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Intangibles

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Transfer pricing Clarity

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Introduction

Dear readers,

The global transfer pricing practice of Deloitte Touche Tohmatsu Limited is pleased to present a collection of articles on different aspects of transfer pricing particularly focused on intangibles.

As OECD's transfer pricing guidance in Actions 8, 9 10 and 13, issued as part of the Base Erosion and Profit Shifting (BEPS) Project, continue to take centre stage in transfer pricing planning and documentation, in this guide, we provide valuable insights into some of the most significant challenges that multinational corporations (MNCs) face with respect to transfer of intangibles and, in particular, in identifying and assigning value to intangibles.

In the first article, *Applying the profit split method*, Alan Shapiro, Eunice Kuo and Anis Chakravarty, discuss the OECD's non-consensus discussion draft on proposed changes to the transactional profit split method. They observe that the tone of the discussion draft suggested the broad applicability of profit splits to integrated value chains. Their main takeaway, however, from the supplemental guidance on value chain analyses provided in the discussion draft is the casting of a value chain analysis as a delineation tool for a specific transaction, rather than as a justification to apply a profit split on every integrated MNE operating through a global value chain. This is a significant change in direction from the non-consensus draft on profit splits, which suggested the latter rather than the former.

In the second article, *The OECD hard-to-value intangible guidance*, Philippe Penelle attempts to understand where the concepts in the hard-to-value intangible (HTVI) guidance came from, and explains what the views of the US government have historically been in connection with the arm's-length nature of such concepts. That discussion will encompass a simple theoretical discussion of the use of *ex post* results to assess the arm's-length nature of *ex ante* pricing as a means to set up one commonly cited reason to believe that the HTVI guidance may, in fact, go beyond the arm's-length principle, as commonly understood or interpreted. Ultimately, the article provides useful insights as to what to expect from the OECD HTVI guidance, based on lessons learned from the US experience with the commensurate income standard and the periodic adjustment rules.

The third article focuses on OECD guidance on transfer pricing documentation (Action 13) which requires multinational corporations to identify where and how value is created in business operations. In their article, *Value*

chain analysis, Shanto Ghosh and Arindam Mitra outline the key approach to a value chain analysis and how one may apply economic principles to determine the *ex post* split of the consolidated contribution margin in a global value chain taking into consideration the economic risks being borne by the various entities within an MNC. Their novel methodology allocates the *ex post* contribution margin (or revenue) among the sub-units of an integrated supply chain based on the relative modified operating leverage of the sub units. The result is a reasonable arm's-length approximation of the allocation of profits within an MNC that are aligned by the creation of value within the MNC's integrated supply chain.

Although the guidance in the non-consensus discussion draft on proposed changes to the transactional profit split

method provides a reasonable foundation on which the OECD member states can build upon in the next release, which is expected in the next few months, it is hoped that OECD will provide additional clarification in a number of areas, including better coordination with its valuation guidance on intangibles.

Navigating the world of transfer pricing is not easy. We hope this guide provides you with useful insights into the transfer pricing of intangibles. If you have any questions, or would like to engage in a discussion, please contact the Deloitte transfer pricing professionals featured in this guide.

[Mark Nehoray](#)
Partner

Applying the profit split method

Alan Shapiro,
Eunice Kuo and
Anis Chakravarty of
Deloitte discuss the
OECD's new
discussion draft.

The release of the final BEPS deliverables on Actions 8-10 on October 5 2015 contains a completely revised Chapter VI of the OECD Transfer Pricing Guidelines (TPG) on intangibles. Section B of Chapter VI of the TPG introduced new concepts on the right to receive intangible income. The right to receive intangible income is based on the functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection, and exploitation (DEMPE) of the intangibles. In accordance with the changes to Section D. 1 of Chapter I of the TPG, the assumption of risk in the DEMPE activities, in particular the management and control of risk with respect to those activities is intended to drive the entitlement to intangible returns. Section D of Chapter VI of the TPG provides guidance on the valuation of the various contributions to intangible income. Par. 6.141 suggests that one-sided methods, such as the transactional net margin method (TNMM), are unlikely to provide a reliable method to value entitlement to intangible returns. Par. 138 suggests that an appropriate comparability analysis will lead to the conclusion that there are no comparable uncontrolled transactions in many cases that can be used to determine the arm's-length price. Therefore, as a practical matter, the guidance heavily relied on the transactional profit split method and valuation techniques described in Section D.2.6.3 to determine rights to intangible returns. Because the transactional profit split method and valuation techniques had many common elements, additional guidance on the transactional profit split method was eagerly anticipated.

The OECD on December 16 2014, released the first non-consensus discussion draft on proposed changes to the transactional profit split method contained in Chapter II of the TPG. The tone of the 2014 discussion draft suggested to many the broad applicability of profit splits to integrated value chains. The OECD received numerous comments that suggested the discussion draft appeared to adopt many strains of a formulary apportionment approach to allocating intangible returns, and did not sufficiently rely on the basic tenets of the arm's-length standard. A public consultation on the topic was held at the OECD in March 2015. The BEPS final reports, published October 5 2015, did not incorporate any proposed changes to Chapter II of the TPG contained in the discussion draft, rather they provided instead that Working Party 6 (WP6) would reconvene in 2016 and 2017 to provide such consensus guidance on the transactional profit split method.



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Alan was selected for inclusion in the 2002-2013 editions of the *Guide to the World's Leading Transfer Pricing Advisers* and in the 2003-2012 editions of the *Guide to the World's Leading Tax Advisers*. He is widely quoted on transfer pricing topics in BNA's *Daily Tax Report* and *Transfer Pricing Report*, he has spoken at numerous forums, including the American Bar Association and International Fiscal Association.

Alan has co-authored the soon to be released update of the Cost Sharing Chapter of BNA Portfolio #890 and has authored or co-authored numerous articles on transfer pricing subjects including: *OECD Discussion Draft on Intangibles*, *66 Tax Notes International* 13 (June 25, 2012), among many others.

Alan holds an LLM in tax and a juris doctorate from Georgetown University Law School, a masters in economics and a bachelors of science in business administration from Boston University. He is a member of the legal bar in the US states of Pennsylvania and Georgia and is a US Certified Public Accountant.

The OECD on July 4 2016, released a Discussion Draft on Revised Guidance on Profit Splits. The discussion draft does not reflect, at this stage, a consensus position of the governments involved, but is designed to provide substantive proposals for public review and comment. The introduction to the discussion draft specifically indicates that insofar as the guidance differs from the guidance contained in the 2010 OECD Transfer Pricing Guidelines For Multinational Enterprises and Tax Administrations (2010 OECD TPG), it is not to be relied upon by taxpayers or tax administrations.

Overview of discussion draft

The discussion draft modifies the 2010 OECD TPG Chapter II guidance on profit splits (rather than withdraw

and replace it in its entirety, as was the case with Chapter I, Chapter VI, and Chapter VIII). It clarifies and expands on the 2010 OECD TPG Chapter II guidance to conform to the new 'risk control' framework of Chapter I. Missing from the discussion draft is a clear link to the valuation guidance contained in Section D.2 of Chapter VI on intangibles.

Along with discussing conditions under which transactional profit splits are most appropriate, the discussion draft also articulates the role of a value chain analysis in accurately delineating a transaction (within the meaning of Chapter I), and in determining the most appropriate transfer pricing method. The discussion draft specifically indicates that the existence of an integrated value chain does not necessarily imply the use of transactional profit splits, as many multinational enterprises (MNEs) operate through a global value chain.

If the December 2014 draft could reasonably be interpreted as suggesting formulary apportionment of an MNE's profit as appropriate in certain circumstances, the discussion draft dismisses such an interpretation. The draft contains a number of safeguards and cautions against application of transactional profit splits when it would not be appropriate, including as a default method when comparables are hard to find, other methods are not reliable, or group synergies exist as some interpretations of the intangible valuation methods section of Chapter VI may have implied. The discussion draft also recognises that profit splits are difficult to apply, and are generally not appropriate when a party makes only routine contributions.

Analysis of discussion draft

Value chain analysis: An approach to delineating the transaction

The discussion draft provides four new paragraphs under Section C.3.4 articulating the role of a value chain analysis in a transfer pricing study. Some were concerned that Par. 6.133 of Chapter VI, which emphasised the need for an undefined valuation chain analysis in valuing intangibles, would result in the transactional profit split method being the primary method in valuing intangibles:

"The *selection of the most appropriate transfer pricing method* should be based on a functional analysis that provides a clear understanding of the MNE's global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify all factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies among others." [Emphasis added.]

The supplemental guidance clarifies that a value chain analysis is merely a tool to assist in accurately delineating a

transaction, in particular with respect to the functional analysis, and thereby determining the most appropriate method, which may or may not be the profit split. The discussion draft makes clear that there is no causal relationship between a value chain analysis and use of the transactional profit split method.

A value chain analysis should consider where and how value is created in the business operations, including:

- Consideration of the economically significant functions, assets, and risks;
- Which company performs the functions, contributes the assets, and assumes the risks;
- How the functions, assets, and risks are interrelated;
- How the economic circumstances may create opportunities to capture profits in excess of what the market would allow (e.g., unique intangibles or first mover advantages); and
- Whether the value creation is sustainable.

Because the value chain analysis discussion appears to provide additional guidance on identifying the commercial or financial relations between the associated enterprises required under paragraph 1.34, commentators have questioned the placement of such guidance in Chapter II (guidance on profit split), rather than in Chapter I (guidance on accurate delineation) and requested clarity in the next draft as to whether or not a value chain analysis is viewed by WP6 as part of a functional analysis to be performed in the accurate delineation of every transaction, or merely as a tool to be applied in transactions in which the profit split is being considered as the most appropriate method. Providing this guidance under Chapter I would reinforce what *appears* to be the intent of WP6, namely, to use value chain analyses to *inform* the selection of the most appropriate method as opposed to *cause* the transactional profit split to be the most appropriate method in every case of an MNE operating through a global value chain.

The main takeaway from the supplemental guidance on value chain analyses provided in the discussion draft is the casting of a value chain analysis as a delineation tool for a specific transaction, rather than as a justification to apply a profit split on every integrated MNE operating through a global value chain. This is a significant change in direction (likely to be welcomed by taxpayers) from the December 2014 non-consensus draft on profit splits, which suggested the latter rather than the former.

Profit split guidance

The overriding purpose of the use of a transactional profit split should be to approximate as closely as possible the split of profits that would have been realised had the parties been independent enterprises. Consistent with the guidance provided in the October 5, 2015, final report under actions 8-10, identifying the economically significant risks each party to a transaction controls, and accurately delineating such



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Eunice has actively participated in business model optimisation projects in China. The advisory services she has been involved in include the selection of principal company location, restructuring of transactional flow in China and across Asia-Pacific to eliminate tax inefficiency and to mitigate China tax risks, doing financial models to have detailed analysis of the pros and cons with business restructuring and assistance in implementation. Her clients in this area are mainly large MNCs and also include China-based companies.

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transactions (including the respective contributions of each party and the profits to be split), is the starting point to inform whether or not transactional profit splits are appropriate and reliable.

The discussion draft describes transactional profit split as a method whereby the combined profits are split between associated enterprises on an *economically valid basis* that approximates the division of profits that would have occurred in comparable circumstances at arm's-length. The discussion draft distinguishes transactional profit splits of *anticipated profits* from profit splits of *actual profits*. In many cases, the split of profits using anticipated profits will rely, in part, on the additional guidance in Section D.2.6.3 in Chapter VI of the TPG on valuation techniques. Although most of the guidance provided in the discussion



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He is currently recognised by Euromoney/Legal Media Group headquartered in London, as one of the world's leading transfer pricing advisers.

Anis specialises in financial services, intellectual property planning and tax-aligned supply chain implementation of cross-border structures. He has assisted with large cross-border due diligences and post-merger integration projects.

He advises on transfer pricing litigation and dispute resolution for both inbound and outbound companies and has assisted in negotiating APAs and MAP settlements involving complex transfer pricing issues including one of the largest cases in the country.

Anis has been the co-leader of Deloitte's Global Economists Network leading the intellectual property transfer pricing group in the Asia Pacific region. Anis is also a guest faculty at IBFD Asia Pacific lecturing on transfer pricing for business restructuring and supply chain issues.

He is a regularly contributor to the print and electronic media on various macroeconomic issues and trade policies. His technical views have been published in BNA's *Transfer Pricing Report*, Euromoney's annual *Transfer Pricing Review*, Bloomberg and the Wall Street Journal amongst others.

In India, Anis is regularly quoted in The Economic Times, The Hindu, Mint, Business Standard and media channels on economic matters. He is a speaker at seminars on topics related to economics, transfer pricing and business and has appeared in various publications.

Before joining Deloitte India, Anis was based in Brussels, Belgium, advising European inbound as well as outbound clients tax and business matters.

He is a member of the governing Board of the Indo-Belgian-Luxembourg Chamber of Commerce and Industry.

Irrespective of whether anticipated or actual profits are split, the determination of which profits need to be combined (base for the split), and the way combined profits are split (key for the split) must be determined *ex-ante* on the basis of data that are reasonably available at the time of the initial transaction and are capable of being measured in a reliable and verifiable manner and without the use of hindsight, a key criterion to ensure that profit splits are consistent with the arm's-length standard.

These requirements make profit split keys constructed through subjective weighing of taxpayers' representations or tax authorities' unsubstantiated view of the various value drivers in their business inappropriate, and significantly decrease any perceived authority granted by the guidance to tax administrations to allocate taxable income between parties based on formulary-type apportionments.

When is a profit split most appropriate?

Transactional profit splits are most appropriate in cases of (i) highly integrated operations, and (ii) unique and valuable contributions by multiple parties.

Highly integrated operations

The use of a transactional profit split of *actual* profits is most appropriate in cases of high integration of activities performed by the parties, with greater sharing of uncertain outcomes resulting from the economically significant risks controlled by the parties. In contrast, the use of a transactional profit split of *anticipated* profit does not require the level of integration or risk sharing required for a transactional profit split of actual profits. Thus, a taxpayer that wishes to use the transactional profit method *ex ante* in order to share the risks associated with the use of intangibles may be able to share the risk through the use of the transactional profit split method even though the transaction would not otherwise warrant the sharing of profits because of the lack of high integration.

The discussion draft includes a paragraph discussing the concept of 'integration of activities' within an MNE, distinguishing between 'sequential' and 'parallel' integration. In the former case, parties sequentially perform discrete functions in the integrated value chain. The discussion draft suggests that it often will be the case that reliable comparables exist for each stage or element in the value chain. An example of sequential valuation is a distributor's use of a trademark or trade name or a manufacturer's use of design and process technology developed by the licensor. The suggestion that in sequential integration of a value chain it is often possible to reliably benchmark the sequential activities would suggest in a DEMPE analysis, in which the exploitation functions sequentially follows development functions that a profit split of actual profits may not be reliable as long as the exploitation function can be

draft addresses splitting actual profits, this distinction, and the provision of separate guidance for these two types of transactional profit splits, expands on Chapter II of the 2010 OECD TPG.

benchmarked. This interpretation would leave valuation methods as the only suggested method to price intangible returns if no reliable comparable uncontrolled price (CUP) exists. It is unclear whether Chapter VI, as currently drafted, concurs with that view.

In parallel integration, multiple parties to the transaction are involved at the same stage of the value chain in contributing assets or sharing functions; it is therefore more likely that an accurate delineation of the transaction will determine that each party shares economically important risks, and a transactional profit split may thus be appropriate. An example of parallel integration is when two parties separately develop an important component or share the development, enhancement, or maintenance of the intangibles.

Although the distinction between sequential and parallel integration may be valid as a theoretical matter, it is unclear how useful the current guidance is as a practical matter. For example, taxpayers and tax administrations seeking to apply the guidance and determine in a specific transaction whether there is sufficient ‘parallel’ integration of activities to justify the use of a transactional profit split may end up at both ends of the spectrum – resulting in taxpayers benchmarking activities and tax administrations applying a transactional profit split, or *vice versa*. Additional examples may help to illustrate when the ‘sufficient integration’ bar is crossed to justify the use of transactional profit splits.

Unique and valuable contributions

Another situation in which a transactional profit split may be the most appropriate method is when multiple parties make unique and valuable contributions. ‘Unique and valuable’ is defined as cases in which (i) the contributions are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) the use of the contributions in business operations represents a key source of actual or potential economic benefits. As a practical matter, such situations are likely to involve intangibles in which each party controls the development risks of their unique and valuable contributions and share in the combined profits resulting from their contributions per Chapter I. An example of such a situation may be where one entity has developed the technology platform and the other entity has developed the trademark, trade name, and other marketing intangibles. In such a case, even though the activities may be sequential, the transactional profit split method may be the most appropriate method because of the inability to benchmark each party’s contribution.

Profit to split, profit split key, and delineation of transaction

The discussion draft does not provide many details as to how a transactional profit split of actual or anticipated profits should be performed. However, some general principles are laid out, most of which highlight how the accurate delineation of the transaction that reflects the functions performed, assets used, and risks assumed is essential to applying an arm’s-length transactional profit split.

The discussion draft suggests that profits can be split by using a contribution analysis or a variation, the residual profit split analysis. The contribution analysis splits the combined profits on the basis of comparable data or the relative value of functions performed by each of the parties, taking into account the assets used and risks assumed. The residual profit split analysis is similar to the contribution analysis, except that in the residual profit split analysis the combined profits are first reduced by the functional routine returns of the parties.

The discussion draft provides guidance on the determination of the profits to be split. The first step is to determine the combined profits to be split for the transaction under review. For companies with multiple product lines and products, this step is likely to require significant segmentation of financial data. The financial data to be used will need to be expressed under a common accounting method and currency. The guidance cautions that: “Experience suggests that that this initial stage in performing the profit split can in some circumstances be extremely complex.” Some may view this statement as an understatement for companies with complex or multistep value chains.

The guidance notes that the measure of profits used as the basis for the profit split will depend on the nature of the integrated operations and the sharing of risks they share, as determined by the accurate delineation of the transaction. Sharing of gross profit margins would be appropriate when the parties share market risks, which affects volume and prices, as well as risks associated with producing or acquiring goods and services, including intangible development. Sharing operating margin would be appropriate if the parties share the risks of the entire value chain, including level of operating expenses. Thus, sharing gross margins would be expected to involve less integration and risk sharing by the parties than splitting operating margins.

The guidance notes that the determination of an appropriate profit-splitting factor should be based on objective data, such as sales to third parties, verifiable and supported by comparable data, internal data, or both. The profit split factors should reflect the key value drivers in relation to the transaction. Depending on the key value drivers, asset-based factors or cost-based factors may be appropriate. If cost-based factors are used, it may be necessary to risk-weight the cost factors and adjust the factors for a time value of money component. Importantly, the guidance suggests that if costs are used, costs may have to be adjusted for cost of living differentials and location savings. Although the discussion draft seems to suggest that multiple factors could be weighed into one profit-splitting key, such weighing cannot be subjective and must be verifiable

by tax administrations. This requirement is likely to make it difficult to use multiple weighed factors as a practical matter, because finding objective and verifiable data to derive the weights will be challenging in most cases.

Significant improvement

The latest discussion draft on the transactional profit split method is a significant improvement on the prior discussion draft. The latest discussion draft makes it clear that the transactional profit split method is not a default method in valuing intangibles, and that the arm's-length standard will be the

guiding principle in the application of the method rather than what appeared to be a formulary apportionment approach in the prior discussion draft. In the next release, which is not expected before the second half of 2017, it is hoped the WP6 will provide additional clarification in a number of areas, including better coordination with Chapter VI's valuation guidance on intangibles. However, fundamentally the guidance in the discussion draft provides a reasonable foundation on which the OECD member states can build upon in the next release to apply the transactional profit split method in accordance with the arm's-length standard.

The OECD hard-to-value intangible guidance

Philippe Penelle of Deloitte Tax LLP looks at the lessons learned from the US commensurate with income standard.

One of the first orders of business carried out by the Organisation for Economic Cooperation and Development (OECD) Working Party 6 (WP6) in the Base Erosion and Profit Shifting (BEPS) OECD/G20 project Actions 8-10 was to reaffirm the use of the arm's-length principle.

Formulary apportionment, on the other hand, remained specifically rejected at paragraph 1.21, Chapter I, Section C.2 of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TPG).

The arm's-length principle was then clarified with the 2010 provisions of Chapter I Section D of the TPG deleted in their entirety, and replaced by new language. The clarification was substantial.

How the clarified provisions of Chapter I were to be interpreted in specific types of transactions was the subject of significant amendments to the guidance provided in Chapter VI (intangible), Chapter VII (low-value adding services), and Chapter VIII (cost contribution arrangements). The provisions of all of these chapters were deleted in their entirety and replaced with new ones.

Conforming adjustments to other chapters were introduced as well, mainly in Chapter II (transfer pricing methods) and Chapter IX (business restructuring).

Non-consensus changes to Chapter II (transfer pricing methods) were proposed on December 16 2014, and subsequently on July 4 2016; they are still in the works and not expected to become consensus guidance until later in 2017.

This early reaffirmation of the arm's-length principle did, however, contemplate the use of special measures that, in certain limited specific circumstances perceived as highly conducive to BEPS risks, could deviate from the arm's-length principle.

Specifically, the non-consensus draft issued on December 16 2014, entitled Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures) (the Risk and Recharacterisation Draft) introduced five such options to address the BEPS Action Plan mandate to examine the use of special measures that are "either within or beyond the arm's-length principle".

The first option, called hard-to-value intangibles (HTVI), addressed the informational asymmetry between taxpayer and tax administrations, while the remaining four options addressed the attribution of inappropriate returns for providing capital.

Only one out of the five options proposed in the Risk and Recharacterisation Draft – the HTVI option – made it to the October

5 2015, OECD/G20 BEPS final deliverable (the final deliverable).

The other four options were dismissed without much explanation.

Since this final deliverable was adopted into the TPG in May 2016 (the 2016 TPG), it now controls the application of Article 9 of the OECD's Model Tax Convention on Income and on Capital. Some tax administrations are taking the view that the revised 2016 TPG apply prior to their formal adoption in May 2016 by the OECD Council by pointing that these revisions are merely clarification of the arm's-length principle that has always existed in nature, and therefore always applied.

The Risk and Recharacterization Draft stated (Part II at paragraph 6) that "some of these measures could be seen as within the arm's-length principle and others beyond. *At this stage, it is not critical to determine whether a potential measure if on one side or the other of the boundary*, but the aim is to consider the effectiveness of the measure," [Emphasis added]. However, it is likely that the four options were dismissed because they were perceived by some countries as deviating too substantially from the arm's-length principle.

Given public statements made by US Treasury officials shortly after the Risk and Recharacterization Draft came out, it is safe to conclude that the US was among those countries, and feared that adopting any of these options would create unmanageable daylight between US authorities (including Treasury regulations and court decisions) and the OECD TPG, or provide tax administrations with too much discretion to force non-arm's length outcomes in too many situations resulting in endless controversy. See, for example, Brian Jenn's comments at the American Bar Association tax section conference in Houston held January 30 2015. Jenn is an attorney advisor at U.S. Treasury (Office of Tax Policy), and a US representative at the OECD Working Party 6.

If the previous assumption turns out to be correct, then it must be the case that the US representatives at WP6 felt that the HTVI guidance was either close enough or entirely consistent with the US authorities' interpretations of the arm's-length principle.

The remainder of this article will attempt to understand where the concepts in the HTVI guidance came from, and explain what the views of the US government have historically been in connection with the arm's-length nature of such concepts. That discussion will encompass a simple theoretical discussion of the use of ex-post results to assess the arm's-length nature of ex-ante pricing as a means to set up one commonly cited reason to believe that the HTVI guidance may, in fact, go beyond the arm's-length principle, as commonly understood or interpreted.

Ultimately, our purpose is to provide useful insights as to what to expect from the OECD HTVI guidance, based

on lessons learned from the US experience with the commensurate income (CWI) standard and the periodic adjustment rules.

Information asymmetries

The inspiration for the HTVI guidance came from the periodic adjustment rules of the US transfer pricing regulations. These periodic adjustment rules were enacted as a result of the US Tax Reform Act of 1986, and the introduction in the 482 statute of the CWI standard that states: "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be *commensurate with the income attributable to the intangible*." [Emphasis added].

The periodic adjustment rules of the US transfer pricing regulations and the HTVI guidance were designed to provide tax administrations with a tool to address the informational asymmetry occurring when taxpayers value intangible transfers upfront, based on projections that tax administrations cannot audit at the time, and typically have a very difficult time auditing years after the fact. "For such intangibles, *information asymmetry between taxpayer and tax administrations*, including what information the taxpayer took into account in determining the pricing of the transaction, *may be acute and may exacerbate the difficulty encountered by tax administrations in verifying the arm's-length basis on which pricing was determined* for the reasons discussed in paragraph 6.186." [Emphasis added] OECD 2016 TPG at paragraph 6.191.

There are several differences between the US periodic adjustment rules and the OECD HTVI guidance. The US periodic adjustment rules, for example, apply to any and all transfers of intangible rights, while the OECD HTVI guidance applies only to hard-to-value-intangibles within the meaning of paragraphs 6.189 and 6.190. To understand all these differences, see US Treas. Reg. §1.482-4(f)(2) and paragraphs 6.192-6.194 of the OECD TPG; such detailed understanding is not necessary for the purpose of the present discussion.

The US periodic adjustment rules and the OECD HTVI guidance generally provide that, in a transfer of intangible rights, when the *ex-post* results are substantially different from the *ex-ante* projections, tax administrations can use the *ex-post* results as presumptive evidence of the *ex-ante* projections. "In these circumstances, the tax administration can consider ex post outcomes as *presumptive evidence* about the appropriateness of the *ex-ante* pricing arrangements." [Emphasis added] OECD 2016 TPG at paragraph 6.192.

Under US rules, such presumptive evidence can be rebutted. See Treas. Reg. §1.482-4(f)(2)(ii)(D) (or Treas. Reg. §482-7(i)(6)(vi)(A)(2)(2011) for cost sharing arrangements). Under OECD 2016 TPG, satisfactory evidence of the adequacy and robustness of the *ex-ante* projections

actually used by the taxpayer to price the transfer may protect from an HTVI adjustment initiated by a tax administration based on *ex-post* results. See OECD 2016 TPG at paragraph 6.193.

This is the sense in which US periodic adjustment rules and OECD HTVI guidance are designed to address the informational disadvantage of tax administrations *vis-à-vis* taxpayers.

Notwithstanding the aforementioned, the use of *ex-post* evidence to challenge an *ex-ante* valuation is conceptually problematic.

Perfectly arm's-length transactions could therefore easily end up being adjusted without cause other than, for example, the taxpayer's inability to (i) convincingly rebut the presumptive evidence of non-arm's length pricing (US rules), or (ii) satisfactorily demonstrate the adequacy and robustness of the *ex-ante* projections actually used (OECD HTVI guidance).

Why is the use of *ex-post* evidence to challenge an *ex-ante* valuation conceptually problematic? Clearly, the *ex-ante* valuation will price the possible upsides of the transaction, but also the possible downsides. As such, financial projections are not designed to predict the future outcome, they are designed to average all possible future outcomes to ensure a fair exchange of *ex-ante* value, in a probabilistic sense.

Ex-post outcomes, however, are not averages, they are actual realisation of one out of all the possible risk outcomes envisioned in the *ex-ante* average of all possible risk outcomes.

The OECD 2016 TPG are much clearer than the US regulations in prescribing financial projections used for valuation purpose to be weighed on probability. For example, the first exculpatory provision at paragraph 6.193 specifies that the HTVI guidance will not apply to transactions involving the transfer or use of HTVI when the taxpayer provides: "Details of the *ex-ante* projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (e.g. probability-weighted), and the appropriateness of its consideration of reasonably foreseeable events and other risks, and the probability of occurrence...".

To illustrate the idea that *ex-ante* projections are probability-weighted averages whereas *ex-post* results are one-time actual realisation of risk, consider a simple game of chance whereby a fair coin is tossed. If the coin lands on heads, the player wins \$1 million; if the coin lands on tails, the player loses \$1 million. The *ex-ante* expected value of the game is thus:

$$V = \frac{1}{2} \times v(\$1,000,000) + \frac{1}{2} \times v(-\$1,000,000)$$

The function $v(\cdot)$ captures the attitude of the player towards risk – how cash translates into value *for the player*. A risk-neutral player values a win of \$1 million equally to a loss of \$1 million: $v(\$1,000,000) = \$1,000,000 = -v(-\$1,000,000)$. Therefore, for a risk-neutral player, the value of this game is such that $|v(-\$1,000,000)| = |v(\$1,000,000)|$:

$$V = \frac{1}{2} \times v(\$1,000,000) + \frac{1}{2} \times v(-\$1,000,000) = \$0$$

The operator $|\cdot|$ takes the argument and returns the absolute value of the argument. So if $x < 0$ then $-x = |x| > 0$ while if $x > 0$ then $x = |x| > 0$.

A risk-averse player, however, values the downside risk of losing \$1 million more than the upside risk of winning \$1 million. Therefore, for a risk-averse player, the value of this game is negative because $|v(-\$1,000,000)| > |v(\$1,000,000)|$. To induce such a player to play the game, a payment of at least $|v(-\$1,000,000)| - |v(\$1,000,000)|$ is necessary to make the risk-averse player at least indifferent between playing the game and not playing the game, or better off.

A risk-loving player, finally, values the upside risk of winning \$1 million more than the downside risk of losing \$1 million. Therefore, for a risk-loving player, the value of this game is positive because $|v(\$1,000,000)| > |v(-\$1,000,000)|$. Such a risk-loving player is therefore willing to pay up to $|v(\$1,000,000)| - |v(-\$1,000,000)|$ to play the game.

This is why casinos exist and are profitable – the odds are stacked against players in favor of the house; therefore, the house will be profitable. Risk-averse and risk-neutral players do not play, only risk-loving players are willing to forgo fair odds for the sake of gambling. This is the sense in which risk-loving players do pay-to-play; they do not pay cash to the casino to play and face fair odds, they pay by accepting unfair odds instead. The words "fair" and "unfair" refer to whether or not the *ex-ante* value of the game is zero or negative.

Regardless of the player's attitude toward risks, and thus regardless of whether the game has positive, zero, or negative expected value, the concept of "value" is clearly *ex-ante* value, the probabilities of heads and tails do appear in the definition of value.

Obviously, *after* the coin is tossed, either the player will have won or lost \$1 million, plus or minus the side payment that was made. At that point, for a risk-neutral player, the *ex-post* value of the game will be \$1 million (if the player win) or minus \$1 million (if the player loses) – no side payment needs to be factored in. In the coin toss game, the *ex-post* value of the game will never be equal to the *ex-ante* value of the game.

The game of chance we described above is no different than the game of chance a pharmaceutical company plays

when engaging in a research and development project. The technical risk of success or failure of the project is captured by probabilities of success or failure that appear in the *ex-ante* value of the project (the financial projections), but not in the *ex-post* value (the actual financial statements). There is nothing nefarious or suspicious about it, and yet the US periodic adjustments rules and the OECD HTVI guidance provide tax administrations with the authority to perform adjustments, under certain circumstances, when the difference between *ex-ante* value and *ex-post* value is above a certain threshold.

It is generally accepted that at arm's length, once parties have an *ex-ante* agreement as to their respective rights and obligations, unless specifically contractually allowed (and hence priced *ex-ante*), regardless of what the *ex-post* result is, each party will have to perform under the contract. What that means is that adjustments to *ex-ante* pricing are not possible using the benefit of hindsight. Forced renegotiation of the agreement is not possible.

Those who argue that the US periodic adjustment rules and OECD HTVI guidance are inconsistent with arm's-length pricing rely on this principle to make their case. In addition, they will argue that if the government has the authority to make upwards adjustments based on the benefit of hindsight, then taxpayers should have the authority to make downward adjustments based on the benefit of hindsight – if one can renegotiate one way (i.e. government favourable), one can equally renegotiate the other way (i.e. taxpayer favourable).

These arguments are diametrically opposed to the arguments the US government historically has put forth.

US government position

The issue of the consistency of the periodic adjustment rules with the arm's-length standard of Treas. Reg. §482-1(b)(1) is particularly important in light of the *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015) decision.

In *Altera Corp. v. Commissioner*, the US Tax Court invalidated the Treasury regulations requirement that controlled participants in a cost sharing arrangement (CSA) share stock-based compensation costs.

Although the basis for invalidating the aforementioned regulatory requirement was grounded in administrative law and the Administrative Procedure Act (APA), Judge Marvel's decision (reviewed by the Tax Court) reaffirmed the decision by the Court of Appeals for the 9th Circuit in *Xilinx, Inc. v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010) that the Treasury's implementation of the arm's-length standard to a transaction must be performed by reference to empirical evidence as to how uncontrolled participants in such a transaction actually price it.

This empirical view of the arm's-length standard could therefore suggest potential challenges to the periodic adjust-

ment rules of Treas. Reg. §482-1(f)(2) insofar as a taxpayer adjusted under that rule could proffer empirical evidence that uncontrolled parties do not use *ex-post* evidence to modify an *ex-ante* deal, unless specifically authorised by their written agreement and priced accordingly.

The position of the IRS and Treasury in connection with the *Xilinx* decision is articulated in the Action on Decision 2010-03 issued July 16 2010: “The majority, however, mistakenly interprets the arm's-length standard to limit the behaviour of controlled taxpayers, or the transactions into which they may enter, based on the behaviour or transactions into which uncontrolled taxpayers may or may not enter. To the contrary, the regulations accept the controlled taxpayers' actual transaction, provided it has economic substance. The regulatory arm's-length standard asks what would have been the pricing that uncontrolled taxpayers would have adopted, had they entered into the same transaction in which the controlled taxpayers actually engaged.” [Footnotes omitted].

Despite the government's nonacquiescence with the decision of the Court of Appeals for the 9th Circuit, judges decide the outcome of disputes between the IRS and taxpayers, not IRS Chief Counsel. It is therefore particularly instructive to understand what the starting position of the IRS and Treasury is, insofar as the arm's-length nature of the periodic adjustment rules is concerned.

Note that the mere finding by a court that Treas. Reg. §482-4(f)(2) conflicts with the arm's-length standard of Treas. Reg. §482-1(b)(1) does not automatically and necessarily invalidate the periodic adjustment rules of Treas. Reg. §482-4(f)(2). Even when the IRS maintains its position that the periodic adjustment rules of Treas. Reg. §482-4(f)(2) are consistent with the arm's-length standard, *Chevron* deference by the court would avoid invalidation of the periodic adjustment rules.

Xilinx and *Altera*, however, have made that scenario much less likely to occur.

The words “fair” and “unfair” refer to whether or not the *ex-ante* value of the game is zero or negative.

RS will follow a significant non-appealed adverse opinion by the court. An action on decision alerts IRS personnel to the Chief Counsel's current litigation position, and it is issued to enhance IRS consistency for future litigation or dispute resolution. Although actions on decision are published in the Internal Revenue Bulletin, they are not intended to serve as statements of IRS positions that can be relied on by the public, and they are not to be cited as precedent. An action on decision is issued by the Office of Associate Chief Counsel with subject matter jurisdiction over the substantive issue addressed in that action on decision.

The white paper

In addition to adding the CWI standard to the 482 statute, and still in the context of the Tax Reform Act of 1986,

Congress instructed the IRS to perform a comprehensive study of the Internal Revenue Code (IRC) Section 482 intercompany transfer pricing rules to assess whether those rules ought to be amended. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-638 (1986).

The IRS complied with Congress's request by issuing in 1988 Notice 88-123, "A Study of Intercompany Pricing under Section 482 of the Code", 1988-2 CB 458, colloquially referred to as the "white paper".

"Congress intended the commensurate with income standard to be consistent with the arm's-length standard. And it will be so interpreted and applied by the Internal Revenue Service and the Treasury," the white paper states at page 458.

Since the interpretation by the IRS and Treasury of the CWI standard can be found in the periodic adjustment rules of the Treasury regulations, the white paper makes it clear that the periodic adjustment rules, as written in Treas. Reg. §482-4(f)(2), were intended to be consistent with the arm's length standard of Treas. Reg. §482-1(b)(1).

The periodic adjustment rules of Treas. Reg. §482-4(f)(2)

The second sentence of Treas. Reg. §1.482-4(f)(2)(i) mandates that adjustments made pursuant to the periodic adjustment rules should be consistent with the arm's-length standard and the provisions of Treas. Reg. §1.482-1: "Adjustments made pursuant to this paragraph (f)(2) shall be consistent with the arm's length standard and the provisions of § 1.482-1." [Emphasis added].

The generic legal advice memorandum 2007-007

Remember that the second sentence of the IRC Section 482 statute (added in 1986) reads: "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be *commensurate with the income attributable to the intangible*." [Emphasis added].

A possible interpretation of "income attributable to the intangible" can be found in Treas. Reg. §1.482-4(c)(2)(iii)(B)(1)(ii). According to that guidance, it is the net present value of the benefits to be realised based on prospective profits to be realised or costs to be saved through the use or subsequent transfer of the intangible.

Consistent with that definition of "income attributable to the intangible," the Generic Legal Advice Memorandum 2007-007 (GLAM 2007-007) provides a detailed discussion of how the use of *ex-post* results envisioned in the periodic adjustment rules fits within the arm's-length standard of Treas. Reg. §1.482-1(b)(1).

More specifically, GLAM 2007-007 states that the IRS must exercise its periodic adjustment authority consistent with what would have been a conscientious upfront valuation.

In other words, "income attributable to the intangible" must be construed to mean the reasonably anticipated net



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All opinions expressed in Philippe's publications and in the comments submitted by USCIB and BIAC to the OECD represent the views of the author and of these organisations, respectively, and should in no way be construed as representing those of Deloitte Tax LLP, or of any of the Deloitte Touche Tohmatsu Limited member firms.

present value of the benefits to be realised by the exploitation or subsequent transfer of the intangible measured at the time the transaction is entered into – i.e. the upfront valuation.

Bringing it all together

Many taxpayers tend to view the periodic adjustment rules as providing the IRS with the authority to unilaterally obtain an *ex-post* renegotiation of the upfront deal when the US taxpayer faces an adverse realisation of risk – for example, the outbound license of a US intangible turned out to be more profitable than the US licensor and foreign licensee envisioned at the time of the transfer; hence, the price paid by the licensee to the licensor is less than it would have been had the parties known how profitable the intangible was going to be.

These taxpayers see the periodic adjustment rules as inconsistent with the arm's-length standard.

The US government, on the other hand, tends to view the periodic adjustment rules as providing the IRS with the authority to challenge the financial projections used by the taxpayer in the *ex-ante* valuation by performing an alternative *ex-ante* valuation using a different set of financial projections (the *ex-post* financial results). Despite the fact that such exercise is carried out on an *ex-post* basis, it is still an *ex-ante* valuation, or a conscientious upfront valuation in the parlance of GLAM 2007-007, because other than the different set of financial projections used, no information that was not available at the time of the upfront valuation can be used – see GLAM 2007-007.

Because the government has no meaningful way to audit the *ex-ante* financial projections used at the time the transaction was entered into, it reserves the right through the periodic adjustment rules to perform the *ex-ante* valuation using the *ex-post* financial results as presumptive evidence of the *ex-ante* financial projections.

In the US government's view, this has nothing to do with using the benefit of hindsight to renegotiate a transaction.

Thus, the US government sees the periodic adjustment rules as consistent with the arm's-length standard.

Lessons learned

The language used by WP6 in drafting the HTVI guidance strongly suggests that it benefitted from lessons learned in the US regarding the lack of a common understanding between taxpayers and the government as to the ultimate purpose of CWI and periodic adjustments discussed herein.

There is no ambiguity left in the HTVI guidance that its purpose is to resolve information asymmetries between taxpayers and tax administrations. It also very clearly articulates that taxpayers have the opportunity to resolve information asymmetries by providing tax administrations with details of the *ex-ante* projections used at the time of the transfer to determine the pricing arrangements, and reliable evidence

that any significant difference between the financial projections and actual outcomes is either due to unforeseeable events, or to the playing out of reliable probabilities used in the financial projections.

In other words, if taxpayers volunteer reliable *ex-ante* information to proactively eliminate the information asymmetry tax administrations suffer from, then there is no reason left to authorise tax administrations to use *ex-post* information to adjust the *ex-ante* deal – that would be inconsistent with the arm's-length principle.

As a practical matter, though, tax administrations will have great latitude in determining whether the exculpatory provisions of paragraph 6.193 are met or not; this determination involves a level of subjectivity that may not be particularly reassuring to taxpayers.

HTVI is a blunt tool that can easily be abused. As noted in this article, *ex-post* results will always be different from *ex-ante* projections because *ex-post* outcomes reflect a single realisation of all possible risk outcomes, while the *ex-ante* projections reflect the average of all possible risk outcomes. Thus, authorising tax administrations to perform an HTVI adjustment solely based on the size of the spread between the average risk outcome and the actual risk outcome could easily and often result in large adjustments that may be difficult for taxpayers to contest.

This issue will be particularly salient in industries that require risky intangible development activities, when the actual realisation of risk outcomes may be far away from their *ex-ante* average just because of the level of risk involved.

In the US, it is no secret that the IRS has been extremely restrained in its reliance on the periodic adjustment rules as its sole reason to adjust taxpayers. One possible explanation of that extreme restraint is the way the periodic rules are written, and especially the exculpatory provision (rebuttal) of Treas. Reg. §1.482-4(f)(2)(ii)(D).

Once a taxpayer rebuts the presumptive evidence of the inappropriateness of the *ex-ante* pricing based on *ex-post* results, it is unclear what information the government would have, at that point, to actually rebut the taxpayer's rebuttal when the whole premise and reason for being of the periodic adjustment rules is that the government is at such a severe information disadvantage in the first place.

The irony of the rebuttal provision of Treas. Reg. §1.482-4(f)(2)(ii)(D) is that it relies on private information that a taxpayer has, but that the IRS almost certainly does not have. The information asymmetries between taxpayers and tax administrations go much deeper than just financial projections.

Once an IRS-initiated proposed periodic adjustment has been rebutted by a taxpayer, short of a smoking gun hinting at fraud, or some other clear evidence of nefarious behaviour by the taxpayer, the US periodic adjustment rules may well be

ineffective in achieving their intended goal, because of the way they are written – the exception has swallowed the rule.

This, however, may not be the case with the HTVI guidance. And because the HTVI guidance was written very differently from the US periodic adjustment rules, we may

currently be in a world where tax administrations are endowed with a very blunt tool they will be able to use with few safeguards protecting taxpayers from abusive use.

WP6 should keep that in mind when issuing the HTVI implementation guidance expected in 2017.



Transfer pricing Consistency

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Value chain analysis – the role of operating leverage

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examine the role of
operating leverage.**

Recent OECD guidance on transfer pricing documentation (Action 13) requires multinational enterprises (MNEs) to identify where and how value is created in the business operations, including:

- Consideration of the economically significant functions, assets and risks;
- Which party performs the functions, contributes the assets and assumes the risks;
- How the functions, assets and risks are inter-related;
- How the economic circumstances may create opportunities to capture profits in excess of what the market would allow (e.g. unique intangibles or first mover advantages); and
- Whether the value creation is sustainable.

We will refer to this as the value chain analysis, or VCA. Recent (non-consensus) guidance on the transactional profit split method (PS, or PS method) cautions that a VCA is merely a tool to assist in accurately delineating a transaction and is therefore part of a functional analysis. In particular, it may be helpful in determining the most appropriate method, which may or may not be the PS method. The existence of a global value chain does not cause the transactional PS to be the most appropriate method. Describing a value chain analysis as a delineation tool for a specific transaction, rather than as a justification to apply a profit split, is a significant change in direction from the (non-consensus) December 2014 discussion draft on the use of profit splits in the context of global value chains. While certain parts of a business may be considered routine (i.e. can be benchmarked based on a functional analysis), benchmarking vertically integrated businesses can be challenging and thus make a VCA difficult to perform.

To understand why this is the case, we must delve into the economics of vertical integrated supply chains, best summarised by Paul Joskow in his paper titled “Asset Specificity and the Structure of Vertical Relationships: Empirical Evidence” (see “Nature of the Firm” edited by Williamson and Winter; Oxford 1993) – “The conditions under which businesses decide to engage in market-based transactions on a non-exclusive “spot” basis are very different from the conditions under which businesses decide to engage in market based transactions on an exclusive “long-term contractual” basis which in turn are very different from the conditions under which businesses decide to internalize market transactions within the same organisation through vertical integration.” This is a consequence of potential mismatch in the incentives of parties over

time and is often referred to as the “hold-up problem”. Joskow further writes: “The key considerations behind such differing structures rest on the importance of asset

- specificity, uncertainty, product complexity and the constraints on repeat transactions. Examples of asset specificity include:
- Site specificity – where the buyer and seller are in a long-term relationship, reflecting *ex ante* decisions to minimise inventory and transportation costs. Once sited, the assets in place are highly immobile;
- Physical asset specificity – when one or both parties to the transaction make investments in equipment and machinery that involves design characteristics specific to the transaction and which have lower values in alternative uses;
- Human asset specificity – investments in relationship-specific human capital that often arise through a learning-by-doing process; and

Dedicated assets – general investments by supplier that would not otherwise be made but for the prospect of selling a significant amount of product to a particular customer. If the contract was terminated prematurely it would leave the supplier with significant excess capacity.”

An integrated supply chain characterised by a high degree of asset specificity, uncertainty or product complexity may be hard to benchmark and, therefore, certain parts of such a supply chain may be considered non-routine. A PS analysis may then be the most reliable method for analysing such supply chains or parts thereof. It should be noted that at arm’s length each party to a transaction optimise their own value, however MNEs by definition optimise value of the group as a whole.

For a meaningful discussion of VCA, we must, at the outset, have a common (a) definition of value and (b) understand what contributes to the creation of such value. One can think of three potential definitions:

- Price of goods or services sold to third parties;
- Value added or price of goods or services sold to third parties less price of related inputs purchased from third parties; or
- Some measure of profit, e.g. gross profit, operating profit, contribution margin.

Value is created by labour and capital. Price must, on average, cover costs of inputs purchased from third parties, wages and salaries of employees, and provide an adequate return to capital adjusted for risks. Capital carries residual risk and return to capital (profit) is the key focus of transfer pricing.

Therefore, to document and measure how value is created we must understand how risks are created. Risks of a business (as measured by unlevered beta) emanate from two main sources:

- Nature of product or service offered: Other things being equal, the more discretionary the demand for the prod-

uct or service, the higher the risk. For an integrated supply chain, this risk is common for all sub-units of the supply chain; and

- Operating leverage (fixed costs as a percentage of total costs): Other things being equal, the higher the proportion of fixed costs in total costs, the higher is the risk in the business. Unlike the first source of risk, this risk is not common for all sub-units of an integrated supply chain because fixed costs vary between the stages of a supply chain.

Our framework for defining and measuring value creation rests on this determination of risks that is non-diversifiable and is therefore entitled to an adequate market based return.

We build on this notion of operating leverage by recognising that fixed costs in any business not only reflect accounting fixed costs (such as rent, utilities, etc.) but also fixed costs of assets (both on and off balance sheet) usage (i.e. depreciation and amortisation) as well as the opportunity cost of financing the (on and off balance sheet) assets. This is an essential first step to move from an accounting P&L to an economic P&L so that the financials reflect the economic fixed costs of running the business or the sub-unit within the MNE. In the rest of our discussion below, our reference to operating leverage should be interpreted using the definition of operating leverage that reflects the economic fixed costs in the numerator.

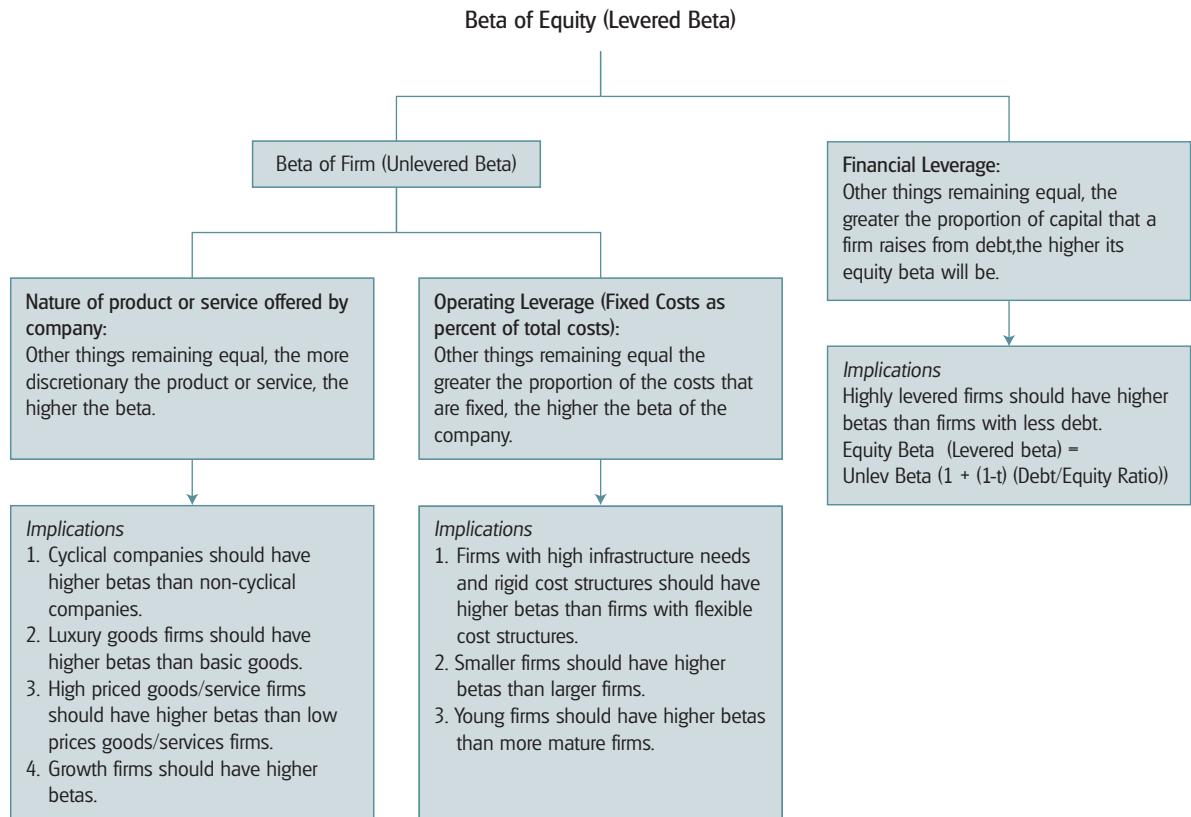
Consistent with operating leverage, we choose contribution margin (defined as revenue minus variable costs) as the measure of value for the VCA analysis of an integrated supply chain. Contribution margin must, on average, cover fixed operating costs and provide an adequate return to debt and equity capital. Aligning profits based on value creation is therefore analogous to allocating the consolidated contribution margin to the various entities that have contributed to the creation of such value which, in turn, is measured by their share of risks in the business defined by their respective operating leverages. We will call this analysis economic profit split (EPS).

In transactions between unrelated parties, the parties agree *ex ante* on their expected respective cost structures, investments and assets, and often agree on revenue sharing arrangements reflecting their relative risks. This is to counteract the asymmetric information problem that exists in any long term arrangement between unrelated parties.

In related party transactions, this asymmetric information problem is alleviated through centralised management and control. Thus *ex post* contribution margin (or revenue) can be split among the sub-units of an integrated supply chain based on the relative modified operating leverage of the sub-units.

It should be noted that while almost all fixed costs can be tied to a location where they are first incurred, they can

Diagram 1



This diagram is adopted from Aswath Damodaran – Estimating Beta <http://people.stern.nyu.edu/adamodar/pdf/eqnotes/discrete2.pdf>

be made variable and shifted contractually (e.g. by providing a fixed *ex post* mark-up on all operating costs or by providing a fixed *ex post* operating margin), thereby shifting risks from the location where incurred to another location (e.g. a principal). However, contractual risk shifting arrangements without meeting the control requirements articulated at paragraphs 1.61, 1.65 and 1.94 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations may be ignored by tax authorities. More specifically, risks must be accompanied by the performance of risk control and management (OECD Par. 1.61;1.65) defined as (a) capability and performance of the decision to take risk; (b) capability and performance of responding to changes in risk; and (c) capability and performance of risk mitigation. Risk control and management focusses on responses to potential and actual events; not necessarily the control of whether an event occurs because many events are not within the control of the MNE (e.g. business cycle). Day-to-day risk

mitigation may not be an important function if the controlling party (OECD Par. 1.65) (a) determines the objectives or the outsourced activity; (b) has the ability to hire/fire; (c) can and does access whether the objectives are being met; and (d) can terminate the contract.

To perform a meaningful EPS, economically meaningful P&Ls and balance sheets need to be constructed. Those economic financial statements are often constructed using accounting P&Ls and balance sheets as a starting point and then separating out variable costs from fixed costs (for example) rather than separating out cost of goods sold from operating expenses, as is the case in an accounting P&L. Similarly, an economically meaningful balance sheet will show intellectual property as an on-balance sheet asset rather than not showing it, as is the case in an accounting balance sheet (when the IP is internally developed).

More specifically, the steps required for an EPS analysis are as follows:

1. Prepare consolidated income statement (P&L) and balance sheet based on region/country of final sale for product or product lines;
2. Prepare un-consolidated P&L and balance sheet broken down amongst entities in the supply chain with respect to item #1 above;
3. Identify all costs that are not correlated to current revenue. This is our measure of fixed costs that create off-balance sheet assets, (e.g. certain portions of R&D, marketing and promotion, training, leadership and strategic management);
4. Estimate lead time, useful life and probability of failure (if necessary) for the above costs and quantify value of off-balance sheet assets;
5. Create analytical P&L by removing the above costs from the P&L and replacing with amortisation of off balance sheet assets;
6. Bifurcate COGS into variable and fixed. Accounting fixed costs would include PPE depreciation and certain factory overhead. Detailed cost accounting combined with qualitative research or regression techniques may be used to create this bifurcation;
7. Bifurcate SGA from analytical P&L (after removing current costs of creating off balance sheet assets described above and adding amortisation of off-balance sheet assets). Fixed costs would include amortisation of off-balance sheet assets and depreciation of tangible property. Detailed cost accounting combined with qualitative research or regression techniques may be used to create this bifurcation;
8. Compute consolidated contribution margin (revenue minus variable costs in COGS and SGA of analytical P&L);
9. Compute financing fixed cost (or opportunity cost of carrying assets) using on and off- balance sheet asset balances multiplied by risk-free rate;
10. Perform the control test (within the meaning of 1.61, 1.65 and 1.94) to determine control over the economically significant risks resulting from the commitment of significant fixed costs. Re-allocate the fixity of the costs to the legal entity satisfying the control test (if different from the legal entity bearing those costs in accounting statements);
11. Split contribution margin based on relative share of fixed costs (sum of operating fixed costs and financing fixed costs) of the parties in the supply chain; and
12. Recreate accounting P&L of entities in the supply chain based on split of contribution margin calculated above.

We have provided a detailed step-by-step example of how this method can be applied in the context of a hypothetical example in the Appendix to this paper. In this stylised example, a MNE with a manufacturer, an IP principal and distributors in its global supply chain generates

15 units of consolidated operating profit which gets split seven units, 4.7 units and 3.4 units between the manufacturing entity, IP principal and the distributors respectively. Intuitively, the example captures the fact pattern that of the total consolidated costs of 85 being borne in the group, the manufacturer bears 68% of such costs and the distributor bears 16.5% of the expenses (excluding the COGS) as distribution related operating expenses.

The EPS method provides an alternate to a CPM/TNMM based approach to justifying profits to any sub-unit within an MNE and can therefore form a very useful basis to validate the results of such benchmarking analyses. It is also a powerful framework to test the outcomes from this method against actual results (based on the chosen transfer pricing policy of the MNE) of the sub-units that may give rise to meaningful questions to identify gaps/risks in justifying the actual results against the economics of the business as a whole.

In conclusion, we have outlined the key approach to a VCA and how one may apply economic principles to determine the *ex-post* split of the consolidated contribution margin in a global value chain taking into consideration the economic risks being borne by the various entities within a MNE. Our methodology allocates the *ex post* contribution margin (or revenue) among the sub- units of an integrated supply chain based on the relative modified operating leverage of the sub units. The results of our EPS provides a reasonable arm's-length approximation of the allocation of profits within an MNE that are aligned by the creation of value within the MNE's integrated supply chain.

Appendix: Application of the EPS

The following example and tables demonstrate the execution of the above steps in a simplified fact pattern. Consider five entities in the MNE's supply chain – a manufacturer (MFG), a principal (P) responsible for investing in R&D and certain advertising and promotion, and distributors (DSTs). The intercompany transactions are (1) sale of finished and semi-finished products from MFG to P and (2) sale of finished products from P to DSTs in various locations.

Tables 1 and 2 show the first two steps in the analysis outlined above: the consolidated P&L and balance sheet for the MNE, as well as for its different units respectively. For each entity, the line item affected by related party transactions is denoted using a question mark. Table 3 shows step three in the EPS analysis outlined above, which consists of estimating the costs related to the creation of off-balance sheet assets (OBSA). First, the cost categories that generate off-balance sheet assets need to be identified, as shown on Table 3. Second, the percentage of costs in that category, which are NOT related to current revenue, must be isolated

Table 1: MNC segmented and consolidated P&L for 2015 (\$ mil)

	Consolidated	Manufacturer in Country A	Principal in Country B	Distributors in Countries C, D & E
Revenue	100	?	?	100
COGS	50	50	?	?
Gross profit	50	15	18	17
SG&A	35	8	13	14
Sales	7	0	0	7
Development (R&D)	8	0	8	0
Promotion (A&P)	5	0	2	3
G&A	10	4	3	3
Depreciation	5	4	0	1
EBIT	15	?	?	?

Table 2: MNC segmented and consolidated balance sheet for 2015 (\$ mil)

	Consolidated	Manufacturer in Country A	Principal in Country B	Distributors in Countries C, D & E
Cash	5	3	0	2
Receivables	15	0	0	15
Inventory	10	5	0	5
PP&E	55	50	0	5
Other	10	4	3	3
Operating assets	95	62	3	30
Payables	16	16	0	0
Others	0	0	0	0
Current liabilities	16	16	0	0
Net operating assets	79	46	3	30

Table 3: Identification of costs generating OBSA

	Consolidated	Costs generating off-balance sheet assets
COGS	50	
SG&A	35	
Sales	7	
R&D	8	88% of the costs generate off-balance sheet assets
A&P	5	80% of the costs generate off-balance sheet assets
G&A	10	<ul style="list-style-type: none"> - 10% of costs relate to training, and 80% of the training costs not related to current revenue, but affect value of workforce in place (WIP) - 20% of the costs relate to leadership and strategic management, and 60% of these costs relate to long term strategy initiatives, which we call here leadership and strategic management (LSM)
Depreciation	5	

in order to determine the costs generating OBSA that will drive revenue in the future.

Additionally, this step also involves determining the lead time, life, amortisation schedule, and probability of success tied to the costs identified as generating OBSA. These analyses are performed to in order to determine the costs incurred in the past that are generating revenue in the current period. Information about life, lead time, and amortisation schedule should be gathered during functional interviews with personnel knowledgeable about the MNE's business and its risks. Tables 4, 5 and 6 show a sample analysis to identify the costs that generate OBSA, the balance of the OBSA related to each cost category, and the OBSA amortisation for the period.

The life and lead time are used to generate an amortisation schedule to determine when the costs incurred generating OBSA will generate revenue. Table 5 shows a sample

OBSA amortisation schedule based on the lead and life information from Table 4, and for the scenario where OBSA are not subject to a probability of success adjustment and the amortisation schedule is linear.

The amortisation schedule and historical costs generating OBSA allows for the calculation of the stock of the OBSA (i.e. the total costs incurred in the past that will drive revenues in the future) and the depreciation of the OBSA, which determine the costs that are generating revenue in the current period.

Table 6 present the build-up of the OBSA generated by A&P costs under the amortisation schedule from Table 5, and that the net present value of costs incurred in the prior years is the same as during the current period. The OBSA stock is the total costs incurred in the past that will generate revenue in the future, and the OBSA amortisation (i.e. the fixed costs contributing to the current period revenue) is the

Table 4: Construction of OBSA

OBSA generating costs	Costs in P&L	% not related to current revenue	OBSA costs	Lead time	Life
R&D	8	88%	7	2	5
A&P	5	80%	4	0	3
Training	1	80%	0.8	0	2
LSM	2	60%	1.2	0	2

Table 5: Amortisation schedule of OBSA

	0	1	2	3	4	5	6
R&D	100%	100%	100%	80%	60%	40%	20%
A&P	100%	67%	33%	0%	0%	0%	0%
Training	100%	50%	0%	0%	0%	0%	0%
LSM	100%	50%	0%	0%	0%	0%	0%

Table 6: Build-up of A&P off-balance sheet assets and amortisation example

	2012	2013	2014	2015
Amortisation of A&P 2012	4.0	2.7	1.3	0.0
Amortisation of A&P 2013		4.0	2.7	1.3
Amortisation of A&P 2014			4.0	2.7
Amortisation of A&P 2015				4.0
Total A&P OBSA stock	4.0	6.7	8.0	8.0
<i>A&P OBSA amortisation</i>	0.0	1.3	2.7	4.0

Table 7: Classification of accounting P&L costs

	Consolidated	Manufacturer in Country A	Principal in Country B	Distributors in Countries C, D and E
COGS	50	50	0	0
	Variable	40	0	0
	Fixed	10	0	0
	Off-balance sheet	0	0	0
SGA	35	8	13	14
	Variable	16	2.74	9.82
	Fixed	6	0.5	1.5
	Off-balance sheet	13	9.76	2.68
R&D	7		7	
A&P	4		2	
Training	0.8	.32	0.16	.32
LSM	1.2	.24	0.6	.36

Table 8: Contribution Margin

	Consolidated	MFG in Country A	Principal in Country B	DST in Countries C, D and E
Revenue	100	0	0	100
Variable costs				
Cost of sales	40	40	0	0
Sales	7	0	0	7
Maintenance R&D	0.5	0	0.5	0
Maintenance A&P	0.5	0	0	0.5
G&A	8	4	0	4
Total variable costs	56	44	0.5	11.5
Contribution margin	44			

change in OBSA stock minus the OBSA generating costs in the current period. That is: OBSA amortisation = OBSA stock (t-1) – OBSA stock (t) + OBSA generating costs (t).

Following the identification of the P&L costs generating OBSA and the OBSA amortisation determined by an analysis of the historical OBSA generating costs, and the life and lead time of these costs, the remaining costs in the P&L are identified as either period fixed costs (i.e. fixed costs that do not generate OBSA), and variable.

Table 7 shows the classification of the P&L into the three categories of costs: period fixed, variable, and generating OBSA under the following assumptions:

- OBSA amortisation is at steady state (i.e. the amortisation is the same as the costs incurred);
- 50% of R&D and A&P spend that does not generate OBSA is assumed to be fixed (related to maintenance);
- All maintenance A&P will be performed by the distributor;
- The allocation of A&P is 50%-50% to the principal and the distributor;
- The allocation of training related costs is 40%-20%-40% to M, P, and Ds respectively;
- The allocation of LSM costs is 20%-50%-40% to M, P, and Ds respectively; and
- Due to the lead and life assumptions on R&D costs, a portion (40%) of the OBSA generated by R&D spend is not related to current period.

The following step (Step 8 in the EPS outlined above) is to calculate the contribution margin, by subtracting the variable costs from the revenues, as shown in Table 8.

The contribution margin is split based on the fixed costs assumed by each entity in the MNE, which include (1)

OBSA amortisation; (2) period fixed costs; and (3) carrying costs (opportunity cost) of assets for both on- and off-balance sheet assets. OBSA amortisation and period fixed costs are shown in Table 9.

To calculate the carrying costs of assets, the balance of the OBSA assets needs to be added to the net operating assets from the balance sheet. The calculation of the OBSA balance is shown in Table 10, and the carrying cost of assets (assuming a 5% rate) in Table 11.

Finally, Table 12 shows the split of the contribution margin (calculated in Table 8), based on the fixed costs assumed by each MNE participant.

Based on the allocation of the contribution margin, the operating profit for each MNE participant will be its share of the contribution margin minus the fixed costs (both OBSA generating costs and period fixed costs) incurred during the period that appear in the P&L.

Table 13 shows the transfer prices that would generate the profits to the participants aligned with the application of the EPS.

Moreover, the EPS outlined in this article, provides a framework to follow the guidance on the allocation of risk from OECD Par. 1.98; 1.99, in which risks and returns should be allocated to the MNE exercising the control over the risk (within the meaning of Par. 1.61, 1.65, and 1.94), and having the financial capacity to bear the risks. In the EPS, the reallocation of risk is carried out by reallocating the fixed costs associated with the risks. Consider for example the situation where the facts are the same as in the example outlined above, with the exception that the principal is a “dumb cash box”. Hence, the principal does not control any of the risks associated with

Table 9: Operating Fixed Costs

	Consolidated	MFG in Country A	Principal in Country B	DST in Countries C, D and E
Period fixed costs				
Cost of sales	10.0	10.00	0.00	0.00
Maintenance R&D	0.5	0.00	0.50	0.00
Maintenance A&P	0.5	0.00	0.00	0.50
Depreciation	5.0	4.00	0.00	1.00
Total period fixed costs	16.00	14.00	0.50	1.50
OBSA amortisation				
R&D amortisation	7.0	0.00	7.00	0.00
A&P amortisation	4.0	0.00	2.00	2.00
WFIP amortisation	0.8	0.32	0.16	0.32
LSM amortisation	1.2	0.24	0.60	0.36
Total OBSA Amortisation	13.00	0.56	9.76	2.68
Total operating fixed costs	29	14.56	10.26	4.18

Table 10: OBSA balance

	Consolidated	MFG in Country A	Principal in Country B	DST in Countries C, D and E
R&D	35.0	0	35.00	0
A&P	8.0	0	4.00	4.00
WFIP	1.2	0.48	0.24	0.48
LSM	1.8	0.36	0.90	0.54
Total OBSA balance	46.0	0.84	40.14	5.02
R&D not related to current revenue	14.0	0	14.0	0
OBSA balance related to current revenue	32.0	0.84	26.14	5.0

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the costs in its P&L, and the MFG is assumed to have substance and control of the principal. Therefore to reflect the control over the risks, the principal's contribution margin,

fixed costs, and return on OBSA are reallocated to the manufacturer (principal only keeps a return on its on-balance sheet assets). This scenario is outlined in Tables 14 and 15.

Table 11: Carrying Cost of Assets

	Consolidated	MFG in Country A	Principal in Country B	DST in Countries C, D and E
Net operating assets (on balance sheet)	79.00	46.00	3.00	30.00
Intangible assets (off balance sheet related to current revenue)	32.00	0.84	26.14	5.02
Net total assets (related to current revenue)	111.00	46.84	29.14	35.02
Carrying cost of assets (at a 5% rate)	5.55	2.34	1.46	1.75

Table 12: Contribution Margin Split

	Consolidated	MFG in Country A	Principal in Country B	DST in Countries C, D and E
Fixed operating costs	29	14.56	10.26	4.18
Carrying cost of assets	5.55	2.34	1.46	1.75
Total fixed costs	34.55	16.90	11.72	5.93
Share of fixed costs		48.9%	33.9%	17.2%
Allocation of contribution margin	44	21.52	14.92	7.55

Table 13: Transfer prices and P&L aligned with EPS

	Consolidated	Manufacturer in Country A	Principal in Country B	Distributors in Countries C, D and E
Revenue	100	65.0	82.6	100
COGS	50	50	65.0	82.6
Gross Profit	50	15.0	17.7	17.4
SG&A	35	8	13	14
Sales	7	0	0	7
R&D	8	0	8	0
A&P	5	0	2	3
G&A	10	4	3	3
Depreciation	5	4	0	1
EBIT	15	7.0	4.7	3.4

Table 14: 'Dumb cash box' P&L aligned with EPS

	Consolidated	MFG in Country A	Principal in Country B	DSTs in Countries C, D and E
Contribution Margin (from Table 12)	44.00	21.52	14.92	7.55
Add: Reallocation of the Principal's CM		14.92	(14.92)	0.00
Less: Return to Principal		(1.46)	1.46	0.00
Less Fixed Costs of Principal		(10.26)	10.26	0.00
Revised Contribution Margin	44.00	24.73	11.72	7.55
Total Operating Fixed Costs (Table 9)	29	14.56	10.26	4.18
Operating Profit	15.00	10.17	1.46	3.37

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Table 15: 'Dumb Cash Box' transfer prices and P&L aligned with EPS

	Consolidated	Manufacturer in Country A	Principal in Country B	Distributors in Countries C, D and E
Revenue	100	68.17	82.63	100
COGS	50	50	68.17	82.63
Gross Profit	50	18.17	14.46	17.37
SG&A	35	8	13	14
Sales	7	0	0	7
R&D	8	0	8	0
A&P	5	0	2	3
G&A	10	4	3	3
Depreciation	5	4	0	1
EBIT	15	10.17	1.46	3.37



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All opinions expressed in Philippe's publications and in the comments submitted by USCIB and BIAC to the OECD represent the views of the author and of these organisations, respectively, and should in no way be construed as representing those of Deloitte Tax LLP, or of any of the Deloitte Touche Tohmatsu Limited member firms.



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