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**Public Discussion Draft - BEPS Action 10 - Revised Guidance on Profit Splits**

Copenhagen Economics welcomes the opportunity to comment on the OECD's Discussion Draft on BEPS 10, Revised Guidance on Profit Splits, issued on 22 June 2017.

Copenhagen Economics supports the OECD's efforts to develop rules to prevent base erosion and profit shifting by engaging in transactions that require the use of the profit split method.

Copenhagen Economics believes that additional clarifications on the proposed guidance and examples will help both the taxpayer and the tax administration in the application of the profit split method.

It is our opinion that clear and pragmatic guidance on the profit split method would represent a further step in the proper allocation of profits based on economic substance.

We present our comments and feedback to the discussion draft below.

## 1 Background

Action 10 of the BEPS Action Plan identifies that work needs to be undertaken to develop “rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains”.

Further, the report on “Addressing the Tax Challenges of the Digital Economy” developed in relation to BEPS Action 1 identified issues in the digital economy that need to be taken into account in the course of the work on transfer pricing. The report noted in particular that the work should devote attention to the consequences of greater integration in MNEs and should evaluate the need for increased reliance on value chain analyses and profit split methods. The report also noted that this work should address situations where comparables are not available and could consider improvements to the guidance on the use of profit splits and other profit methods along the lines already applied in connection with global trading and other integrated financial services businesses.

In accordance with this mandate, Working Party No. 6 on the Taxation of Multinational Enterprises has considered a number of scenarios where it may be more difficult to apply one-sided transfer pricing methods to determine transfer pricing outcomes that are in line with value creation, and where (as a result) the application of a transactional profit split method may be appropriate.

Given this purpose, the OECD released three discussion drafts on 16 December 2014, on 4 July 2016, and on 22 June 2017 with the final aim to clarify, improve and strengthen the guidance on when and how it is appropriate to apply a transactional profit split method.

The final outcome of this work is to replace Part III Section C of Chapter II of the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“**TP Guidelines**”).

## 2 The Discussion Draft

The newly released public Discussion Draft “Revised Guidance on Profit Splits” (the “**Discussion Draft**”) deals with the clarification and strengthening of the guidance on the transactional profit split method, as set out in the BEPS Actions 8-10, 2015 Final Report, and sets out the text of proposed revised guidance on the application of the transactional profit split method.

Moreover, the Discussion Draft poses a number of questions intended to elicit responses which will then be considered by Working Party No. 6 in its revisions to the relevant guidance in Chapter II of the Transfer Pricing Guidelines.

It is our opinion that although there are significant improvements and in-depth clarifications included in the Discussion Draft, thanks to the numerous comments provided

on the previous discussion drafts, the guidance on the application of the profit split method can be enhanced further.

To further clarify and strengthen the use of the transactional profit split method, it is our opinion that the Working Party No. 6 should consider filling the gaps concerning: (i) **revisions to the current guidance**, (ii) **further guidance** on specific elements, and (iii) **clarifications on technical issues**, as discussed in the paragraphs below.

### 3 Revisions to the current guidance

#### 3.1 Contradiction of the draft guidance on Hard-to-Value-Intangibles

Para 46 of the Discussion Draft<sup>1</sup> appears to contradict the draft guidance on Hard-to-Value-Intangibles (HTVI) released by the OECD on 23 May 2017<sup>2</sup>. This particularly refers to the use or non-use of hindsight. It is our opinion that it is necessary to align the guidance, particularly by a revision of the OECD's draft guidance on HTVI.

#### 3.2 Actual vs. anticipated profits

Para 27 as well as 44 and 45 of the Discussion Draft appear to suggest that the profit split method should be based on actual profits in some instances, given how economically significant risks play out<sup>3</sup>. It is our opinion that this section of the Discussion Draft might be misinterpreted since third parties would undertake a transaction (i.e. determine and exchange the transaction price) based on their expectation of how the transacted functions, risks, or assets, may materialize and would not wait until actual profits arise. To do so, third parties can and would model the possible outcomes of economically significant risks ex-ante to determine their transaction price and would thereby factor these possible risk outcomes in ex-ante, so that no awaiting of actual profits is necessary.

In addition, it is our opinion that even when applying a transactional profit split of anticipated profits, the taxpayer takes in account the probability of the outcome of risk through the discount rate (e.g. WACC<sup>4</sup> used for discounting future income/cash flows).

#### 3.3 Comparable uncontrolled transactions vs. relative contributions

Para 52 and 53 of the Discussion Draft appear to suggest that the splitting of the profits based on "relative contributions" is secondary to the splitting of the profits based on

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<sup>1</sup> In any application of a transactional profit split, care should be exercised to ensure that the method is applied on the basis of information known or reasonably foreseeable by the associated enterprises at the time the transactions were entered into, in order to avoid the use of hindsight. See Discussion Draft, para 46 (Emphasis added).

<sup>2</sup> See Public Discussion Draft - BEPS Action 8 - Implementation Guidance on Hard-to-Value Intangibles (23 May 2017).

<sup>3</sup> Where the transactional profit split method is found to be the most appropriate, the splitting of actual profits, i.e. profits which have been affected by the playing out of economically significant risks, would therefore only be appropriate where the accurate delineation of the transaction shows that the parties either share the assumption of the same economically significant risks associated with the business opportunity or separately assume closely related, economically significant risks. See Discussion Draft, para 44 (Emphasis added).

<sup>4</sup> Weighted average cost of capital.

comparable independent transactions<sup>5</sup>. In this, the Discussion Draft refers to joint-venture arrangements between independent parties under which profits are shared. First, it is our opinion that this hierarchy of application should not be in place (i.e. split based on relative contributions should not be secondary to the split identified in third-party relationships). Second, the reference to joint-venture arrangements could be misleading as these arrangements are often affected by other unobservable interests than the transactional interests under review. By this, joint-venture arrangements rarely qualify as “independent” arrangements, irrespective of any capital contributions.

### 3.4 External data vs. internal data

Para 59 of the Discussion Draft appears to suggest a hierarchy in the use of data sources for the determination of the splitting factors, favouring external data over internal data<sup>6</sup>. It is our opinion that the “most appropriate” data source based on the accurately delineated transaction should be used, rather than the application of an artificial hierarchy of data sources.

## 4 Further guidance on specific elements

### 4.1 Key source of actual or potential economic benefits

Para 16 of the Discussion Draft refers to a “key source of actual or potential economic benefits” as an element to identify unique and valuable contributions<sup>7</sup>. The Discussion Draft, however, does not provide any indication of what taxpayer and tax administration should mean by “key source of actual or potential economic benefits”. Therefore, it is our opinion that further guidance is needed in order to determine what a “key source of actual or potential economic benefits” is.

### 4.2 Economically significant risks and relevant profit

Para 25 of the Discussion Draft introduces “economically significant risks” as one reason for the application of the transactional profit split<sup>8</sup>. In addition, para 26 of the Discussion Draft loosely relates such risk to “such that a share of relevant profits would be warranted for each party”<sup>9</sup>. It is our opinion that further guidance is needed on what an “economically significant risk” and a “relevant profit” are.

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<sup>5</sup> Where there is no more direct evidence of how independent parties in comparable circumstances would have split the profit in comparable transactions, the allocation of profits may be based on the relative contributions of the parties, as measured by their functions, assets used and risks assumed. See Discussion Draft, para 53 (Emphasis added).

<sup>6</sup> Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the relevant profits, consideration should be given to internal data, which may provide a reliable means of establishing or testing the arm’s length nature of the division of profits. See Discussion Draft, para 59 (Emphasis added).

<sup>7</sup> Contributions (for instance functions performed, or assets used or contributed) will be “unique and valuable” in cases 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. See Discussion Draft, para 16 (Emphasis added).

<sup>8</sup> A transactional profit split may be found to be the most appropriate method where, [...], each party to the controlled transaction shares the assumption of one or more of the economically significant risks in relation to that transaction. See Discussion Draft, para 25 (Emphasis added).

<sup>9</sup> The relevance of such a factor as an indicator for the transactional profit split method will depend in large measure on the extent to which the risks concerned are economically significant such that a share of relevant profits would be warranted for each party. See Discussion Draft, para 26 (Emphasis added).

### 4.3 Weighting of splitting factors

Para 55 of the Discussion Draft refers to the use of different splitting factors in the application of the transactional profit split method<sup>10</sup>. While we agree that the use of different splitting factors may be needed in the application of the transactional profit split, it is our opinion that further guidance is needed on how the different splitting factors should be weighed against each other.

In addition, whilst factors based on assets, capital or costs may accurately measure the relative contribution of each party to a transaction in instances where the parties perform activities within the same function, it is unlikely to provide a good representation of the relative contribution in instances where the parties perform different functions within the value chain, employ distinct assets, and or bear different risks.

In order to measure the relative value of each party's contribution to a transaction, one should take into account all the functions performed, assets employed and risks borne by the related parties, as well as the corresponding benefit attributed to such functions, assets and risks.

Since it may not be feasible to accurately quantify how much each activity, asset and risk contributes to the generation of profit in a transaction, room should be made for splitting profits based on a reasonable estimation of (i) the proportion of functions performed, assets employed and risks borne by each party, and (ii) the relative importance of and value created by each function, asset and risk.

## 5 Technical clarifications

### 5.1 Legal ownership of unique and valuable intangibles

Para 17 of the Discussion Draft only states the concept of "legal ownership" of unique and valuable intangibles, while it additionally refers to economically significant risks<sup>11</sup>. It is our opinion that the concept of economic ownership should be introduced more fully within the guidance on the profit split method as indicated by the OECD guidance on intangibles<sup>12</sup> and it should be noted that not only the assumption of economically significant risks builds up or accounts for economic ownership.

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<sup>10</sup> Where more than one profit splitting factor is used, it will also be necessary to weight the factors used to determine the relative contribution that each factor represents to the earning of the relevant profits. See Discussion Draft, para 55 (Emphasis added).

<sup>11</sup> Where each party to the transaction legally owns unique and valuable intangibles that are relevant to the transaction, it will also be necessary to consider whether, under the accurate delineation of the transaction, they each assume the economically significant risks relating to those intangibles. See Discussion Draft, para 17 (Emphasis added).

<sup>12</sup> See OECD TP Guidelines, July 2017, Chapter VI Special Considerations for Intangibles, Section B, para 6.32.

Para 36 of the Discussion Draft appears to suggest that contributions should be assessed based on the “relative contributions” and “external market data”<sup>13</sup>. In this regard, it seems that the specific mention of “internal data”, as outlined in para 51, is missing. Hence, it is our opinion that an alignment to Para 51, by including the notion of “internal data” in Para 36, is needed.

## 5.2 Use of segregated data

Para 42 of the Discussion Draft indicates that segregated data should be used in the application of the transactional profit split<sup>14</sup>. It is our opinion that the revised guidance on the profit split method should also account for the fact that the application of the method may often lead to the split of the total profit of one or more parties, especially for highly integrated businesses as suggested by para 19-24.

## 5.3 Bearing of risks and financial capability

Para 24 of the Discussion Draft refers to the bearing of risk and the allocation of remuneration in this regard<sup>15</sup>. It is our opinion that a further clarification about the link between the bearing of risks and the financial capability to bear such risks (as indicated in the 2016 Discussion Draft on Profit Split, para 9<sup>16</sup>) is needed. In this regard, it seems relevant to clarify whether and how the financial capacity to assume the relevant risks should be considered as a key element in the application of the profit split method.

For clarification of any aspect of our responses presented above please contact:

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<sup>13</sup> It can be difficult to determine the relative value of the contribution that each of the associated enterprises makes to the controlled transactions [...]. The determination might be made by comparing the nature and degree of each party’s contribution of differing types [...] and assigning a percentage based upon the relative comparison and external market data. See Discussion Draft, para 36 (Emphasis added).

<sup>14</sup> Except in circumstances where the total activities of each of the parties are the subject of the profit split, the financial data will need to be segregated and allocations made in accordance with the accurately delineated transaction(s) so that the profits relating to the combined contributions made by the parties are identified. See Discussion Draft, para 42 (Emphasis added).

<sup>15</sup> Where a party contributes to the control of economically significant risk, but that risk is assumed by the other party to the transaction, this may, in some cases, demonstrate that it is appropriate for the first party to share in the potential upside and downside associated with that risk, commensurate with its contribution to control. See Discussion Draft, para 24 (Emphasis added).

<sup>16</sup> In accordance with the guidance in Section D of Chapter I, such an outcome would only be consistent with the accurate delineation of the actual transaction in cases where the economically significant risks associated with the outcomes of the business activities are controlled, either separately or collectively, by the parties sharing in the actual profits, and each party has the financial capacity to assume its share of the risks. See Public Discussion Draft, Revised Guidance on Profit Splits, 04 July 2016, para 9 (Emphasis added).