factor, the cost of living in different countries influences the payroll cost itself and consequentially impacts the comparability of the population. In such a scenario, the application of purchasing power parity might be relevant.

d. Other factors: as noted above, the guidance should not be prescriptive but should support the use of factors that are appropriate for the accurately delineated transaction.

Examples

It is not clear why in some examples (e.g. 1, 2 and 5) the TPSM is considered the most appropriate method as it appears that other pricing methodologies could be used.

It would be helpful for the examples to include a discussion of whether a split of anticipated or actual profits should be used (examples 1, 2, 3 5 and 7). This would demonstrate that the circumstances where a split of actual profits should be used are in practice limited and the use of anticipated profits would be more common.

Examples 4 and 6 both conclude that TPSM is not the most appropriate method, but the conclusions are differently worded "*..the profit split method may not be the most appropriate method…*" compared with "*..the profit split method is unlikely to be the most appropriate method*". It is not clear from the examples why the strength of the conclusion is different.

In example 10, it is not clear why, based on the information provided in the example, that an asset-based profit splitting factor is appropriate and the proviso "*that the functional analysis concludes that there is a strong correlation between the assets of Company A and Company B and the creation of value..*" would be better shown as a fact in an earlier paragraph, so that the conclusion is based on the presented facts, not an assumption.

Yours sincerely,

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