Profit-Split Methods and the OECD: Leaning Toward Formulary Apportionment?

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The opinions expressed in this article are solely those of the author.

In this article, the author highlights the converging features between the purported uses of profit-split methods put forward by the OECD in its latest public discussion draft on the matter, titled "BEPS Action 10: Revised Guidance on Profit Splits," and the theoretical use of formulary apportionment.

On July 22 the OECD issued the public discussion draft "BEPS Action 10: Revised Guidance on Profit Splits" (the profit-split methods, or PSM, draft) through the public consultation taking place from June 22 to September 15.

This is the third draft issued by the OECD on the matter of PSM for transfer pricing purposes following the earlier drafts in 2014 (the 2014 PSM draft)[1] and 2016 (the 2016 PSM draft).[2] These three drafts stem from the OECD's initial guidance on the matter of PSM, "Transactional Profit Methods Discussion Draft for Public Comment," issued January 25, 2008, which then led to revisions to Chapter II of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as they read at the time, in 2010.[3]

The wording included in the latest PSM draft leads one to believe that the OECD may indeed be slowly but surely leaning toward formulary apportionment, if not in principle at least in spirit, regarding PSM use in the determination of arm's-length transfer pricing.

This article highlights the converging features between the purported use of PSM put forward by the OECD and the theoretical use of formulary apportionment, as it is characterized by the OECD.

Related Parties Contractual Arrangements

Contractual terms constitute an essential feature of any comparability analysis.[4] However, the 2017 edition of the OECD transfer pricing guidelines insists on the need to "properly" identify the commercial or financial relations between the parties before carrying out the comparability analysis.[5] This essentially comes back to the determination of the "nature of the transaction."

Regarding the nature of the transaction, paragraph 12 of the PSM draft posits that the

[1] OECD, "Public Discussion Draft. BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains," public consultations from Dec. 16, 2014, to Feb. 6, 2015 (2014).

[2] OECD, "Public Discussion Draft. BEPS Actions 8-10. Revised Guidance on Profit Splits," public consultations from July 4, 2016, to Sept. 5, 2016 (2016).

[3] OECD, "Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines," public consultations from Sept. 9, 2009, to Jan. 9, 2010 (2009).

[4] *See* OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter I, section D.1.1 (para. 1.42-1.50) (2017 ed.).

[5] *Id.*, Chapter I, section D.1 (para. 1.33-1.41).

accurate delineation of the transaction should have "regard to the commercial and financial relations between the associated enterprises, including an analysis of what each party to the transaction does, and the context in which the controlled transactions take place." This guidance is restated in similar terms in paragraph 17 of the draft. It is an explicit validation of the general guidance on comparability analysis. Paragraph 46 of the draft adds for greater clarity that "the starting point in the delineation of any transaction will generally be the written contracts which may reflect the intention of the parties at the time the contract was concluded." So far, so good. The guidance included in the latest PSM draft seems to be aligned on the arm's-length principle. However, it goes downhill from that point.

Integration

Paragraph 7 of the PSM draft suggests that the "transactional profit split method can also provide a solution for highly integrated operations in cases for which a one-sided method would not be appropriate." This assumption duplicates what is found in earlier drafts on PSM, which discussed "integration and the sharing of risks"[6] and "highly integrated operations"[7] in detail. Paragraph 19 of the PSM draft indicates that a "particularly high degree of integration in certain business operations is an indicator for the consideration of the transactional profit split method." Paragraphs 20 and 21 and Example 6 offer "high degree of integration" instances that may justify the use of a PSM according to the OECD, including in cases of so-called high degree of interdependency.

Yet this is incorrect from an economic or commercial standpoint. For instance, none of the existing versions of the franchise model are based on split of profits, although franchisees oftentimes draw heavily on the franchiser's expertise, supplies, processes, marketing, and brand to conduct their businesses. In fact, a "franchise typically involves the granting by one party (a franchisor) to another party (a franchisee) the right to carry on a particular name or trade mark, according to an identified system, usually within a territory or at a location, for an agreed upon term. The franchisee is granted a franchise license to use the franchise company's trademarks, systems, signage, software, and other proprietary tools and systems in accordance with the guidelines in the franchise contract."[8] In short, arm's-length parties that intend to cooperate on specific business ventures would rarely, if ever, engage in profit-split schemes.

By itself, this indicates a first subtle tilt by the OECD toward the use of PSM for reasons other than the purpose of arm's-length transfer pricing determination.

Unique and Valuable Contributions

Paragraph 6 of the PSM draft discusses situations in which "both parties to a transaction make unique and valuable contributions . . . to the transaction." In the same paragraph, it is suggested that in such occurrences the allocation of profits "may be based on the contributions made by the associated enterprises, by reference to the relative values of their respective functions, assets and risks." Paragraph 13 of the draft adds that the "existence of unique and valuable contributions by each party to the controlled transaction is perhaps the clearest indicator that a transactional profit split may be appropriate." Paragraphs 16-18 of the draft push forward with that proposal. Paragraphs 35-36 provide an overview of the "contribution analysis," this time based on "the nature and degree of each party's contribution of differing types (for example, provision of services, development expenses incurred, assets used or contributed, capital invested)."[9]

This overarching idea that the relative values of the contributions of the parties could be based on their respective functions, assets, and risks does not materially differ from what can be found in the OECD transfer pricing guidelines as early as 1995. On that specific matter, paragraph 3.16, at the time, indicated that the profits "would be divided between the associated enterprises based

[6] OECD (2014), *supra* note 1, at paras. 5-8 and 22-25.

[7] OECD (2016), *supra* note 2, in particular, paras. 21, 24-27.

[8] Joel Libava, "Introduction to Franchising," Small Business Trends (blog) (Dec. 1, 2011).

[9] *See* OECD, "BEPS Action 10: Revised Guidance on Profit Splits" (2017), at para. 36.

upon the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions."[10]

However, the explicit link between "unique and valuable contributions" and the PSM is novel. Based on recent and current OECD PSM drafts and Chapter VI of the 2017 edition of the OECD transfer pricing guidelines, this claim regarding "unique and valuable contributions" must now be read through the lens of controlled transactions involving "unique and valuable intangibles," as they are labeled by the OECD. A case in point is paragraphs 17-18 of the PSM draft, which indirectly assumes that the "correct" delineation of the transactions "[w]here each party to the transaction legally owns unique and valuable intangibles that are relevant to the transaction" may lead to the use of the PSM. This specific line of reasoning is obviously motivated by the needs of each tax authority to grab a proverbial piece of the intangible pie. Nevertheless, it is unsubstantiated from an economic and commercial standpoint.

On the one hand, as seen above, none of the existing versions of the franchise model are based on "split of profits." Franchisees oftentimes heavily draw upon the franchiser's expertise, supplies, processes, marketing, and brand. In return, franchisers receive royalty-like payments from the franchisees for the services rendered, the know-how provided, and the rights to use the image, marketing, and brand owned by the franchisers.

On the other hand, in complex arm's-length settings that do not revolve around the franchise model, arm's-length parties work together on a commercial basis within the scope of contractual arrangements in which each party's "unique and valuable contributions" are brought to the table. Each party gets rewarded on an arm's-length basis without resorting to any type of "split of profits." For example, the service provider gets paid an arm's-length compensation; the marketing agency gets paid for its arm's-length professional fees; the contract manufacturer gets paid for its arm's-length manufacturing services; the transportation company gets paid for its arm's-length logistic services; and the entrepreneur gets its own arm's-length profits from the sale of its goods or services to arm's-length customers.[11]

Furthermore, the intended use of a PSM highlighted by the OECD, the case in which "unique and valuable contributions by each party to the controlled transaction" are present, would require a complete value chain analysis. But the necessity of a complete value chain analysis is conspicuously absent from the PSM draft, especially from paragraph 32, which pertains to the functional analysis. In fact, one can only find a vague allusion regarding the "understanding of the broader context of the value chain" in the draft's preamble.

Having noted the above, it should be energetically underscored that the concept of "value chain" simply does not exist in the 2017 edition of the OECD transfer pricing guidelines. Combined with the inconsistency regarding the relevancy of "external market data," reviewed below, this indicates a noteworthy inclination by the OECD toward the use of PSM for reasons other than the purpose of arm's-length transfer pricing determination. This is further demonstrated by the front-and-center role of the value chain analysis in the 2016 PSM draft, released in July 2016, as discussed below.[12]

Interlude: Value Chain Analysis

Without a complete value chain analysis, the use of a PSM to determine a transfer price would in fact become a variation of formulary apportionment. As indicated in paragraph 36 of the PSM draft, "[i]t can be difficult to determine the relative value of the contribution that each of the associated enterprises makes to the controlled transactions, and the approach will depend on the facts and circumstances of each case." This hammers home the necessity of a value chain analysis.

However, as mentioned above, there is no direct reference to the necessity of a value chain analysis in the 2017 edition of the OECD transfer pricing guidelines. This oversight is unwelcome

[10] *See also* paras. 3.8 and 3.16-3.18, which discuss the "contribution analysis."

[11] For an overview of the theoretical background, see OECD, "Interconnected Economies: Benefiting From Global Value Chains," 16-20 (2013).

[12] OECD (2016), *supra* note 2.

and somewhat concerning. Value chain analysis should be an integral part of the functional analysis, especially for PSM purposes. In fact, the value chain analysis is one of the most explicit differentiations between PSM and formulary apportionment as it relates to arm's-length transfer pricing.

Without a value chain analysis, many types of contribution analyses become variations of formulary apportionment approaches. The 2014 PSM draft included many of these formulary apportionment-like contribution analyses in an effort to seemingly circumvent the requirements of a value chain analysis. They were based on either a "lack of comparables,"[13] a rather mechanical "RACI responsibility assignment matrix,"[14] or factors such as "production capacity, headcount, and value of production."[15] However, there was no contextual reference to the value chain "to recognise the key input of labour,"[16] among other things, as it was purported at the time by the OECD.

Paragraphs 24-27 of the 2016 PSM draft provide a good starting point on the matter of value chain analysis. However, unlike what is suggested in paragraph 24, the value chain analysis should not "merely [be] a tool to assist in delineating the controlled transactions." Instead, the value chain analysis should be a key component of the comparability analysis. It becomes vital to any situation in which the PSM may be deemed the most appropriate method for the determination of an arm's-length transfer price.

External Market Data

The relevance of "external market data" in the PSM has been the subject of a lasting controversy since the release in 1995 of the restructured OECD transfer pricing guidelines. At the time, paragraph 3.6 posited in broad terms that "[o]ne strength of the profit split method is that it generally does not rely directly on closely comparable transactions, and it can therefore be used in cases when no such transactions between independent enterprises can be identified." For serious practitioners, it was and still remains difficult, if not methodologically impossible, to claim with a straight face that such a transfer pricing method is not derived from formulary apportionment approaches. Following its 2008-2010 public consultations on "transactional profit methods,"[17] the OECD reiterated its position on the matter in the 2010 transfer pricing guidelines.[18]

Fast-forward to 2017. Paragraph 36 of the PSM draft reminds us that the "determination [of the relative value of the contribution that each of the associated enterprises makes to the controlled transactions] might be made by comparing the nature and degree of each party's contribution of differing types (for example, provision of services, development expenses incurred, assets used or contributed, capital invested) and assigning a percentage based upon the relative comparison and external market data." This exact wording is also found in the 1995 edition of the OECD transfer pricing guidelines.[19] In short, regarding the use of "external market data" (or lack thereof) in the PSM, not much has changed in more than 20 years.

As seen above, value chain analysis should be an integral part of a functional analysis, even more so for PSM purposes. In fact, going one step further, the value chain analysis must be combined with at least minimal use of "external market data" to enable a clear differentiation between the PSM and formulary apportionment approaches. Otherwise, the transfer pricing method would essentially have no arm's-length basis in its implementation, hence no factual comparability to any given legitimate arm's-length situation or transaction. In other words, without "external market data," there is room for the arbitrary use or plain disregard of market conditions, key features of formulary

[13] *See* OECD (2014), *supra* note 1, at "Scenario 5," paras. 29-32.

[14] *See id.*, at "Scenario 6," paras. 38-43.

[15] *See id.*, at para. 37.

[16] *See id.*

[17] *See* OECD, "Transactional Profit Methods Discussion Draft for Public Comment," public consultations from Jan. 25, 2008, to Apr. 30, 2008 (2008); and OECD, "Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines," public consultations from Sept. 9, 2009, to Jan. 9, 2010 (2010).

[18] *See* paras. 2.111 and 2.112.

[19] *See* para. 3.18.

apportionment approaches underlined by the OECD.[20]

It is also noteworthy that the language on "external market data" appears quite inconsistent in the latest PSM draft. On the one hand, regarding the contribution analysis, paragraph 36 of the PSM draft indicates that the "nature and degree" of each party's contribution may be assigned a "percentage based upon relative comparison" and "external market data." This first assertion seemingly lines up with a proper use of the PSM under the arm's-length principle since it is based on the comparability analysis.

On the other hand, Example 8, found in paragraphs 101-102 of the PSM draft, suggests that "the combination of profits (losses) can be split based on the development costs incurred by each of the parties." It is undeniable that indicating "there is a direct correlation between [the] expenses and the performance of each company" is insufficient to claim that genuine "external market data" is present in the analysis since it will always be the case that a company's performance is to some extent linked to its expenses, for better or worse.

In the same general line of reasoning, paragraph 14 of the PSM draft indicates that a "lack of information on closely comparable, uncontrolled transactions . . . should not *per se* lead to a conclusion that the transactional profit split is the most appropriate method." Paragraph 28 of the draft adds for greater clarity that "if information on reliable comparable uncontrolled transactions is available to price the transaction in its entirety, it is less likely that the transactional profit split method will be the most appropriate method."

In addition to Example 8, both these statements provide some areas of concern. They are deeply flawed if the intent is to abide by the arm's-length principle. By its nature, the arm's-length principle can only be used through external market data — that is, by carrying out a comparability analysis. Paragraph 1.6 of the OECD transfer pricing guidelines indicates unequivocally that "'comparability analysis,' is at the heart of the application of the arm's-length principle." No truer words have ever been written by the OECD regarding the arm's-length principle. External market data is a prerequisite to any transfer pricing method.

In other words, the use of a PSM for the determination of an arm's-length transfer price should not be dependent on the availability of "information on reliable comparable uncontrolled transactions." As it is highlighted in the PSM draft, this rationale leans toward formulary apportionment uses for PSM.

This brings us back to paragraph 1.25 of the OECD transfer pricing guidelines, which we should now quote at length. Paragraph 1.25 specifically objects to formulary apportionment based on its:

> disregard [for] market conditions, the particular circumstances of the individual enterprises, and management's own allocation of resources, thus producing an allocation of profits that may bear no sound relationship to the specific facts surrounding the transaction. More specifically, a formula based on a combination of cost, assets, payroll, and sales implicitly imputes a fixed rate of profit per currency unit (e.g. dollar, euro, yen) of each component to every member of the group and in every tax jurisdiction, regardless of differences in functions, assets, risks, and efficiencies and among members of the MNE group.

This wordy OECD statement against formulary apportionment, although politically and ideologically charged, should suffice to highlight the need for external market data. Without external market data, the PSM simply cannot be properly implemented in an arm's-length setting. By the same token, the PSM without external market data displays no distinctive characteristics from any formulary apportionment approach.

Overlooking the crucial role played by external market data in PSM indicates another predisposition by the OECD toward the use of PSM for reasons other than the purpose of arm's-length transfer pricing determination.

[20] OECD (2017), *supra* note 4, at para. 1.25.

Actual or Anticipated Profits?

Paragraph 27 of the latest PSM draft suggests that "[i]f each party shares the assumption of economically significant risks or separately assumes inter-related, . . . it is likely that a split of actual profits, rather than anticipated profits, will be warranted since those actual profits will reflect the playing out of the risks of each party." The draft offers no economic or commercial reason to justify this position. Paragraph 45 adds that a split of "anticipated profits would be more appropriate" when "one of the parties does not share in the assumption of the economically significant risks." This is another baseless assertion from an economic or commercial perspective. The unproven relevance of actual profits for PSM purposes is present all over the draft. The alleged distinction between the relevance of anticipated versus actual profits was also found in every section of the 2016 PSM draft, particularly paragraphs 2-10.

It demonstrates a significant departure from previous OECD guidance on the matter. As indicated in paragraph 3.14 of the 1995 edition of the OECD transfer pricing guidelines, "care would need to be exercised to ensure that the application of a profit split method is performed in a context that is similar to what the associated enterprises would have experienced, i.e., on the basis of information known or reasonably foreseeable by the associated enterprises at the time." Such "care" obviously implied the use of anticipated or "projected" profits, as they were labeled at the time. As the OECD also properly indicated at the time, in paragraph 3.11, "it is not possible for the taxpayers to know what the profits of the business activity would be at the time the conditions are established" in the dealings between independent parties. This key feature of the PSM was reiterated in the 2010 edition of the OECD transfer pricing guidelines.[21]

The direct use of actual profits for PSM purposes is a direct infringement of the arm's-length principle. It has no practical application for a multinational enterprise keen on abiding by the arm's-length principle. The split of actual profits is one of the key variables in formulary apportionment approaches as pointed out by the OECD.[22] Emphasizing the relevance of actual profits for PSM purposes shows a strong propensity by the OECD toward the use of PSM for reasons other than the purpose of arm's-length transfer prices determination.

Conclusion

As seen above, without a complete value chain analysis combined with external market data, the use of a PSM to determine transfer prices becomes a variation of formulary apportionment. Surprisingly, the OECD in its latest PSM draft has removed explicit mentions of both conditions from the application of the PSM.

The draft's persistent emphasis on "actual profits" and baseless proposals regarding the need for PSM in alleged "highly integrated operations," which would not be encountered in arm's-length settings or arrangements, add another layer of uneasiness to the already blurred picture in front of us.

Based on the language, or lack thereof, in this latest PSM draft, henceforth PSM will slowly but surely develop into a form of formulary apportionment which may be implemented by an MNE group instead of by various tax authorities. It also authorizes implementation after the fact instead of contemporaneously with the transactions. This hybrid formulary apportionment/PSM approach determines the apportionment of profits "on the basis of a predetermined and mechanistic formula," as indicated in paragraph 1.17 of the 2017 edition of the OECD transfer pricing guidelines, that is, the formula created by the MNE group.

This newfound philosophical approach to PSM is solely grounded on a "contribution analysis." As seen above, according to the OECD this "contribution analysis" does not seem to require external market data or a value chain

[21] *See* OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010 ed.), at para. 2.127-2.130.

[22] *See* OECD (2017), *supra* note 4, at para. 1.17: "accurately determining the global profits," which refers to actual profits.

analysis. Furthermore, results may be applied to actual profits — that is, after the fact. Despite the warnings on the matter included in paragraph 1.18 of the guidelines, the OECD indeed seems to be confusing transactional profit methods with formulary apportionment.

If they were all candid inconsistencies in language and honest oversights, the omissions and assertions would not, as a whole, amount to one more decisive step toward the inclusion of formulary apportionment in the OECD transfer pricing guidelines. But this is not the case here. Based on previous changes now included in the guidelines for the "simplified determination of arm's length charges for low value-adding intra-group services" and on use of "*ex post* outcomes" for "hard-to-value intangibles," this was not the first step in that direction and will likely not be the last. ■