STUDIO
BISCOZZI NOBILI
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To Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

Dr. Com. Luigi Biscozzi
Dr. Com. Carlo Garavaglia
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
Avv. Alessandro Dubini
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
Avv. Enrico Valerio

Dr. Com. Fabio Fiorentino
Dr. Com. Federico Innocenti
Dr. Com. Piera Tula

Avv. Chiara Baldi
Dr. Grazia Biancofiore
Dr. Matteo Bianchi
Avv. Maurizio Busecchian
Avv. Gaia Chifari
Avv. Nadia Corti
Dr. Roberta D'Angelo
Dr. Com. Raffaella Di Foggia
Dr. Com. Elisa Fiandaca
Dr. Martino Filippi
Dr. Matteo Formenti
Avv. Filippo Frabasile
Dr. Matteo Meli
Dr. Com. Fabrizia Orsillo
Avv. Roberta Pierantoni
Dr. Com. Roberta Sironi
Dr. Com. Andrea Spinzi
Dr. Com. Lisa Vascellari Dal Fiol
Avv. Cristiana Visco
Dr. Com. Marco Zanetti
Dr. Com. Simona Zangrandi
Avv. Anna Zullo

Consulenti
Prof. Avv. Fabrizio Guerrera**
Avv. Emilio Zecca

* Solicitor of England and Wales, non-practising
** Ordinario di Diritto Commerciale

Re: Comments on "BEPS ACTION 8 – 10: REVISED GUIDANCE ON PROFIT SPLITS"

Studio Biscozzi Nobili (SBN) is pleased to provide comments on the public discussion draft "*BEPS ACTION 8 – 10: REVISED GUIDANCE ON PROFIT SPLITS*" (the "*Draft*").

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 (the "*Guidelines*").

Preliminary remarks

The Draft addresses the issues deriving from the application of the transactional Profit Split Method (PSM) and the review of the 2010 Guidelines in respect thereof after the *Discussion Draft on the use of profit splits in the context of the global value chain*, aimed at identifying criteria for the PSM application assuring that transfer pricing outcomes are in line with value creation.

In our practical experience, the application of the PSM has became a key issue of Italian tax practice over the last couple of years not only from a transfer pricing perspective, but also in relation to the introduction of a Patent Box regime (on election basis) in the Italian Tax system; therefore, views and

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

proposals included in the Discussion Draft are welcome and a final consensus of the 2010 Guidelines is appreciated in the due course.

Before dealing in detail with the Draft and questions to commentators from WP6, it is worth noting that, our feeling about the proposed changes to PSM Guidelines is positive considering that:

- the Draft includes various new paragraphs aimed at coordinating PSM with already approved BEPS Actions 8 – 10;
- moreover, various paragraphs of the Draft address in detail the key issue of the "*most appropriate method to apply to controlled transactions*", clarifying that a lack of comparables alone is not sufficient to justify the application of the transactional PSM. We agree with the conclusion that adjustments of inexact comparables data, where possible, could result more appropriate in order to establish a reasonable transfer pricing range than the application of the PSM, that should always require transactions among two or more associated enterprises involved in activities where they share economical significant functions and risks;
- the Draft attempt to clarify different scenarios where PSM of anticipated profit is preferable to PSM of actual profit and *viceversa*, notwithstanding the uncertainties described here below.

Thus, the revised Guidelines should include additional and more detailed examples[1], as the 2010 Guidelines and the Draft are mainly based on a theoretical approach that could trigger subjective interpretations.

In other words, the revision of Chapter II of the Guidelines should include specific sector guidance, where applicable, notwithstanding the fact that each controlled transaction will maintain its specific characteristics and a correct transfer pricing analysis cannot take place without a detailed examinations of the integrated functions and value chain, risks shared, unique and valuable contributions of the associated enterprises (with reference to the "*Group synergies*" please see our further comments in the following).

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1 A starting point could by represented by examples included in *Discussion Draft on the use of profit splits in the context of the global value chain* and comments received in respect thereof.

Answers and Comments

For your convenience, the answers and comments below are numbered in accordance to the Draft.

1. In our opinion, the guidance contained in par. 2.127 of 2010 Guidelines did not clearly outline the distinction between the approach based on actual profits and anticipated profits.

   Please consider that we appreciate the (new) clear distinction proposed by the Draft. In particular, we find it very useful since it explains the substantial difference between the two approaches: "*under a transactional profit split of actual profits there is a greater sharing of the effect of uncertainty resulting from risks*" (par. 6). Paragraphs 8 and 9 deeply examine such substantial difference.

   Notwithstanding, we consider that in practice the PSM based on anticipated profits should have limited application depending on the industry involved, since it seems to trigger an uncertain way to determine compensation in a related party transaction. As explained in the above mentioned paragraphs 8 and 9 of the Draft, uncontrolled parties may try to mitigate their individual risks through, for example, variations in prices, but this generally does not result in sharing the outcomes of the business controlled by another party.

   In case an entity does not agree to participate to the future outcome of a whole business, probably the required remuneration would be a non contingent payment, which can be determined through the use of one-sided method (see par. 17 of the Draft).

   In our opinion, then, the distinction is considered useful, but the use of the PSM in the majority of cases should be based on actual profits, while anticipated profits could find application in limited cases.

   Finally we would appreciate further clarification from WP6 about the practical way of application of PSM based on actual profits: in particular, since the transfer pricing method should be applied on actual results of the controlled transaction(s), revised Guidelines should clearly state whether PSM would bring to year-end adjustments or it would imply timing differences between the collection of final data concerning the profits to be split and the final remuneration of the related parties involved in the transaction.

2. In our view, in case of high integration of functions (for which PSM may be assessed to be the most appropriate method) and continuing involvement in the business key risks of all the parties involved in the controlled transaction, the approach to be used should be based on actual profits, since it is the only way through which each party involved in the transaction can participate to the future outcome of the common business.

3. The below examples show the practical use of actual profits:

   - new brand development: brand owner and licensee would both perform marketing, advertising and promotion activities, take the strategic decisions and bear the related risks; consequently, both of them are supposed to participate to future outcomes of the brand. Under this scenario the use of anticipated profit to determine the compensation of brand owner would lead to results not in line with the arm's length principle;
   - software development: different parts of a potentially successful and innovative software are developed by different parties. Related entities are strategically linked and they cannot work without the other parties; in this case all the parties are expected to participate to the outcomes of the whole business on actual basis.

   The example below shows a practical use of anticipated profits:

   - in our opinion the PSM based on anticipated profits may have limited application. Notwithstanding, we can consider R&D activities concerning a new product where at first stage (research) is remunerated with non-contingent payments, based on anticipated profits of the business. Since a party involved in the first stage research will not bear the risks related to the subsequent development of the product (and cannot control the related risks), it does not seem appropriate that it participates to the (positive or negative) uncertainty of the future economic and financial outcomes of the final product. At the same time, the selection of PSM as the most appropriate method could be justified by the fact that the contribution is unique and valuable: the party that performed the first scientific discovery could be reasonably compensated through a payment based on the expected results of the whole business, but it would not accept a compensation based on risks subsequently controlled by other parties. In such situation, PSM on anticipated profit could represent the appropriate way to determine arm's length remuneration.

4. In our opinion, strengths and weaknesses of the PSM are well outlined and they are substantially in line with the 2010 Guidelines. Moreover, the Draft, better clarifies situations in which PSM would not be appropriate, in order to prevent "*profit-split abuse*".

5. The two different approaches in principle share the same strengths and weaknesses. Thus, PSM based on anticipated profits is more discretional since it requires projections of future flows (income or cash flows) related to an integrated business; in our opinion, the use of such approach would be recommended only in presence of the following conditions:

   - consolidated and stable market trends;
   - consolidated performance of the entities/business under analysis;
   - reliable projections of future trends and results (sales, working capital changes, etc ..);
   - no start-up phase and stable investments (we suppose this additional condition is consistent with the Draft, since par. 2.123 of 2010 Guidelines has been deleted).

   Consequently, one additional weakness of anticipated profits approach is that it could lead to misleading and not accurate results (unless the above conditions are met) and – therefore – it might be inconsistent with the strengths outlined in par. 13 of the Draft (par. 2.113 of 2010 Guidelines).

6. In our opinion, it should be clarified and stressed the fact that risk sharing means the possibility to exercise control over the relevant business risks, decision making and financial capacity of controlling the relevant risks. The valuation of PSM as the most appropriate method cannot be limited only to the presence of integrated functions or unique and valuable contributions; the level of risk sharing can be broadly based on the possibility – and capacity – of affecting / influencing / controlling the relevant key / strategic drivers of the business. Consequently, PSM should be applied only in cases where two or more related parties actually share relevant continuing risks of a common business.

The Draft is also helpful to clarify the circumstances where PSM is considered the most appropriate method, in particular it is very helpful in clarifying that the use of profit split cannot be justified by the mere lack of exact comparables. In this regard, Par. 18 seems very reasonable as it formalised a concept long discussed.

As an example, we can refer to Scenario 3 included in the Discussion Draft on the use of profit splits in the context of the global value chain[2]: it would be useful to clarify if in such a case WP6 and / or commentators consider PSM or adjustments to a one-sided method as the most appropriate transfer pricing approach.

7. In our opinion the anticipated profits approach <u>necessarily</u> requires the use of financial valuation techniques, since future outcomes of a combined business must be estimated. In other words, business plans or projections of financial data are required; consequently, such approach should only be used in presence of: (i) reliable provisions of future flows; (ii) market stability; (iii) consolidated industry trends; (iv) no start-up businesses (see also above answer no. 5 about weaknesses of anticipated profits approach). In case reliable consolidated entities' trends and reasonable assumptions for future trends are not available, different valuation techniques might be used (e.g. sectors / industry multiples).

   In our opinion the most useful valuation technique is the "Discounted Flow" model, either based on economic profits or on cash flows. We hold that a profit split based on anticipated profits with the use of future cash flows

[2] A party (Company S) is 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.

projections would be appropriate only in the case the entity being compensated with anticipated profit accept to share the financial risks of the business.

8. Yes, the distinction is useful and it is consistent with par. 18 of the Draft (no use of PSM for the mere absence of exact comparables).

9. In our opinion, the concept of parallel integration is sufficiently clear; however, additional examples could be useful to further clarify the definition.

10. In our opinion, Guidelines should better clarify the fact that in order to use the PSM as most appropriate method the risk sharing must exist over the whole life of a product.

    In this respect, a substantial statement is included in par. 10 of the Draft: *"However, a key indicator for the appropriateness of a profit split of actual profits is that the parties continue to share in the outcomes of the business activities and the risks associated with those subsequent outcomes. It would be contrary to the guidance in Section D of Chapter I to apply a transactional profit split of actual profits where the functional analysis demonstrates that one party does not exercise any degree of control over those risks, since to do so would assign to that party the impact of risks it does not control".*

    In our opinion, then, in a deal between independent parties, no one would enter in an agreement where the remuneration would be based on risks that are controlled by another party.

    On the other side, if one of the party bears significant risks, but related to one stage only of the value chain, it would probably require to be compensated through a non-contingent payment and would not accept to bear risks of subsequent stages. In such situations, even though the contribution of the party asking a non-contingent compensation is unique and valuable, PSM may not be the most appropriate method, or it could be used through the anticipated profits approach. This seems to be consistent with the scenario described in paragraph 17 of the Draft.

11. As already anticipated, in our opinion if one of the party involved bears risks related to only one stage of the value chain, it would not accept a compensation based on future outcome of the whole business, even though

its contribution is unique and valuable. In this regard, more guidance should be provided to clarify when the contribution of a party is unique and valuable, but the risks borne it is limited to one stage of development of the business, and as a consequence other methods could be applied. For example, depending on the industry under consideration, when the value chain can be split in a number of subsequent steps that lead to a finished product, they can also be seen as independent from the others; therefore, the party which has completed its work would not accept to be exposed to uncertainty of future stages.

12. Our understanding of the Draft is that the WP6 intends to avoid the use of PSM for the mere presence of group synergies. In other words, group synergies are factors to be allocated to the MNE group parties in a manner similar to the allocation of costs of share services.

    The first step is to determine the incremental / marginal benefit of group synergies, and the subsequent step is to identify proper allocation keys. We appreciate the intention to simplify the analysis (a different approach would lead to a wider use of profit split), but it seems difficult and very discretionary to calculate the incremental or marginal advantage / disadvantage deriving from group synergies. In addition, we are not in the condition to understand the real effect of such approach. We are not sure that group synergies should be compensated in any case. We think a very useful distinction is the one proposed in paragraph D.8 of BEPS Actions 8-10 Final Report between incidental benefits and deliberated group actions. We think that only in this latter case (deliberated actions) synergies could be reliably measured and consequently compensated.

13. We hold the section properly describes the use of value chain analysis as a tool for delineating the actual transaction and its key features and consequently in determining the most appropriate transfer pricing method.

14. We agree about the fact that value chain analysis is a useful tool in determining the most appropriate transfer pricing method. However, in our opinion, value chain analysis must be a substantial part of functional analysis, since the identification of the key drivers of value is an important step in order to assure that prices are in line with value creation.

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Some final comments are requested in respect to paragraph C.4. of the Draft in respect to the "*Guidance for application*" of the PSM.

Paragraph 31 and following of the Draft seem not to be materially different from the 2010 Guidelines and clarification set forth in paragraph 40 about the measure of profits to be split (gross or operative profit) sounds reasonable and consistent with practice already adopted in the past, since PSM shall trigger transfer pricing outcomes aligned with value creation and risk borne by the various entities of the MNE.

Moreover, as already stressed in our comments to the Discussion Draft on the use of profit splits in the context of the global value chain, material issues arise when the allocation factors utilised are not objectively perceived and, therefore, it is uncertain what third parties would have agreed upon. Again, we recommend that a possible guidance should identify a (non-exhaustive and non binding) 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;
- Software development: Direct cost of employees and external counsels
- Consumer product: Marketing and Advertising; Digital investment (e-commerce), if any.

The list of allocation factors to be included in the 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.

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Finally, we also suggest that WP6 explicitly addresses in the revision of the 2010 Guidelines situations where associated enterprises consistently realizes losses while the MNE group as a whole is profitable (i.e. situations dealt with in Chapter I of the revised Guidelines, par. 1.129 – 1.131). More in detail, we recommend that further clarification are included in the revised Guidelines in cases dealt with paragraphs mentioned above, where a loss making business (to be identified in different ways, products, geographical ares, etc ...) should be allocated among the entities that could (indirectly) benefit through the application of PSM, notwithstanding the fact that one sided method could be the preferable criteria for the identification of the ordinary compensation of the related entities.

Moreover, it is worth noting that in the "*Discussion Draft on the use of profit splits in the context of the global value chain*" it has been described a scenario involving a banking group carry on trading activities and discussions whether profit split methods may be applied in a different way when there are losses to split instead of profits. We are of the opinion that 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 (see additional detail in our comments of February 5, 2015).

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Truly yours,
Franco Pozzi
Lisa Vascellari Dal Fiol Lisa Vascellari Dal Fiol