

Public comment received from Lorraine Eden

September 5, 2016

Dr. Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
OECD
2, rue André Pascal 75775 Paris Cedex 16
France
By email: transferpricing@OECD.org

Comments on the OECD's BEPS Public Discussion Draft BEPS Actions 8-10, "Revised Guidance on Profit Splits", issued on 4 July 2016.

Dear Dr. Hickman:

Thank you for the opportunity to comment on the OECD's BEPS Public Discussion Draft for BEPS Actions 8-10, "Revised Guidance on Profit Splits" (for short, OECD-PSM), issued on 4 July 2016. I would like to offer a few comments on four topics in the draft.

1. Value Chain

The "value chain" is a well-known concept, first developed by Michael Porter in his 1985 book, *Competitive Advantage*, which is now taught in all courses in strategic management in business schools. In Porter's value chain, value-adding activities are divided into two types: primary and support. A firm that in-house performs sequential primary activities in the value chain (e.g. resource extraction and processing or manufacturing and distribution) is said to be "vertically integrated". A vertically integrated multinational enterprise (MNE) typically performs several primary activities in the value chain in-house through majority or wholly owned affiliates, and is said to have "greater vertical scope" or "greater sequential interdependence." The MNE is said to be "horizontally integrated" if it has multiple plants at the same stage of the value chain, for example, multiple retail banking outlets or multiple assembly plants. Most MNEs are both vertically and horizontally integrated to some extent, which international business scholars refer to as "complex integration", depending on the relative costs of doing value-adding activities in-house versus through various forms of non-equity relationships versus open market purchases.

In paragraph 21 of the document, the terms "sequential integration" and "parallel integration" are used. These terms are not used in the business school literature on value chains, and I am not sure how they related to vertical and horizontal integration.

The definition of "sequential integration" may be similar to that of vertical integration, but this is not clear to me. Paragraph 21 says that sequential integration occurs when "parties perform discrete functions in an integrated value chain", which could mean activities that are performed at the same stage of the value chain (horizontal integration) but are "discrete." If sequential integration is the same as vertical integration, it might be simpler to use the familiar term.

The term "parallel integration" is also not familiar. The document in paragraph 21 says that parallel integration is defined as "multiple parties to the transaction are involved in the same stage of the value chain." This is clearly different from horizontal integration where different retail banks, for example, or Starbucks coffee shops, may be relatively independent of one another.

I believe the term “parallel integration” may be referring to a situation, for example, where a MNE has four R&D locations, which regularly share scientists, locations and co-develop intangibles together. The related parties pool their assets and resources and all benefit from the innovations that are generated by their combined activities. The four related parties engage in co-development activities that are so interdependent it is not possible to identify or separate their activities. If this is meant to be the definition of “parallel integration,” I recommend shifting to the term “integrated network.” Multinationals, especially from small open economies such as the Scandinavian countries, often structure their high value-adding activities using integrated networks of R&D affiliates to develop new technologies.

2. Value Chain Analysis

The term “global value chain” or GVC, on the other hand, refers to all the value-adding activities involved in the production and sale of a particular product or product line worldwide, for example, the mapping of the GVC in coffee or automotive components or footwear. GVCs typically show all the main value-adding activities and the entities (which could range from MNEs and large state owned enterprises to small firms and farmers) engaged in all the stages from inception to final sale.

The term “value chain analysis” (or VCA), which appears in section C.3.4 of the document, is a new term and one that appears to have conflicting meanings at least among business faculty. Performing a VCA could mean, for example, mapping out the global value chain in the footwear industry. Or performing a VCA could mean mapping out the value chain within a multinational enterprise.

Paragraphs 25-27 in the document explain what kinds of information a VCA could “usefully provide”, but do not clearly differentiate a VCA from a functional analysis. I would like to propose that the document be revised to more carefully differentiate between a functional analysis and a VCA, as follows.

A value chain analysis (VCA) is designed to map the value-adding activities involved in a particular transaction (that is, product line or line of business) that are performed by related parties in a multinational enterprise (MNE). A VCA includes a functional analysis that maps the *conduct* of the related parties in terms of their functions performed, assets contributed and risks assumed. A VCA also includes identifying the entity or entities that *control* these value-adding activities (including managerial, operational and strategic control) and the *capacity* of the entity or entities to bear the risks associated with those value-adding activities.

A key distinction between a VCA and a functional analysis is that a functional analysis typically focuses only on the two related parties directly involved in the transaction: the seller (typically, the manufacturer) and the buyer (typically, the distributor); in other words, a dyadic relationship. A VCA, on the other hand, maps out all the activities for all the related parties involved in a particular value chain, with the purpose of identifying the activities and entities within the chain that are likely to be earn above-normal rents, reflecting sustainable competitive advantage. These key sources of economic advantage are likely to depend on three factors: conduct (FAR), control and capacity. The location of significant people functions (SPFs) within the various entities of the MNE group is likely to be a bellwether for determining the location of value-adding contributions to group profits.

3. Contributions

The OECD's 2010 *Transfer Pricing Guidelines* for the profit split method and the IRS Section 482 Regulations both recommend that the allocation key for dividing profits among the related parties be based on the parties' contributions. The word "contribution" appears nearly 80 times in the July 2016 draft for the Profit Split Method also, suggesting that contributions of the related parties are an important driver of how related parties should split the profits (whether anticipated or actual).

In the July 2016 document, however, the term contribution appears to be more closely tied to what each of the parties spent (their costs) than to the value of what each of the parties spent. In the 2010 TPG and the Section 482 Regulations it is clear that the transfer pricing policy should be paid on the value of the contributions of the related parties. That value may or may not be closely tied to what each of the parties spent.

For example, three parties might each spend \$100 million on R&D, but only one of the three parties develops a successful commercialized invention. The other two parties spent money with nothing to show for it. How should the profits be split among them? What would independent enterprises have done? Would they have agreed ahead of time to split the profits based on what each of them spent? In that case, an allocation key based on spending would give them each 1/3 of the profits. An allocation key based on inputs, however, encourages each of the parties to spend more since the more they spend the greater their share of the profits, even if their spending is unsuccessful. Independent enterprises would be unlikely to continue contracts that divided their profits based on what each of them spent, ignoring the productivity of their spending.

Both the 482 Regulations and 2010 TPG stress that contribution should be measured not based on what was spent, but on the value of that spending. If costs and value were related to one another, then share of costs would be a practical way to measure each party's relative contribution. However, in cases where costs (inputs) and value (outputs) are not necessarily related –which is typically the case for high value added, risky intangibles – contribution should be measured by estimating the value of that contribution not what was spent.

I would like to see a stronger statement in this document reaffirming that the definition of contribution is in terms of the value added by that function performed, asset used or risk assumed, rather than by the cost incurred. The section on "cost-based profit splitting factors" (paragraphs 51-53) should make the point that using cost is likely to be a less reliable method where costs are a poor proxy for value added. The section on "asset-based factors" should make the point that contribution is to be measured by the value-added by the assets used, which for intangibles may involve estimating projected income from the intangibles. More generally, earlier in the document, a clear definition of "contribution" would be helpful.

4. Profit Split Method

My last comment is with respect to the strengths and weaknesses of the profit split method. I believe that a key weakness of the profit split method is that there are multiple steps involved in applying the method. A mistake made at any of these steps can generate compounding errors that can greatly reduce the reliability of the method. This is particularly true for the residual profit split method (RPSM) because it is an "umbrella method" that contains other methods within it.

The basic steps in the RPSM are the following:

1. Determine the transaction or group of transactions to which the RPSM will apply
2. Determine which related parties are involved in the transaction or transactions
3. Determine which costs and revenues are applicable to that transaction or transactions
4. Where some costs or revenues are shared or fixed, determine the share of those costs or revenues that apply to this transaction or transactions and include only those that apply
5. Determine the group profits for the transaction or transactions
6. Determine which functions, activities and risks of each of the related parties can be considered routine functions, assets and risks
7. For each of those routine functions, assets and risks, determine its routine return using one of the other transfer pricing methods (e.g., resale price method, cost plus method, TNMM)
8. Subtract the sum of all the routine returns from the group profits to determine the group residual profit
9. Decide on an appropriate allocation key for splitting the residual profits
10. Apply that allocation key to the residual group profits to allocate them among the non-routine functions, assets and risks
11. Each entity's profit consists of its share of the routine profits plus its share of the Nonroutine profits.

There are 11 steps in this method and a mistake in the top-level decisions should cascade through the lower-level decisions. Mistakes at any of the stages reduces the reliability of the method.

Moreover, this is an umbrella method with other methods hidden within it. Deciding what are routine functions, assets and risks; what methods should be used for each case; and applying those methods (each of which may involve interquartile ranges of its own), suggests the complexity of the decision making involved in this method.

Historically, the profit split method was seen as a method of last resort, primarily because the data involved were based on internal firm-level data and not on outside market-based prices. However, I see the profit split method – particular RPSM, the version most commonly used -- as inherently problematic due to the complexity of the method, the likelihood of compounding errors, and the fact that it is an umbrella method with multiple other transfer pricing methods buried inside.

Thank you for the opportunity to comment on the draft.

Sincerely yours,

Lorraine Eden, PhD

Professor of Management

Gina and Anthony Bahr '91 Professor in Business

Department of Management, Mays Business School

4221 TAMU, 415D Wehner Building

Texas A&M University

College Station, TX 77843-4221 USA

Phone: 979.845.4851 (dept) 979.845.9641 (fax) 979.777.3489 (cell)

leden@tamu.edu; Lorraine.eden@gmail.com