Irish Tax Institute

*Leaders in Tax*

# Irish Tax Institute

# Response to OECD Discussion Draft: Use of Profit Splits in the Context of Global Value Chains

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## 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 Use of Profit Splits in the Context of Global Value Chains, which the OECD released on 16 December 2014. We prepared this submission with consideration and input from a number of our members.

**Introduction**

Base Erosion and Profit Shifting (BEPS) Action 10 is broadly for the purpose of "*assuring that transfer pricing outcomes are in line with value creation in the context of other high-risk transactions*". The Discussion Draft on profit splits was introduced as a consultation paper, with the objective to clarify the application of the transactional profit split method for globally integrated value chains. The draft primarily cites characteristics of global value chains, illustrated through nine scenarios. The OECD has asked for input on 32 questions linked to the issues and scenarios.

Each scenario invites tailored input on the application of a transactional profit split to the brief facts identified. It is understood that feedback on the Discussion Draft would be considered in revision of Chapter II of the OECD Transfer Pricing Guidelines for Multinational Enterprises ("the Guidelines") and would help to clarify the application of profit split method in the context of global value chains. The OECD has emphasised the scenarios are illustrative on the points raised, and not meant to imply the profit split method is most appropriate.

We have chosen to provide both general comments and more tailored comments to the Discussion Draft that will address many of the specific questions raised on the scenarios.

**A. General comments**

There are core principles to selecting and applying the most appropriate transfer pricing method. A change to any core principle that may bias one method over another carries the risk of resulting in increased controversy. By featuring the profit split method apart from others in developing guidance for global value chains may be unreasonably interpreted by tax authorities to convey support by the OECD for increased use of this method. Greater controversy and double tax is a likely outcome where tax authorities apply methods that are not the most appropriate or apply profit split methods in unique and uncoordinated fashions. It should be the objective of this work to provide greater guidance that will result in greater consistency.

*Scenarios to reflect real business models including risks and assets*

The Discussion Draft provides examples of global business models to solicit guidance on how to determine if the profit split method may be the most appropriate solution. We consulted with business leaders across various sectors, and suggest that the brief facts in the nine scenarios illustrated are unlikely to occur in practice as currently drafted. It would be most helpful to represent illustrative facts on functions, risks and assets that reflect real business models. In particular, the scenarios should describe how the companies interact with each other.

An example of our concern is Scenario 4 where three companies research and develop products (two being components) seemingly with no co-ordination or common oversight amongst them. This might occur if the companies were to develop independent products, though highly unlikely in an integrated business. Within a globally integrated multinational, and between third parties, we would expect one of the parties to take lead responsibility (and risk) for the overall research and development.

Appling the arm's length principle to any transaction, including global value chains, should follow the functions performed, risks borne and assets owned by each affiliate taking into account how third party transactions would be arranged. The Draft says (in para 7) "..*where there is significant integration, involving parties to a specific transaction or transactions within that value chain, for example in the effective sharing of key functions and risks, the reliability of one-sided methods may be reduced* ".

In this regard, the Draft limits the facts to functions performed with no mention of risks borne or intangibles assets owned in the value chain. The types of risks and intangible assets are often the most critical facts to select the most appropriate transfer pricing method, and particularly in order to select the transactional profit split method over other methods.

If consultations on transfer pricing of global value chains are to be beneficial, we recommend developing scenarios that reflect real business activity, address potential risks borne and assets owned in the value chain, and describe the interaction of the companies. We recognise the importance of providing greater certainty to taxpayers on circumstances where the profit split method might be appropriate, and welcome the guidance.

*Profit split consultation to co-ordinate with other Actions (Intangibles and Risk)*

Current business operating models and the allocation of income within some of those models have led to government concerns that have driven the BEPS Actions. A broad objective of the OECD is to ensure that transfer pricing outcomes are in line with "value creation". In this case, the output of this initiative is to create enhanced guidance where the profit split method may be regarded as most appropriate to match income allocation in accordance with value creation.

The profit split method seeks to evaluate relative values that related parties contribute to a specific transaction, and allocate profit on that relative value. Such an approach corresponds with the BEPS objective that profit should be earned and taxed where the economic activity driving profit is undertaken. BEPS Action 8 (Transfer Pricing Aspects of Intangibles) seeks to refine the definition of intangible assets and to attribute the intangible return in accordance with the place where the economic activity takes place. Further, the work on Risk and Capital (Actions 8-10) is evaluating the proper allocation of risk, ensuring risks are appropriately attributed to the parties responsible for managing and controlling those key business risks.

We noted earlier that the Discussion Draft only describes scenarios identifying limited functions performed without covering risks or intangibles assets. It is clear that this Discussion Draft and any resulting recommendations should closely align with the work on Intangibles and Risk (above). The current language in the Guidelines note that contributions of unique intangibles and risk allocation may suggest the profit split method as most appropriate (paras 2.108-2.117). We suggest future draft papers focus specifically on providing clear guidance on the use of profit split methods to value chains where multiple parties contribute unique and valuable intangibles or share in the assumption of entrepreneurial risks.

*Expectation of consistent and fair application*

A key outcome of this initiative to revisit Chapters I-III of the Guidelines should be to ensure there is guidance that can achieve a consistent and fair application of the profit splits method in the context of globally integrated value chains or any multinational business model. An individual function that is valuable to a multinational business should not by itself suggest the party performing that function is entitled to share in a large pool of profits or to absorb losses.

Therefore, we strongly recommend the next phase of this initiative is to provide clearer guidance related to the selection of profit split methods, in order to ensure that tax authorities will fairly and consistently select, interpret and apply the most appropriate method based on the complete facts. Not achieving consistency or fairness will increase the level of international double taxation and place increased burden on Competent Authority resources.

## B. Technical comments

*Selection of the most appropriate method*

The intent of this work is to provide guidance for the application (*or not*) of profit split methods in the context of global value chains. The Discussion Draft refers to the most appropriate method principle where the transfer pricing method applied must be the one that provides the **most reliable** measure of an arm's length result for a particular case. The Draft re-iterates there should not be any implied change in this principle. While this is an important and useful comment in the Discussion Draft, we believe future papers need to include clearer, consistent and practical guidance to taxpayers and tax authorities on how the Guidelines might be evolving.

The selection of the most appropriate method should equally evaluate the five prescribed methods, and determine the most appropriate method using the framework described in the Guidelines. The Discussion Draft or other work should not be seen to favour profit splits against the application of other approaches, especially when it seems there are challenging comparability issues with other transfer pricing methods. If, however, the profit split method is most appropriate after full consideration of the strengths/weaknesses of the methods, then another method should not be chosen in its place.

*Scenarios where profit split might **not** be appropriate*

The purpose of the Draft focuses on identifying facts and circumstances in global value chains in order to clarify the application of profit split methods in those cases. There is risk in only providing direction about when and how taxpayers might apply profit split methods. It may lead certain readers to suppose a bias towards profit split methods, supported by the BEPS project. The exercise to generate guidelines needs to strike a balance so not to bias the analysis toward the use of the profit split but to a fair evaluation of the most appropriate method.

In order to provide fair guidance, the OECD should consider issues, and scenarios of business models, where the profit split method might not be appropriate or where it might not be reliably applied. Therefore, we recommend the scenarios are balanced to include a detailed discussion of facts (functions, risk and assets) where a profit split is likely most appropriate, and contrast with slightly different facts where a profit split is not likely most appropriate.

*Data reliability to apply profit split method*

The selection and application of any transfer pricing method is guided by the availability and reliability of data on how arm's length parties conduct business. The Discussion Draft should clarify the relevant importance of data reliability as a critical factor to applying the profit split method to global value chains, in a manner that is both practical and consistent. Comparability issues generally exist in all methods. When there are comparability or data issues to apply other transfer pricing methods, there will likely be similar data availability or comparability issues to apply a profit split method. Therefore, the absence of reliable and comparable data for other transfer pricing methods should not imply a default choice to profit split as the most appropriate method for integrated value chains. The **relative**

reliability of the comparable data for the different methodologies needs to be simultaneously considered when selecting the most appropriate method.

Hence, we believes it is particularly important for the OECD Guidelines to ensure that the selection of a profit split method as the most appropriate method is not dissociated from an evaluation of whether the profit split method can be reliably applied. In other words, this evaluation should not be based on the absence of reliable or good comparables for other approaches and then default to using allocation keys which may not reflect the best indication of arm's length pricing.

*Subjectivity in allocation keys increases likelihood of disputes*

If the profit split method is most appropriate to select, the method requires a formula, an allocation key, to share the profits between the parties. A critical step is the determination of the most reliable allocation key(s), in line with relative value contributions or observations of independent parties. In practice, it can be challenging to finding suitable allocation keys to reflect value contributions. The OECD Guidelines and certain tax authorities recognise and prefer objective data, such as headcount or compensation, as reliable and readily available. In our view, this data does not regularly provide reliable measures of value contributions because they largely represent functions or certain types of assets. It becomes a subjective exercise if the parties' valuable contributions are a combination of functions, risks and assets.

Introducing subjectivity to the allocation of profits can foreseeably lead to bias views by interested parties, e.g. tax authorities. Consistency is certainly needed for the profit split method to be reliably implementable and accepted. It is critical to predict and find ways resolve potential disputes between taxpayers and tax authorities, as well as between tax authorities, on the allocation of profits.

Double tax relief can generally be available to taxpayers when there is a dispute on a transfer price between two jurisdictions. When profits are to be allocated to more than two companies in a global value chain, an adjustment by one tax authority may require double tax resolution with more than one counter party. An increase in the use of profit split methods to multi-party transactions may place significant complexity and strain on Competent Authority processes.

*One sided methods*

The Discussion Draft regularly refers to "*one-sided*" methods and how they may not be the most appropriate method for globally integrated business models. While a profit split is considered as a "*two-sided*" method and the transactional net margin method (TNMM) is a "*one-sided*" method, it is not clear what is more broadly meant by a "*one-sided*" method.

The Draft seems to imply that any method different from the profit split method is presumably "*one-sided*", indicating where a one-sided method is not reliable, a profit split approach is likely to be most appropriate. In particular, paragraph 7 of the Draft frames the "*one-sided*" methods as inferior, lacking the ability to attribute reliable arm's length outcomes to characteristics of a global value chain.

It would be helpful for the OECD to clarify its reference to "*one-sided*" method and acknowledge that potentially reduced reliability of "*one-sided*" transfer pricing methods does not imply that a profit split approach will be most appropriate.

*Multiple-year issues*

A section of the Discussion Draft highlights the possibility to use a profit split approach as an appropriate way to deal with situations where there may be significant differences between *ex ante* and *ex post* results or scenarios where losses arise. Multinationals may be concerned that profit splits, if viewed appropriate to the transaction, will be applied by tax authorities in a biased manner to tax profitable periods while disregarding loss-making years. Specific guidance would be welcome on the appropriate allocation of losses and treatment of loss-making companies when applying the profit split method.

Guidance should be developed in relation to the period(s) when and how profit split methods should be applied. In most business models, a profit split considering a single year is unlikely to achieve reliable results to measure business investment, e.g. intangible property development. Since most entrepreneurial actions and costs are undertaken for future gains, appropriate periods should be part of the profit split analysis.

## C. Scenarios

The Discussion Draft outlines several conceptual issues related to the application of transactional profit split methods, furthered by nine scenarios in order to raise public input. Rather than provide specific commentary on each scenario and respond to each question, in this section we provide general comments.

- **Additional facts** - Several scenarios ask whether a profit split approach is most appropriate in the circumstances presented. A recommendation for all scenarios is to provide enough information (i.e. functions, assets and risks involved) for a relative evaluation of the different transfer pricing methods. In addition, the scenarios should also discuss considerations of fact that lead to the profit split approach as most appropriate over other methods.

- **Remove bias from scenarios** - The Draft notes the scenarios "*have been provided to illustrate points for discussion only and should in no way be taken to imply that transactional profit split methods will be the most appropriate method in the circumstances outlined in those scenarios*." However, it is not clear from the scenarios as drafted, if these were so phrased as not to illustrate facts where the profit split method will be viewed as most appropriate.

- **Relationship of parties** - Certain scenarios are unclear in distinguishing the relationship between the companies from a mere principal-contractor relationship and a joint venture/partnership arrangement. While many third parties render value added services, they are not automatically entitled to share in the residual profits of the principal entity. For example, in Scenario 2, the services provided by the subsidiaries of RCo might be valuable to the RCo Group and still be viewed as support services depending on the arm's length allocation of risk.