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cc	Stephen Blough, KPMG in the U.S.		

Comments on Discussion Draft: Revised Guidance on Profit Splits

Professionals in the member firms of KPMG International ("KPMG") welcome the opportunity to comment on the Organisation for Economic Co-operation and Development ("OECD") Discussion Draft titled *BEPS Action 10: Revised Guidance on Profit Splits* (the "Discussion Draft").

The Discussion Draft is fourth in a series of documents[1] from the OECD addressing revised guidance on the transactional profit split method ("TPSM") discussed in Chapter II of the OECD Transfer Pricing Guidelines. The OECD received numerous comments from the public on the earlier documents, and it is clear that the Discussion Draft has tried to address some of those comments. For example, the discussion on parallel and sequential integration, which many commentators had questioned, is excluded from the Discussion Draft. The Discussion Draft takes a more balanced view of the TPSM, for instance, noting the *relative* reliability of the selected method over other methods. As another example, much of the discussion on anticipated versus actual profit splits that commentators had questioned as overly prescriptive has been revised or eliminated.

KPMG commends the OECD for its effort on the profit split guidance and recognizes how far the draft has advanced in the few years since the OECD first started working on the revisions. KPMG appreciates the openness of the OECD to comments on the earlier drafts on the TPSM and the improvements it has made to those earlier drafts. Nonetheless, we still have concerns on several key issues.

KPMG's comments on the Discussion Draft are presented below.

Summary of Comments

We first start with some general comments on the Discussion Draft, then go on to discuss the examples in the Discussion Draft in greater detail, and end with our comments on the three questions the OECD posed to commentators in the Discussion Draft.

KPMG has the following general comments on the Discussion Draft, which are discussed in greater detail in the sections below:

- The Discussion Draft would benefit from a clearer linking of the profit split guidance to the guidance previously provided in Chapter I of the OECD Transfer Pricing Guidelines ("Chapter I") on the role of contracts in determining the allocations of risk in a controlled transaction.
- We recommend that the OECD guidance reaffirm in Section C.2.2 (Nature of the Transaction) of the Discussion Draft the principle that the most appropriate method should be selected for evaluating the arm's length pricing of a transaction.

[1] The previous three are (i) *BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains*, December 16, 2014, (ii) section on *Scope of Work for Guidance on the Transactional Profit Split Method* in *Actions 8-10: 2015 Final Reports on Aligning Transfer Pricing Outcomes with Value Creation*, October 5, 2015, and (iii) *BEPS Actions 8-10: Revised Guidance on Profit Splits*, July 4, 2016.

- Section C.5 of the Discussion Draft provides general principles for the determination of profit-splitting factors. We recommend that the OECD include as a principle that the profit-splitting factors chosen should be in alignment with the guidance in Chapters I and VI[2].
- Annex I to the Discussion Draft, which contains ten examples to illustrate the guidance on the TPSM, is new to the OECD guidance on profit splits. KPMG believes that the examples should reflect the principles laid out in the Discussion Draft more clearly. In addition, we recommend that the OECD include an example to illustrate the principle that the TPSM should generally also apply, and apply in the same way, regardless of whether the transaction(s) result in a relevant profit or loss.

We discuss each of these issues in greater detail below.

Role of contracts

The Discussion Draft would benefit from a clearer linking of the profit split guidance to the guidance already provided in Chapter I on the allocation of risk. Chapter I of the OECD Transfer Pricing Guidelines provides a six-step framework for analyzing risk in a controlled transaction in order to accurately delineate the actual transaction. Under this framework, the contractual allocation of risk is respected unless the parties' conduct is inconsistent with the contract.

The sharing of risks plays a prominent role in the discussion on the appropriateness of profit splits in the Discussion Draft. The Discussion Draft, however, makes just one reference to contracts—more than halfway through the Discussion Draft, in paragraph 46.[3] Since contracts are a starting point for the determination of whether and how risks are shared, we believe that it is important for the OECD to clearly articulate that the profit split guidance is intended to follow the Chapter I guidance on the role of contracts.

For instance, paragraph 24 of the Discussion Draft reiterates the guidance in paragraph 1.105 of the OECD Transfer Pricing Guidelines that "[w]here 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." It does also note that the "mere fact that an entity performs control functions in relation to a risk will not necessarily lead to the conclusion that the transactional profit split is the most appropriate method in the case." However, we believe that the guidance should make a stronger statement on respect for contractual terms when such respect for contracts is consistent with the Chapter I guidance in order to make clear that paragraph 24 does not necessarily support an application of a profit split whenever multiple parties control the risk. In other words, where multiple parties control risk, the profit split guidance should make clear that the contractual allocation of risk to one or more of those parties will be respected, as stated in paragraph 1.94[4] of the OECD Transfer Pricing Guidelines, and the evaluation of the TPSM as the most appropriate method should factor in the contractual allocation of risk. If the contract does not specify a sharing of risks between the parties even though both parties control the economically significant risks, a tax authority or taxpayer should not be allowed to assume the sharing of risks in contradiction to the contract and select the TPSM as the most appropriate method based on an inference of shared risks. The distinction between a split of actual profits and a split of anticipated profits is important in this respect as they may correspond to significantly different allocations of risk between the parties.

For instance, it is common for multiple entities to collectively control economically significant risks through their membership in global committees within the multinational group. It is possible that the intercompany arrangement in place allocates risks to all the entities controlling the risks, in which case

[2] All references to "Chapter VI" in this document refer to Chapter VI of the OECD Transfer Pricing Guidelines.

[3] Paragraph 46 of the Discussion Draft states "Additionally, it should be remembered that the starting point in the delineation of any transaction will generally be the written contracts which may reflect the intention of the parties at the time the contract was concluded."

[4] Paragraph 1.94 of the OECD Transfer Pricing Guidelines states "Furthermore, in some cases, there may be more than one party to the transaction exercising control over a specific risk. Where the associated enterprise assuming risk …controls that risk…, all that remains…is to consider whether the enterprise has the financial capacity to assume the risk. If so, the fact that other associated enterprises also exercise control over the same risk does not affect the assumption of that risk by the first-mentioned enterprise…"

there is a sharing of economically significant risks and the TPSM may be an appropriate method for evaluating the arm's length pricing between the relevant entities. Alternatively, the intercompany contract may assign the economically significant risks to one of the parties to the transaction. In this case, it would not be reasonable to assume shared risks or to split actual profits as if risks were shared, ignoring the risk allocation embodied in the intercompany contract.

Without a clearer reaffirmation of the Chapter I guidance on the role of contracts, the Discussion Draft may lead some to argue for a TPSM more often than is warranted.

Reaffirmation of the Principle of Selecting the Most Appropriate Method

As the Discussion Draft notes, "the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case",[5] and the selection of the most appropriate method should take into account "the *relative* appropriateness and reliability of the selected method as compared to other methods which could be used."[6] The Discussion Draft discusses the strengths and weaknesses of the TPSM as well as the nature of transactions where a TPSM may be potentially applicable.

The Discussion Draft describes three types of transactions in Section C.2.2 where the TPSM may be appropriate – (i) transactions where both parties make unique and valuable contributions, (ii) transactions involving highly integrated business operations, and (iii) transactions with shared assumption of economically significant risks (or where the parties separately assume closely related risks).

While we understand that the OECD's intent is to provide guidance on certain situations where the TPSM may be applicable, the guidance should reaffirm the principle of selecting the most appropriate method in its discussions of the three types of transactions listed above. In particular, the discussion of highly integrated business operations in Section C.2.2.2 should acknowledge that highly integrated business operations need not lead to the selection of the TPSM as the best method.

The second sentence in paragraph 19 of the Discussion Draft makes an absolute statement that a "*high degree of integration* means that the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with, and cannot reliably be evaluated in isolation from, the way another party to the transaction performs functions, uses assets and assumes risks." The following sentence states that "[i]n contrast, many *instances of integration* within an MNE result in situations in which the contribution of at least one party to the transaction can in fact be reliably evaluated by reference to comparable uncontrolled transactions." (emphasis added).

The phrasing in the two sentences seems to imply that whereas in many instances of integration the TPSM may not be the most appropriate method, where there is a "high degree" of integration, the TPSM will be the most appropriate method. We disagree with this implication and believe that the second sentence in paragraph 19 should be revised. The term "high degree of integration" is subjective—what one tax authority or taxpayer considers a high degree of integration may be different from what another thinks is a high degree of integration. The guidance could then, in practice, be taken to mean that the TPSM will be the most appropriate method for a range of integration. More importantly, we do not agree that a high degree of integration will always lead to a TPSM, as it is only one amongst a variety of relevant factors. Finally, the selection of the TPSM as the most appropriate method cannot be made without comparing its reliability to the reliability of other potential methods under the specific facts and circumstances of the transaction involved.

Therefore, we recommend that the OECD either delete the second sentence of paragraph 19 or revise it and the following sentence as follows: "A high degree of integration means that the way in which one party to the transaction performs functions, uses assets and assumes risks is closely interlinked with the way in which another party to the transaction performs functions, uses assets and assumes risks. Many such instances of integration within an MNE result in situations in which the contribution of at least one party to the transaction can in fact be reliably evaluated by reference to comparable uncontrolled transactions."

[5] Paragraph 3 of the Discussion Draft.

[6] Paragraph 5 of the Discussion Draft.

As an example of highly integrated business operations, Paragraph 21 of the Discussion Draft describes a situation where each party has made a significant contribution (e.g., of an asset) whose value depends on the counterparty to the arrangement, and treats it as an example of a situation where the TPSM may be the most appropriate method. It is not clear why the OECD considers this an example of a highly integrated business operation. For instance, if in a transaction between two related entities within a pharmaceutical manufacturer one party licenses a molecule to the other for further development into a commercial drug product, each party contributes intangible assets (the molecule and the fully developed drug) whose value depends on the counterparty to the arrangement. However, their operations need not be highly integrated since one party simply hands off the development of the molecule to the other. Even if this situation is considered an example of a highly integrated business operation, it is not uncommon to find such arrangements between unrelated parties and it may be possible to find comparable uncontrolled prices for the license, so that the TPSM may not be the most appropriate method. Consequently, we suggest that the OECD also state in Paragraph 21 that the most appropriate method given the facts of the transaction should be selected (which, as illustrated by the pharmaceutical example in this paragraph, may not be the TPSM).

Further, we believe that the OECD combines two very different circumstances in its discussion of the third situation where the TPSM may be appropriate, i.e., transactions where the parties share the assumption of economically significant risks as compared with transactions where they separately assume closely related risks. The latter type of transaction, i.e., a transaction with the separate assumption of closely related risks, is a common occurrence between independent parties when they enter into market transactions. Independent parties typically do not resort to a profit split as a pricing mechanism for their transaction and there is no reason why related parties should be more likely to do so. Thus, we recommend that the separate assumption of closely related risks not be discussed as a situation where a TPSM may be most appropriate.

The relative reliability of the TPSM will depend in significant part on the reliability of specific determinations that must be made in its application, which are discussed in Sections C.3, C.4 and C.5 of the Discussion Draft. This consideration is relevant to all aspects of application including determination of profits to be split, where reliability of segmentation is an important consideration, and selection and weighting of profit-splitting factors, discussed further below. We suggest that the OECD emphasize the importance of considering the reliability of specific implementation determinations in assessing the relative reliability of the TPSM in determining the most appropriate method in a specific case. Specifically, we recommend that the Discussion Draft clarify that cases may commonly be encountered in practice where these issues materially impair the reliability of the TPSM such that another method is most appropriate, even in cases where the TPSM might otherwise be indicated.

Selection of Profit-Splitting Factors

Fundamental to the reliability of the TPSM is the identification and weighting of profit-splitting factors that reliably correspond to the allocation of profits that would be realized between unrelated parties. Sections C.3 and C.5 of the Discussion Draft provide general principles for the determination of profit-splitting factors but do not emphasize this critical point.

In cases where a residual analysis is used and the quantum of residual profit or loss is large, the reliability of the TPSM rests heavily on the reliability of the profit-splitting approach. The Discussion Draft properly notes that profit-splitting factors should be verifiable and accurately measured but says little on principles for determining whether the profit-splitting approach reliably reflects the allocation that would be realized between independent parties. As discussed below in our answers to the OECD's questions posed, KPMG does not believe additional guidance on specific profit-splitting factors is warranted. Rather, we recommend that the OECD emphasize (1) the need to support clear alignment of the profit-splitting factors with relative contributions to value of the parties (and, in the case of multiple factors, the need to weight factors based on relevance), and (2) that subjectivity in such judgments significantly reduces the reliability of the TPSM and that should be taken into account in determining the most appropriate method.

An important principle missing from this discussion is the alignment of the profit-splitting factors with the guidance in Chapters I and VI on risk and intangibles. The OECD does state in Section C.3 of the Discussion Draft that the relevant profits to be split and the profit splitting factors should be "consistent

with the functional analysis of the controlled transaction under review, and in particular reflect the assumption of economically significant risks by at least one of the parties." We recommend that the OECD further elaborate that the profit-splitting factors chosen should be in alignment with the guidance in Chapters I and VI on the assumption of economically significant risks and transfer pricing of intangibles.

In addition, the concept of arm's-length range is equally applicable to TPSM. The Discussion Draft is currently, however, silent on this point. Where the TPSM is applied *ex-post* as a means to test the financial results of intercompany transactions, as opposed to *ex-ante* as a planning tool to determine intercompany allocations, the OECD could consider an approach whereby the weights assigned to the profit-splitting factors are systematically varied to generate multiple allocation scenarios for each participating entity, and therefore a range of arm's length results.

Examples in the Discussion Draft

Annex I to the Discussion Draft, which contains ten examples to illustrate the guidance on the TPSM, is new to the OECD guidance on profit splits. KPMG believes that the examples should reflect the principles laid out in the Discussion Draft more clearly. In particular, the examples do not shed much light on why the TPSM was selected as the most appropriate method and why the other methods were not more appropriate. The examples fail to consider the effect of contractual relationships on the assumption of risk in selecting or rejecting the TPSM as the most appropriate method (except where Example 9 Scenario B refers to an agreement to split actual profit). Further, the examples are silent on the size of the residual profit and why the chosen approach in the example is a reliable way to split profits when the residual profits are large. KPMG recommends that the OECD provide more details on the application of the profit split in the examples addressing these issues.

We discuss below some open issues in the Discussion Draft's examples that we believe the OECD should address to make the examples more useful.

- We recommend that all the examples include a discussion of the contractual arrangements between the parties to the transaction; in particular, their contractual allocation of economically significant risks. As noted above, contracts are a starting point for the determination of whether and how risks are shared, and the profit split guidance should not replace the Chapter I guidance on respect for contracts. For instance, Example 8 presents a situation where multiple related entities jointly control an economically significant risk—development risk. However, the example is silent on the contractual allocation of the development risk. Example 8 states that "the accurately delineated transaction shows that the parties share the assumption of the same economically significant risk", but does not indicate what role the contractual arrangements among the parties plays in this determination.[7] Instead, it seemingly assumes that the parties share the development risk. Under the Chapter I guidance, the joint *control* of an economically significant risk is not equivalent to a *sharing* of the risk unless the contract also specifies that the parties will share the risk. By simply assuming a sharing of the risk in the presence of joint control over the risk, Example 8 overlooks the role of contracts in the allocation of risk as specified in Chapter I of the OECD Transfer Pricing Guidelines. We believe that the OECD should include a discussion of contractual terms in every example since (i) the contractual terms are an important element of the factual background of the case, and (ii) the discussion of contractual terms in the examples will also help to reaffirm the practice of applying the six-step framework on risks in Chapter I, which considers contractual terms under step 2.
- As noted in the Discussion Draft, the choice of the most appropriate method should depend on the *relative* appropriateness and reliability of the different methods.[8] We fully agree with this principle but find that the examples do not shed light on its application. Instead, the examples generally assume the TPSM to be the most appropriate method without consideration of the other methods. We believe that the OECD could greatly improve the applicability of the examples, as well as reduce potential misapplication of the TPSM by taxpayers and/or tax administrators alike, by discussing the

[7] In general, none of the examples provide guidance on the role of contractual arrangements in the accurate delineation of intercompany transactions.

[8] Paragraph 5 of the Discussion Draft.

relative reliability of the TPSM in comparison to the other specified methods. Each example would benefit from a discussion of how the other methods were considered and why they were rejected. For instance, Example 1 presents a situation where one party takes the development of a new pharmaceutical formulation to a certain stage and then licenses its intangible property to another entity for further development and commercialization. In addition to not discussing the contractual terms of the transaction (e.g., how risks are allocated between the parties—see previous point), the example assumes that both parties make unique and valuable contributions and, thus, the TPSM is the most appropriate method. There is no discussion of why the TPSM is more reliable than the other methods, such as the comparable uncontrolled price ("CUP") method. The pharmaceutical industry, in particular, sees numerous deals between third parties in just such situations, i.e., where one party does the initial development of a pharmaceutical molecule and licenses the right to further develop and commercialize the molecule to an unrelated party. It is possible to find information on such arrangements in public databases. It is therefore unclear why the CUP method, for instance, could not be more reliable than the TPSM in Example 1. We recommend that the OECD discuss the evaluation of other methods and why the TPSM was found to be the most reliable method in each of the examples.

- The examples give the impression that whenever multiple parties make unique and valuable contributions or share in economically significant risks or engage in highly integrated operations, the TPSM will be the most appropriate method. In other words, the examples seem to imply that meeting these conditions is sufficient for the selection of the TPSM as the most appropriate method. However, as the Discussion Draft notes, the TPSM *may* be the most appropriate method in these situations—which by no means implies that the TPSM will be the most appropriate method whenever these conditions are met. In fact, the Discussion Draft clarifies that the "presence or absence of one or more of the indicators [described in this section] will not necessarily lead to the conclusion that the transactional profit split method will (or will not) be the most appropriate method in a particular case."[9] The two examples where the TPSM is not selected as the most appropriate method (Examples 4 and 6) assume that one of the parties does not assume economically significant risks, does not make unique and valuable contributions, and is only integrated with the other party to a limited degree. These two examples do nothing to allay the impression that the three conditions are sufficient conditions for application of the TPSM. We recommend that the OECD include examples where both parties make unique and valuable contributions, or assume economically significant risks, or have highly integrated operations but the TPSM is not the most appropriate method to make it clear that these conditions are not sufficient for the application of the TPSM.

- Several examples assume unique and valuable contributions and, therefore, apply the TPSM as the most appropriate method. However, it is unclear from the examples why the contributions are considered unique and valuable. In fact, the examples relying on unique and valuable contributions as a basis for applying the profit split present commonplace situations where the contributions might not be unique and valuable. We have already discussed Example 1 above, where while the intangibles of Company A are likely valuable, it is also common to find similarly situated third parties entering into arrangements to license just such intangibles. Several examples[10] assume that the marketing and distribution activities of a party are unique and valuable or lead to the assumption of economically significant risks. For instance, Example 3 notes that the distribution activities of Company B are a key source of economic advantage over competitors. In particular, "Company B has developed a sophisticated algorithm to get feedback from customers on the performance of their products."[11] Since many distributors have mechanisms for obtaining feedback from customers, it is unclear why Company B's algorithm is a distinguishing value driver. By not clearly articulating why a contribution is unique and valuable, the Discussion Draft runs the risk of encouraging an application of the TPSM in situations where other methods may be more appropriate (see also earlier comments on selection of the most appropriate method). We suggest that the OECD develop the factual

[9] Paragraph 30 of the Discussion Draft.

[10] See, for instance, Example 2 and Example 3 of the Discussion Draft.

[11] Paragraph 80 of the Discussion Draft.

background of the examples further, clearly tying the selection of the most appropriate method to the facts of the case.

- We recommend that each of the examples in which the TPSM is selected as the most appropriate method include an affirmative statement that sufficient information is available to reliably determine the profits to be split and the relative value of each party's contribution, thereby emphasizing the importance of such issues in determining the relative reliability of the TPSM.
- Paragraph 2 of the Discussion Draft notes that the TPSM should generally also apply, and apply in the same way, regardless of whether the transaction(s) result in a relevant profit or loss. We generally agree and recommend that the OECD include an example to illustrate this principle. We do note, however, that while the TPSM should be used consistently, the way certain allocation keys are used and measured may need to vary in the case of profits versus losses. For instance, employee bonuses may be positively correlated to the contribution made to generating a profit but negatively correlated to the contribution made to generating a loss. In other words, a bank may give higher bonuses to the traders who have produced a larger profit or a smaller loss. In such a case, if we applied the profit split in the same manner to profits and losses, we would rightly attribute a larger share of the profit to the employees who had higher bonuses but would wrongly attribute a larger share of the loss to the traders who had larger bonuses. This does not mean, however, that either MNEs or tax administrations should be permitted to apply inconsistent methods in profit and loss situations. For example, neither MNEs nor tax authorities should be permitted to selectively apply a profit split to years in which there are combined profits for tax purposes and apply the transactional net margin method to years in which there are combined losses.
- The examples are primarily focused on the selection of the TPSM as the most appropriate method and less so on the application of the TPSM. As noted above, data issues may materially impair the reliability of the TPSM such that another method is most appropriate. The examples would add greater value if they discussed data reliability and illustrated the application of the TPSM based on the principles laid out in the Discussion Draft. For instance, how is the nature of profit to be split (operating profit, gross profit, or another measure) chosen, how is a contribution analysis applied in comparison to a residual analysis, and how are the profit-splitting factors chosen, weighted and applied. Example 8, for instance, talks about development expense as the profit-splitting factor but does not discuss how it is applied—e.g., are relative historical development expenses, capitalized expenses, annual ongoing development expenses, etc. used for splitting profits?
- The purpose of Example 5 is unclear. It does not appear to consist of anything more than an assertion that the TPSM is likely to be the most appropriate method if both parties' contributions are unique and valuable, and not the most appropriate method if the contributions are not unique and valuable. Examples 3 and 4 make this point in a more detailed fashion; further, Example 5 clearly embodies our concerns about conveying the incorrect idea that unique and valuable contributions by both parties is a sufficient condition for the TPSM to be the most appropriate method. We recommend Example 5 either be clarified to illustrate a discrete issue, or deleted.
- Example 7 would benefit from significant clarification. In KPMG's experience, the TPSM method may be used in the case of such portfolio management companies, but the specific facts advanced in the example leave unclear both the specific method used and the rationale. It appears that ASSET Co. contracts to provide portfolio management services to (unrelated) FUND Co. Related parties Company A and Company B provide valuable services to ASSET Co. with respect to ASSET Co.'s contract with FUND Co. Paragraph 100, at the end of the example, provides critical information relevant to the most appropriate method selection. It states that "Comparables for … the services performed by Company A and Company B together are available, but these provide no information on how to split those profits between Company A and Company B." Based on this statement it appears that comparables are available to reliably determine the total payments from ASSET Co. to Company A and Company B together. Some method would then be required to split that payment between Company A and Company B. If this reading is correct, we suggest that the example be revised to (i) provide this information earlier in the example before a conclusion regarding the most appropriate method is stated; (ii) indicate whether and how the available comparables are used to determine the total payment to Company A and Company B, or if instead the TPSM is used why it is

more reliable given the existence of those comparables; and (iii) explain why a profit split is the most appropriate method for allocating such payment between Company A and Company B, rather than, for example, some other allocation of the total fee using available comparables. Paragraph 96 states "Company A employs portfolio managers who specialise in Country A equity and Company B employs portfolio managers who specialise in Country B equity." Consequently, the example would benefit from further elaboration as to potential circumstances in which available market data, such as sub-advisory fees, would be a less reliable method of splitting the total fee than the TPSM.

- Example 9 provides a comparison of situations where actual or anticipated profit splits might be appropriate. The general points discussed above are applicable to this example. In addition, this example makes certain critical assumptions that we believe are either unwarranted or should be supported further. In particular, we question the assumption that a profit split is the most appropriate method based solely on the fact that both parties make unique and valuable contributions. Local marketing of trademarks and other intangibles is often carried out by an enterprise that is independent of the enterprise that developed the intangible, and a profit split usually is not used in those arm's length transactions. In addition, in Scenario 1, Company A develops intangibles and Company B markets the new product. In Scenario 2, Company A develops the intangibles and both Company A and Company B market the product. The example assumes that in Scenario 1 Company A does not bear economically significant risks related to the commercialization of the product whereas in Scenario 2 it shares these risks with Company B. The implicit assumption in Scenario 1 is that since Company A does not engage in marketing activities it cannot share in the risks of the commercial product. It must, therefore, share in anticipated profits and get a payment that is determined *ex ante* based on the discounted cash flows of the expected profits from selling the product. This example's view of the application of the TPSM has several flaws: (i) Scenario 1 does not explicitly discuss the contractual relationship, which might in fact specify a sharing of risks and actual profits, consistent with the conduct of the parties; (ii) both scenarios assume that actual volatility in the profits from the commercial product are attributable to commercialization risk whereas anticipated volatility (as captured in a discount rate, for example) is attributable to development risk—but there appears to be no basis for this assumption, and (iii) the related-party payment terms represent a certain allocation of risk, which the example overlooks in its determination of anticipated or actual profit splits.

Questions Posed in the Discussion Draft

The preamble to the Discussion Draft posed three specific questions to commentators. KPMG has provided its responses to these questions below.

1. The discussion draft addresses situations in which profit splits of anticipated profits or profit splits of actual profits are appropriate. Where it is established that the transactional profit split is the most appropriate method, please comment on the factors which should be taken into account in determining whether a profit split of anticipated profits or a profit split of actual profits should be used.

   Response: Splits of anticipated or actual profits embody different allocations of risk. The allocation of risk in a transaction will be determined under the principles of Chapter I. The allocation of risks between the transacting parties will, thus, depend on the contractual arrangement between them and their conduct. This allocation of risk in the accurately delineated transaction should be respected in the choice of most appropriate method, which includes the decision as to whether a split of actual or anticipated profits is most appropriate. Thus, the choice of actual or anticipated profit split will largely be driven by the taxpayer's decision on how to allocate risk in the transaction, assuming its conduct is consistent with that risk allocation. We expect that the allocation of risk in the accurately delineated transaction will be respected in the selection of a split of actual or anticipated profits.

2. A number of profit splitting factors are addressed in the discussion draft. Comments are particularly invited on:

   a. Whether the existing references to capital or capital employed as a potential profit splitting factor in the current guidance should be retained, and if so, what factors need to be taken into account for its selection and application as a reliable profit splitting factor.

Response: We believe that references to capital or capital employed should be retained. Capital or capital employed may be a reliable measure of contribution to profits in certain situations. Capital could refer to operating assets and/or to funding, both of which could be reliable measures of relative contributions depending on facts and circumstances. For instance, investments in physical assets could be an indicator of relative contributions to a manufacturing operation. Financial capital could be an important factor in a financial services transaction. As with any other factor, capital or capital employed can be subject to measurement issues and will not be the most appropriate factor in every context. Thus, the same general principles that are used for selecting any other factor should be applied to the selection of capital or capital employed as a profit-splitting factor.

b. Should headcount of similarly skilled and competent employees be included as a potential profit splitting factor, and if so, in what circumstances would it be relevant?

Response: If it can be demonstrated through the functional and industry analyses that headcount is the best measure of the unique and valuable contributions of the various parties involved in the transaction, then headcount could possibly be a reliable profit-splitting factor. However, we don't believe that having "similarly skilled and competent" personnel is sufficient for using headcount as a profit-splitting factor. The assessment of whether personnel are similarly skilled and competent can be subjective. More importantly, even if personnel are "similarly skilled and competent" their roles and relative contributions can be very different. For instance, two people with the same educational backgrounds (which could be a measure of skills and competency) could have very different contributions to the multinational group if one, for instance, is the head of R&D and the other performs routine testing activities for products that have already been developed.

c. Given the existing guidance in Chapters I and IX of the Transfer Pricing Guidelines, should adjustments for purchasing power parity be made for profit splitting factor amounts, and if so, in what circumstances?

Response: We do not recommend that purchasing power parity ("PPP") be called out as an adjustment factor in the OECD guidance. We believe that the OECD guidance should provide general principles on the application of the TPSM and examples for illustrating those principles. The Discussion Draft does that. The fundamental principle in the application of the TPSM or any other method is that the most appropriate method given the facts of the transaction and the available data be selected. While the Discussion Draft provides examples of profit-splitting factors, these examples are not, and should not, be intended to represent an exhaustive listing of profit-splitting factors. Not all factors will be appropriate in all situations. Any profit-splitting factor selected for a particular case should be required to undergo a careful evaluation as to its appropriateness for the case. PPP indices are harder to measure than market exchange rates, infrequently updated, and not available for all countries – all of which make them less reliable than market exchange rates, which represent true and current market data. We do not believe that specifically discussing PPP adjustments will improve the Discussion Draft—the general guidance on the selection of profit-splitting factors should be sufficient to allow for an evaluation of the most appropriate profit-splitting factor to any particular set of circumstances.

d. What other profit splitting factors should be included in the guidance, and in what circumstances?

Response: As noted in the Discussion Draft itself, the appropriate profit-splitting factors will depend on "the facts and circumstances of the case."[12] What might be an appropriate profit-splitting factor in one case might not be in another. There could be profit-splitting factors that are unique to the facts and circumstances of a case. It is, therefore, not possible to present an exhaustive listing of profit-splitting factors that may be used in a TPSM. The OECD guidance should lay down general principles for selecting profit-splitting factors, as the Discussion Draft does, with additional emphasis on the impact of subjectivity on the

[12] Paragraph 31 of the Discussion Draft.

reliability of the TPSM. We do not recommend a lengthy list of profit-splitting factors to be included, which would run the risk of being viewed as an exhaustive listing, with tax authorities potentially questioning any deviation from the list.

3. Additional examples of scenarios in which a transactional profit split is found to be the most appropriate method due to the high level of integration of the business operations are sought, together with an explanation as to the reasoning thereto.

   Response: While we believe examples are useful in illustrating principles, an overuse of examples related to the high level of integration of business operations could encourage overuse of the TPSM whenever business operations are integrated, which is generally the case with multinational enterprises. The Discussion Draft already includes examples where business operations are highly integrated. For instance, Example 10 presents a case where business operations are integrated and the TPSM is applied. As noted above, the Discussion Draft would benefit from a clearer illustration of the principles of the TPSM. The OECD could better illustrate the principles of the Discussion Draft in a situation with a highly integrated business by improving the examples that are already in the Discussion Draft than by including additional examples. As noted above, we also recommend that the OECD include an example where the parties to a transaction are engaged in a highly integrated business operation but the TPSM is not the most appropriate method.

About KPMG

KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 152 countries and have 189,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

KPMG Contacts	**Firm**	**e-mail**
Stephen Blough	KPMG in the U.S.	sblough@kpmg.com
Brian Cody	KPMG in the U.S.	bcody@kpmg.com
Manal Corwin	KPMG in the U.S.	mcorwin@kpmg.com
Gianni De Robertis	KPMG in Italy	gianniderobertis@kpmg.it
Matthew Frank	KPMG in the U.S.	matthewfrank@kpmg.com
Peter Steeds	KPMG in the U.K.	Peter.Steeds@KPMG.co.uk
Prita Subramanian	KPMG in the U.S.	psubramanian@kpmg.com
Montserrat Trape Viladomat	KPMG in Spain	mtrape@kpmg.es
Thomas Zollo	KPMG in the U.S.	tzollo@kpmg.com