Irish Tax Institute

Response to OECD Discussion Draft: Revised Guidance on Profit Splits

5 September 2016

About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition, many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.

Our response

The Irish Tax Institute is writing in response to the Discussion Draft on the Revised Guidance on Profit Splits, released for commentary on 4 July 2016. We prepared this submission with consideration and input from a number of our members.

Introduction

The relevant Discussion Draft on profit splits builds upon the consultation paper on profit splits issued during the BEPS project. The current draft contemplates modifications to Chapter II of the OECD Guidelines, which set the circumstances where the profit split method can be applied. The release of a follow-on paper on the profit split method in relatively short order is a notable achievement. Recognising that consensus has yet to be reached on the revisions to Chapter II, we strongly encourage continued progress and debate.

On this latest draft, the OECD has asked for input on 18 questions linked to the technical application of the profit split method under appropriate circumstances. We provide general comments on the matter of profit splits as well as comments and suggestions on targeted sections of the Draft. Together, our submission will cover what our members feel are the most critical questions that the Discussion Draft has sought input on.

A. General comments

Profit Split (PS) method as one of last resort in most cases

The revisions already made to the OECD Guidelines under BEPS Action 8-10, and those sought by this Draft, place focus predominantly on the PS method. None of the other four methods have received such attention in this process (*albeit some attention on the CUP method vis-à-vis commodity pricing*). In an environment where Country by Country Reporting will illustrate the global distribution of profit, it is a real expectation by taxpayers that certain tax authorities will seek to use new guidance on the PS method to apply it under examination in inappropriate circumstances. As such, these revisions to Chapter II, following the prior consultation draft, may lead to the unintended consequence by the OECD of the incorrect application of the PS method. It is critically important to clarify in the Guidelines, yet also work closely with WP6 delegates, that the proposed revisions shall in practice apply in rare circumstances and the new narrative should not bias toward the PS method.

The PS method is only applicable if, through a proper functional analysis under Chapter I, the actual transaction exhibits the minimum standard attributes specified by the Discussion Draft (e.g. unique and valuable contributions by more than one party). It would be helpful for the final guidance to contain at least one detailed example per attribute, to more specifically refine those circumstances that could qualify for the application of the PS method.

Acknowledgement of role of contracts and control over risk to set prices

Chapter I acknowledges that contractual arrangements serve the purpose to define the role performed by an entity and whether such entity assumes a specified risk, in connection with a transaction. Chapter I recognises that the contract is the designated starting point for a thorough functional analysis, whereby the contract (and its allocation of risk) is respected so long as the functional analysis supporting the contract is a representation of the conduct of the parties. The Discussion Draft focuses exclusively on the role of actual functions, risks and assets (in absence of control functions, financial capacity to assume risk and contracts), except for the small consideration in pgh 10.

The references to Section D of Chapter I, in this context, needs greater explanation with specific reliance on the role of contracts, financial capacity as well as the important control functions that lead to the appropriate allocation of key risks amongst the parties. In addition to the narrative in Chapter I, the guidance on the PS method should contain customised rules to identify the limited circumstances where the contract may be overridden by the parties' actual conduct, with respect to their sharing of risk.

Recognition of purpose to either set or test a transfer price

Transfer pricing analyses and methods are frequently used for either setting "*ex-ante*" pricing of a transaction or testing "*ex-post*" pricing or financial results of the set price. Either use of a transfer pricing method is appropriate. The Draft lacks due recognition on the distinction, and the principle of how arm's length parties would arrange and monitor their transactions. It is conceivable that *ex-ante* prices are based on a split of anticipated profits whereby *ex-post* results are tested on actual results. Both can in theory be valid applications of the profit split method, despite the same facts and circumstances.

The Guidelines should contain guidance on the application of PS in to both contexts. In particular, we would expect that it is not necessary for the same method to be used for setting and testing the same transaction.

Relevance of actual or anticipated profits (or a variant therein)

The OECD Guidelines should consistently advocate that the related party arrangements reflect how arm's length parties would be agreed. That principle should more clearly extend to this issue. The underlying business and transaction at issue are frequent indicators of how arm's length parties will agree on pricing.

The scene setting (particularly in pgh 2) suggest that the anticipated PS has limited application. We believe this is an inappropriate interpretation, as the splitting of anticipated profits would be more readily observed amongst arm's length parties as the basis to establish the price of certain transactions (e.g. sale of an asset or a fixed royalty percentage). Based on input from our members, it is rare for arm's length parties to retroactively re-price a transaction based on actual outcomes. At most, the actual profits would lead them to re-negotiate prices for future transactions. A PS of actual profits will nearly always require a 'true-up' on the price of a transaction at year end, as actual results rarely equal forecast with specificity. In practice, the split of actual profits should be permitted to fall within a range reasonable outcomes, thus not requiring 'true-ups' by default.

The work undertaken with respect to Hard to Value Intangibles demonstrates that pricing of complex transactions or arrangements may not fit squarely as wholly fixed or wholly contingent. Consideration can, in theory, be provided to whether transactions are priced based on anticipated profits (or losses), with appropriate provisions to address unexpected outcomes. For instance, a fixed royalty rate may have been set based on forecast profits. However, if the licensee earns no profit or even a loss (prior to the payment of the royalty) it may be the case that the arrangement should include a provision allowing for the re-pricing of the royalty rate. Franchise arrangements sometimes contain such allowances enabling the licensee as a going concern. Such complex arrangements require foundation in the market, and should apply if the upfront contractual arrangement allocates risk in such a way, and is consistent with Chapter I.

B. Technical comments

C.3 - Selection of most appropriate method

As noted earlier, the revisions focus largely on the splitting of actual profits rather than the method itself. Ideally, the section should contain two sequential parts: (1) determination of whether PS is or is not appropriate, and (2) determination of whether actual or anticipated profits should be split between the parties. To achieve (1), section C.3 should be expanded up front with a more thorough evaluation on the circumstances when the PS is more reliable than the other prescribed methods. This guidance should contain the analytical approach (without examples) to demonstrate where the PS should not be the selected method. The non-contingent remuneration concept in pgh 17 could be expanded upon.

As well, revisions in the introduction C.1 provide useful examples that may better suit in C.3 when choosing which profit split version is most suitable to a set of facts.

- *C.3.1 – Highly integrated operations* - The new guidance appears to define high degree of integration mainly in the context of risks shared, potentially leading to the conclusion that the type and level of integration are key determinants to requiring the PS method. This section requires greater elaboration and deference to the factual control over the core or strategic risks in the value chain, rather than the performance of functions that are highly integrated.
- An assembly line is a highly integrated operation, however, it would be unreasonable to assume an individual on the line controls the risks related to his/her role. A broader perspective of the entire line, and its risks, should be evaluated against those responsible for the control of key decisions and operational risks.

- *C.3.2 – Unique and valuable contributions* are defined in pgh 22 where (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) their use in business operations represents a key source of actual or potential economic benefits. Greater clarification is warranted on this section given disputes on concepts such as marketing intangibles. This paragraph should be clearer on what is and is not unique AND valuable. For instance, when a similar contribution is made by someone else (whether controlled or uncontrolled), then the contribution ceases to be unique. Reference should also be made to Chapter VI, in that the intangible of relevance must be capable of being owned and controlled, which is normally not the case for marketing intangibles.

- *C.3.4 – Value chain analysis* considers the role of the VCA in delineating the transaction in the context of PS. However, delineating the transaction is required for all methodologies. It seems most appropriate to relocate the observations on the VCA either to supplement Chapter I. Chapter II could then refer to this wider guidance on how the VCA might impact the selection of the method.

C.4 – Guidance for application

- *C.4.3 – different measures of profit* makes clear that the choice of which profits to be split shall consider the nature of the transaction, with regard to the degree of integration of activities and risks shared. As the nature of integration and risk sharing can vary, we suggest the terms of gross or operating profit oversimplifies this exercise. For instance, the parties may only be integrated with regard to half of their operating departments. This might suggest profits should be split somewhere between gross and operating profit. Hence, it may be advisable the analyses places greatest effort in identifying the costs and expenses associated with the nature of integration and risk-sharing, and it is the profit after deducting those costs and expenses which is most reasonable to split between the parties.

- *C.4.5 – profit splitting factors* - Pgh 52 provides examples on whether adjustments may be required in order to factor "external" costs (or benefits) into the PS factors, i.e. higher compensation costs in one country vs. another. In order to appropriately align with the Chapter I analysis, however, the factors should measure costs in which are under the control of the relevant parties and not simply reflect a cost paid for by the parties.
- Furthermore, relative value can be most reliable when the same commercial drivers are employed by the relevant parties to the PS (e.g. a global trading function). The reliability weakens when one must relatively weigh two distinct commercial drivers in a business e.g. R&D vs. procurement.

- Reference to location advantages as a driver of profit can be misleading. We strongly suggest this example is clarified and that the location advantages must be controlled by the relevant party and unique to the organisation.

- *C.4.1.2 - Residual profit split method* – When the residual PS method is applied, the routine contribution of the analysis typically relies on other methods (TNMM, Cost Plus Method or Resale Price Method). Pgh 34 addresses this approach solely in context of a split of anticipated profits. If multiple parties exhibit the characteristics necessary for the PS method to apply, then the split of actual residual profits may be necessary as well.

C.2 – Strengths and weaknesses

Section C.2 remained completely unchanged, although some commentary on the issue is discussed in Section C.1 particularly on anticipated vs actual profits. Given the revisions place a great emphasis both concepts, it would be advisable to expand C.2 for each of them.