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To: Andrew Hickman, Head of Transfer Pricing Unit, Centre for Tax Policy and Administration
Date: 6 February 2015
Re: **Comments to the OECD's discussion draft on Action 10 of the BEPS Action Plan of 16 December 2014**

Dear Andrew,

Here are my comments to the above draft. I will try to keep things brief, but will be happy to expand on any issues you require further information on.

My responses to the question posed in the paper are based on the following principles:

A. For transfer pricing purposes, I understand a value chain to mean the following. When following a supply chain from the setting up of a business strategy, through R&D, the acquisition of raw materials, manufacturing, marketing, distribution and sales, one tries to identify those functions which contribute most to the ultimate value of the product for the customer. A pair of jeans made by X may simply be seen as the hottest fashion item to wear; in that case those who have determined the design and marketing of those jeans are likely to have contributed most to the value of those jeans. Another pair of jeans made by Y, may be virtually indestructible, fire and water resistant, and yet comfortable to wear; here the R&D behind the jeans is likely to add the most value and – should the properties of these jeans be patented and unique – the jeans may require basic boiler plate design and little marketing to a very limited market (e.g. global fire departments) to achieve significant profits.

   In addition, I assume a value chain for transfer pricing purposes to resemble a group of people knowing each other and deliberately deciding to cooperate with each other in an open, transparent fashion. I do not assume it to be e.g. a designer and a distributor deciding to cooperate, where they hire in R&D, marketing and sales functions from people whom they know very little of, and share no information with. In such a case, the TP value chain is created between the designer and the distributor, but it does not include the ones performing R&D, marketing or sales.

B. A profit split that is based on a (vertical) value chain analysis and referencing the full system profit created by that value chain (transparency), is more akin to the arm's length principle, than the idea that cooperating unrelated parties would solely base their income expectations on the (horizontal) comparability studies described in chapter III of the guidelines (under the last example given under point A hereabove, this statement would apply to division of results between the designer and the distributor only).

   In short, if a value chain generally creates an average system profit equal to a TNMM of 6%, an independent residual risk taker is unlikely to be prepared to compensate all low risk routine functions in that value chain a TNMM of 5%, just because that is what comparability studies say they should get: carrying virtually all the risk for a compensation that is 1% higher than the compensation of parties carrying little or virtually no risk, hardly seems worth the effort.

C. As stated, unrelated parties cooperating in a value chain will consider the system profit generated by that value chain when dividing the profit among themselves. Those who wish to take no risk, will have limited, if any, decision powers with regard to managing that risk; their share in the system profit will also be lowered down to the lower of the price for which their services can purchased in the market (the horizontal chapter III comparability analysis) or a share of the reasonably certain system profit of the value chain based on the prorated part of the value they contribute to the value chain. Should low risk takers in the value chain receive a higher compensation than would be expected from a chapter III comparability analysis, this will typically occur in higher than average profitably value chains where those low risk takers have a unique and valuable relationship with the residual risk takers.

D. The residual profit in the value chain will be split among the residual risk carriers in proportion to the risk they are prepared to carry. It is very unlikely to come across scenarios where a party accepting liability for 80% of the residual risk, will accept a compensation capped at 20% of the residual profit.

   Outside of true principal structures, I believe that it will be the rule, rather than the exception, that value chains have more than one residual risk taking function and thus that the residual profit will be split over more than one function.

E. Residual profits and losses are not only split on the basis of the value of functions performed, but on the basis of the management of the risks created by those value creating functions. Taken to the extreme: it is not the people suggesting strategic decisions who are liable for and thus entitled to residual results. It is the people who hire the people making those suggestions and then deciding which of those strategic suggestions will be followed, who are entitled to the residual profit. The strategy deciders will base their decisions among others, on the risks they are prepared to manage and to bear which stem from these proposed and chosen strategies.

Based on the above, practically every value chain can be analysed into a residual profit split, where the low risk functions are compensated with a low, positive, value related, return for their contributions. These returns are based, e.g. on CUP's, cost plus, resale minus, or TNMM and the remaining results are split among the residual risk carriers based on the proportional risks carried and contributions made (in that order).

Answers to the paper's questions

1. Yes. It can provide solutions to all scenarios, following the steps described above.
2. More information would primarily be required about the distribution among the OEM's of the functions managing the residual risk.
3. Yes. That said, I see no reason why residual profit split should be limited to highly integrated value chains, as opposed to lowly integrated value chains.
7. Based on points A-E here above and on my answer to point 3, the question is whether there is a need for defining "unique and valuable". I think the discussion ought rather to be if and when authorities can require a transactional profit split. In view of the administrative burden, the circumstances should be limited, e.g. to where it can be shown that a local tax payer is liable for residual risk.
   A party using a unique and valuable intangible but carrying no risk, or very limited risk only, may have no access to residual profits at all under arm's length circumstances. E.g. as a hospital, I can hire the world's best independent brain surgeon to perform an operation for a fixed fee without splitting the profits from charging for that operation with her or him.
12. Within a value chain, one sided methods would be more appropriate to i) those parties akin to the RandD, the marketing and the sales functions mentioned under the last example of point A above and ii) functions within the value chain which do not share in the residual risk.
14-16. I believe I provide answers to these questions under A-E hereabove: follow those who manage and bear the residual risk, and the extent to which they do so.
22. Identifying value can often be made a little more mechanical, using the following criteria. Compare the years of relevant experience, the level of compensation (adjust for geographical differences) and the relative position of persons within the chain of command. Value creating functions are more likely to be found in concentrations of a lot of relevant experience, high compensation and internal seniority.
25. I believe that the question is whether there is a need for a complicated, multi-factor analysis, or whether the predominant factor will always be the proportionate part of residual risk carried by a related party.
26. Risk assumed and managed.
27. Point D here above provides a first part of the answer (an ex-ante answer). Whether, and how that response will change in view of unanticipated results, depends on facts and circumstances, and the issues under point C may come into play as well. It would be necessary to know what caused those results, who was contractually

and actually responsible for the factors causing those results, whether and how those parties acted and whether they were hindered in their actions by other parties in the value chain.
It would also be necessary to realise that unrelated parties will not wait until year end, or the time of preparing the tax returns, before taking action against the occurrence of unanticipated events/results. In addition the realistically available options to those unrelated parties would include continuing their activities with new unrelated parties or with products from unrelated parties. Such options would not always be available or explored by related parties and that lack of availability / action would require a separate pricing.

30. No, not that I am aware of. See point D here above.

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Thank you for taking the time to read this. I am registering to attend the public consultation of 21 January 2015. Should you wish me to elaborate on any of my points at that meeting, I would be happy to do so.

Yours sincerely,

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