StudioBiscozziNobili
Legale ~ Tributario

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Sent via email to: TransferPricing@oecd.org

To the attention of Mr. Andrew Hickman – Head of Transfer Pricing Unit, centre for Tax and Policy Aministration

Dr. Com. Luigi Biscozzi
Dr. Com. Carlo Garavaglia
Prof. Avv. Raffaele Nobili
Dr. Com. Giorgio Silva

Avv. Marco Baglioni
Dr. Com. Aldo Bisioli
Avv. Gianluca Boccalatte
Avv. Eugenio Briguglio
Dr. Com. Oliviero Cimaz
Dr. Com. Enrico Colombo
Avv. Giancarlo Cortese*
Dr. Com. Andrea Di Bartolomeo
Dr. Com. Massimo Foschi
Dr. Com. Luigi Garavaglia
Dr. Com. Emilio Gnech
Dr. Com. Marco Lanza
Dr. Com. Giancarlo Malerba
Dr. Com. Francesco Nobili
Dr. Com. Marco Piazza
Dr. Com. Franco Pozzi
Dr. Com. Fabio Fiorentino
Dr. Com. Federico Innocenti
Dr. Com. Piera Tula

Dr. Nadia Corti
Dr. Roberta D'Angelo
Dr. Matteo Cauteruccio
Dr. Com. Elisa Fiandaca
Avv. Roberta Pierantoni
Avv. Barbara Silva
Dr. Com. Roberta Sironi
Dr. Com. Andrea Spinzi
Dr. Com. Lisa Vascellari Dal Fiol
Dr. Cristiana Visco
Dr. Com. Marco Zanetti
Dr. Com. Simona Zangrandi
Dr. Anna Zullo

Consulenti
Avv. Maurizio Busecchian
Avv. Emilio Zecca

* Solicitor of England and Wales, non-practising

Associazione Professionale
Corso Europa n. 2
20122 Milano
Tel. 02 76 36 931
Fax 02 78 01 46, 02 76 36 93 45, 02 76 01 51 78
nome.cognome@slta.it
www.biscozzinobili.it
C.F. e P. IVA 12607090151

Re: Comments on "BEPS ACTION 10: DISCUSSION DRAFT ON THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAIN"

Studio Biscozzi Nobili (SBN) is pleased to provide comments on "BEPS ACTION 10: DISCUSSION DRAFT ON THE USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAIN".

SBN commends the work that the OECD has undertaken to date in relation to the BEPS Project, and offers its assistance in support of its further efforts.

SBN appreciates the opportunity to further invest in the process and further assist the WP6 by presenting or clarifying our views and comments, if necessary, on the proposed changes to the Transfer Pricing Guidelines.

Introduction

The ACTION 10 Discussion Draft addresses the issues deriving from the application of the Profit Split Method (PSM) with the aim to assure that transfer pricing outcomes are in line with value creation.

Key criteria for applying the PSM is demonstrating the level of aggregation among the different legal entities involved in the transaction. Therefore, the PSM is generally used when transactions are so interrelated in a way that cannot be evaluated on a separate basis.

Generally, the PSM relies on the characterisation of functions, risks, and assets according to which 'routine' functions are distinguished from non-routine functions. In practice, more often than not, key management with strategic decision power are deemed more relevant than other factors.

The allocation of profit is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled parties, each performing functions similar to those of the various controlled entities engaged in the relevant business activity.

Due to the heterogeneous nature of Multinational Enterprises (MNEs) and the lack of comparability, the problem of allocating profits based on the arm's length principle has become more relevant. As a consequence, the contribution made by each party to the transaction, determined on the basis of a division of functions performed, has become an objective exercise difficult to justify in the absence of external comparable data.

In this context, the objective of the Discussion Draft is to obtain views on how the current guidance may be amended so that transactional profit splits can assure that transfer pricing outcomes are in line with value creation.

The Discussion Draft covers the following main topics in relation to the use of profit splits:

1. Value chain.
2. Scope for the application of the PSM in certain situations, including:
    - Unique and valuable contributions;
    - Integration and sharing of risks;
    - Fragmentation of functions; and
    - Lack of comparables.

3. Aligning taxation with value creation when:
    - Hard-to-value intangibles are involved in the transaction;
    - Dealing with ex-ante/ex-post results; and
    - Dealing with losses.

This document is divided into three parts according to the three main topics mentioned above, addressed in the Discussion Draft.

Comments

<u>Value chain</u>

The Discussion Draft states that in certain situations the use of transactional PSMs may be a better way to address the specific features of global value chains than one-sided transfer pricing methods. Global value chain is defined as the "*full range of firm's activities, from the conception of a product to its end use and beyond*".

Scenario 1 describes a situation where there is a high level of co-operation and interdependence between the Original Equipment Manufacturers (OEMs) located in several European countries involved the production of durable goods.

The interrelation is mainly engendered by an over-arching Leadership Board consisting of senior managers from each OEM. The Leadership Board is responsible for taking decisions that ultimately drive the business toward the development of new products and components by each OEM.

Given the facts and circumstances of the case, it is thought that transactional profit split methods may provide a useful solution to this scenario. In particular, the application of a residual PSM (that would also take into account the routine functions performed by the OEMs) it is thought to be suitable.

From a procedural point of view, a key initial step when applying the PSM would be to identify the key intangible assets that underlie the generation of the "main profits" of the business. A second step, would be the identification of the management responsible for taking important decisions capable of drive the business forward and especially in which country this contribution takes place.

In this context, the allocation factors would likely include the costs of the Leadership Board (hereinafter referred to as LB) and the personnel involved in the management and planning activities. In particular, the personnel costs to be considered are those of the individuals who take strategic decisions in relation to the technology know-how and product improvement.

The allocation keys mentioned above, however, should not include the costs of the more junior staff receiving directions from the heads of the departments concerned. This is because the know-how is developed through the experience of more senior staff who is able to convert it into strategic decisions.

On the other hand, the role of the LB shall be quantified in a way not to limit its effect on the pure costs of the senior staff: the impact of the skills and capability of the LB on the whole business and more specifically on the success of the local entities of the OEM varies depending on different factors.

In particular, when a local entity is opened and starts up its activity in a new jurisdiction, the LB role is usually emphasized vs. the role of the local management.

At the same time, when a local entity increases significantly its turnover for reasons different from local or external factors, and the increase is not consistent with the turnover average of the other local entities, it might occur that LB has suggested or advised to introduce new factors of success in the value chain.

Other allocation factors that may be considered are the research and development costs incurred to develop new products and components, together with the costs of depreciation and of consumables, or the production capacity which reflects the capital invested by each OEM.

From a comparability perspective, it would be important to further examine the features of the other functions performed by the OEMs so as to understand whether external comparable data, for the routine functions performed, can be found.

In this context, it may be beneficial to receive further guidance on scenarios where differences between the controlled and uncontrolled transactions can still deemed reliable, therefore applying a more flexible approach. For example, considering differences in time/period, geographic location (assuming that accounting practices are similar) and so on, comparability may still be established.

Furthermore, it may be useful to receive further guidance on a possible reasonable allocation formula that may be used in situations where it is not possible to allocate costs, income, and assets directly based on factual relationships and due to lack of comparability.

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Scenario 2 involves an internet services provider with subsidiaries located in various countries providing technical know-how to the parent company, which owns the trademark and perform the R&D functions, around product development and customisation to reflect local market features.

Based on the fact-pattern set out in Scenario 2, the technical know-how provided by the subsidiaries, may be deemed routine in nature. Therefore, it may be essential, to further investigate to what extent, the functions performed locally create or add value to the transaction.

Conversely, assuming that the functions performed locally are unique and therefore a PSM may be appropriate, it should be beneficial to receive guidance on how the profit can be split when subsidiaries are deemed "digital" permanent establishments of the parent company. In this context, it may be useful to identify relevant factors needed to establish when a "digital" permanent establishment or presence is found to exist.

In this scenario, it should also be important to understand where the profits are earned. More specifically, whether they are earned in the hands of the parent company (i.e. where the technology is developed); where customers are located; or, where the servers are based.

Again, the main focus should be on headquarter functions that generate additional profits (business clients portfolio via cross selling strategies, key factors of the product, glocal marketing campaigns) rather than on functions that, being centralized in the parent company site, allows cost saving to the Group.

Scope for the application of the PSM

This section focuses on the appropriate scope for the application of transactional PSMs.

Based on the 2014 Report "Guidance on the transfer pricing aspects of intangibles", contributions that constitute a '*key source of competitive advantage for the business, and create difficulties in terms of finding reliable comparables*' can be defined as unique and valuable.

One of the situations described in the Discussion Draft (Scenario 3) involves a party (Company S) responsible for selling the equipment produced within the group and carrying out marketing activities. Scenario 3 recognises Company S not merely as a "routine" distributor, but as a source of competitive advantages derived from the customer services and after sales activities which entails developing close relationships with customers.

As high value-added activities/services usually incorporate know-how intangibles, which are reflected in the compensation of the individuals performing those functions, the level of interdependence between group profitability and sales force know-how should be fully examined.

In this context, the analysis should focus on examining to what extent, the significant people functions (the sales force), rather than the risks assumed by the parties, represents a source of competitive advantage therefore giving scope for the application of a PSM. In particular, it should be further examined how the professional qualifications and technical know-how of the sales force, contribute to generate revenues for the group.

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The Discussion Draft describes a situation where an MNE group, operating as a supplier of office stationary to customers with regional activities, has operating companies located in several countries that generate business for each other.

In this case scenario, it is thought that the use of the PSM may not be as appropriate as in other cases. In fact, the interrelation created by the operating companies generating business to each other, may be compensated with a commission based on the profits earned by the related party from the business that has been passed on.

Aligning taxation with value creation

Aligning taxation with value creation is the focus of the BEPS project. The Discussion Draft illustrates considerations for developing profit allocation keys such that transfer pricing outcomes are aligned with value creation.

The problem arises when the allocation factors utilised are not objectively perceived and, therefore, do not reflect what third parties would have agreed upon. In this respect, a possible guidance should identify a (non-exhaustive) list of key factors divided per industry or sector.

The following list identifies examples of allocation keys per industry:

- Luxury: Sales promotion; Marketing and Advertising
- Automotive: Production capacity; Value of production; Headcount
- Pharmaceutical: R&D
- Consumer product: Marketing and Advertising; Digital investment (e-commerce), if any.

The list of allocation factors to be included in the OECD Guidelines, should be non-exhaustive in nature so that the taxpayer should be able to select allocation keys not listed therein, if properly justified, that better fit each particular case.

In addition, developing a framework for conducting profit split analysis to situations where more than one factors is likely to be utilised, it is thought to be too restrictive for taxpayers.

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In relation to hard to value intangibles, the Discussion Draft recognises the difficulty in using transactional profit split approaches based on the cost of the contributions made by the parties.

In practice, when intangible property development expenditures have been relatively constant over time and the estimated life of the intangible property is known, the amount of actual costs incurred in the recent years for example, may be used to estimate the relative value of non-routine intangible property contributions.

Conversely, when there is little relationship between costs and value of contribution made by each party deriving from fluctuating expenses incurred, the PSM is not considered to be as reliable as other transfer pricing methods.

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The Discussion Draft describes a scenario involving a banking group carry on trading activities. This scenario considers whether profit split methods may be applied in a different way when there are losses to split instead of profits.

In practice, there are circumstances under which it might be appropriate to vary the application of splitting factors depending on whether a profit or loss has incurred. For instance, in the presence of proprietary trading transactions when using the hedge fund model to split profits/losses.

The hedge fund model on proprietary trading transactions is usually implemented using a 75% / 25% split of the total positive return and, 100% / 0% of the total negative return.

The 75% of the total positive return of the managed portfolio is allocated to the risk taker, i.e. the legal entity which is the provider of capital (usually the booking legal entity); and 25% of the total positive return is allocated to the provider of "human capital", i.e. the group that manages the bank's own investment exposure, the trader employing legal entity.

In case of losses, 100% / 0% of the total negative return is split as allocating 100% of the total negative return of the managed portfolio to the risk taker, i.e. the provider of capital and, 0% is allocated to the trader. The latter, will not suffer from the loss incurred due to the transaction failure, however, will suffer from not having remunerated the costs incurred for the activity performed.

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Finally, it may be beneficial to receive guidance on the possible weight given to the use of internal data for the recognition of contribution made by each party to the transaction, for example, with regard to information taken from the company's management information systems.

Yours truly,

Franco Pozzi
Marco Abramo Lanza
Roberta D'Angelo