‘Profits’ in Profit-Split Methods: Hazardous Crossovers on the Way To Global Formulary Apportionment

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

In this article, the author examines the OECD’s guidance on the profit-split method from the introduction of the transfer pricing guidelines in 1979 to today, emphasizing the consistency of the guidance on the determination of profits to split and pointing to a shift, one he sees as hazardous, in the guidance on the split of the profits.

Profit-split methods have been a major issue for international tax practice for decades, and their importance, along with the debate over best practices, has only grown over time. On July 22 the OECD issued its most recent public discussion draft on profit-split methods (the 2017 PSM draft). Sections C.3, C.4, and C.5 of the 2017 PSM draft provide guidance on how to determine the amount of profits to be split and how to split the profits among the related parties. These sections will likely replace the equivalent provisions in the 2010 edition of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the 2010 guidelines).

This article highlights the OECD’s guidance on two issues — the determination of profits to split and the actual split of the profits — using the profit-split method, from the first edition of the OECD transfer pricing guidelines in 1979 (the 1979 guidelines) to today. It illustrates the enduring consistency of the OECD guidance on the determination of profits to split. It also shows the numerous hazardous crossovers on the way to global formulary apportionment resulting from the latest guidance on how to actually split the profits. This slow but ever-increasing reliance on global formulary apportionment tools and concepts is disconcerting because it will likely lead to abuse and arbitrariness by tax authorities and create double taxation.

Determining the Profits to Be Split
A Functional Analysis

Using a profit-split method for transfer pricing purposes obviously requires determining the amount of profits to be shared among the related parties. This determination is discussed in section C.3 and the preamble of section C.4 of the 2017 PSM draft. The issue involves both a functional analysis and the use of accounting rules.

Regarding the functional analysis, the OECD’s transfer pricing guidelines for 1979, 1995/1997, 2010, and 2017 all clearly recognize that the comparability analysis is at the “heart of the application of the arm’s-length principle.” Likewise, a functional analysis has always been a cornerstone of the comparability analysis. Accordingly, the same precepts should guide any profit-split method intent to follow the arm’s-length principle.
Paragraph 32 of the 2017 PSM draft indicates that:

in general, the determination of the relevant profits to be split and of the profit splitting factors should be consistent with the functional analysis of the controlled transaction under review, and in particular reflect the assumption of economically significant risks by at least one of the parties, as well as be capable of being measured in a reliable manner.

This guidance is identical to that found in paragraph 2.116 of the 2010 edition of the guidelines. A first draft of this guidance was included in the OECD’s “Transactional Profit Methods Discussion Draft for Public Comment” in 2008 (the 2008 draft).

The determination of the profits to be split relies on the functional analysis. Notably, as the 2017 PSM draft recognizes, this key feature differentiates profit-split methods from global formulary apportionment methods. Global formulary apportionment methods determine the profits to be split solely on an accounting basis using a consolidation process, essentially determining the profit to be apportioned without regard for functions performed, risks assumed, or assets used. As pointed out by the OECD in paragraphs 1.18 and 1.21 of the guidelines, that process would ignore the particular facts and circumstances of the “taxpayer” and instead be mechanistic in nature, leaving room for abuse, arbitrariness, and double taxation.

An Accounting Problem

The determination of the profits to be split in the transfer pricing context is also an accounting issue. Section C.4, paragraph 40 of the 2017 PSM draft highlights four key steps relevant to determining the profits to be split in line with the arm’s-length principle:

• adopting a common basis for accounting practices;
• adopting a common currency;
• ensuring consistent timing and accounting treatment of revenue recognition; and
• ensuring consistent timing and accounting treatment of business expenses.

The same issues were previously identified in paragraph 2.125 of the 2010 guidelines and in the 2008 draft. To address them, paragraph 41 of the 2017 PSM draft suggests that “product-line income statements or divisional accounts may prove to be the most useful accounting records” for the purposes of the profit-split method, a recommendation also found in paragraph 2.126 of the 2010 guidelines and paragraph 182 of the 2008 draft.

Paragraph 42 of the 2017 PSM draft indicates that “the method of identifying the profits relevant to the transaction and any assumptions made in doing so need to be documented.” The nature of the required documentation is, however, left open to interpretation and warrants some observations. Documentation requirements are obviously not new. They have been included in the guidelines since their inception.

However, from an MNE perspective, my experience is that this documentation is likely to come from internal accounting practices and policies, which are usually built on a common basis to facilitate the year-end consolidation process. Conversion into a unique currency is part of typical internal accounting practices and policies. These accounting practices and policies are often based on international financial reporting standards or near-equivalents. Although the U.S.’s generally accepted accounting principles differ from the IFRS, compliance with internal accounting practices and policies typically will not pose significant issues for the parent entity of an MNE.

From a tax authority perspective, it is important to point out (again, writing from experience) that product-line income statements or divisional accounts normally raise numerous accounting audit issues peripheral to the transfer pricing audit. This results in audit litigation, which has nothing to do with the ultimate problem at hand — the determination of arm’s-length transfer pricing. At best, this clutters and lengthens the audit process. Some of these outlying audit issues come from the timing or the accounting treatment of either revenue or expenses. But, in most cases, peripheral audit issues come from the purported mismatch of revenues with expenses. In short, tax authorities tend to minimize expenses related to revenues that are allocated to product or service divisions subject to a transfer pricing audit. Again, I write from experience. This ends up increasing the
profits to be split — along with the respective tax shares of tax authorities.

For an MNE, the only available remedy is demonstrating that product-line income statements and divisional accounts are not only based on sound accounting practices and policies but also on the results of the functional analysis.

That said, for all practical purposes, the current OECD guidance on the determination of profits to be split remains consistent with that found in previous editions of the OECD guidelines. However, the 2017 PSM draft falls short on many counts when it comes to the choice between actual and anticipated profits and subsequent matters related to the split of the profits. Unfortunately, this creates confusion and inconsistency, as well as denotes hazardous crossovers into global formulary apportionment.

Actual Profits or Anticipated Profits?

Bordering the question of determining the profits to be split is the secondary issue of the temporality of the profits.¹ In short, should the split of profits for transfer pricing purposes pertain to actual profits or anticipated profits of the related parties?

Paragraph 27 of the 2017 PSM draft indicates that:

if each party shares the assumption of economically significant risks or separately assumes inter-related economically significant risks, . . . 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.

Paragraph 43 adds that:

[the] determination of the profits to be split, including whether those profits are actual profits or anticipated profits, should be aligned with the accurately delineated transaction.

These statements are simply unsubstantiated from both a theoretical and practical viewpoint.

From an economic perspective, they grossly overlook market forces that may be outside the control of the related parties. Put bluntly, reward is not always correlated to risk.² From a commercial perspective, contrary to the OECD’s suggestion, the choice of using actual or anticipated profits has nothing to do with the “accurate delineation of the transaction.”

On the contrary, profit splits in arm’s-length dealings, if they were ever to occur, would always relate to anticipated profits and never actual profits. At best, in a theoretical world, the choice between actual or anticipated profits might be based on contractual arrangements, if the arm’s-length parties truly agreed to share profits on a regular basis rather than adopting the typical franchisor-franchisee model.

More importantly, the statements in the 2017 PSM draft on the use of actual or anticipated profits go against a long-standing position of the OECD on the matter.

Paragraph 3.11 of the 1995/1997 guidelines observed that:

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.

Paragraph 3.12 added:

when a tax administration examines the application of the method used ex ante to evaluate whether the method has reliably approximated arm’s length transfer pricing, it is critical for the tax administration to acknowledge that the taxpayer could not have known what the actual profit experience of the business activity would be at the time that the conditions of the controlled transaction were established.

The OECD reiterated this position, including the exact language from the latter quotation, in paragraphs 1.127-1.130 of the 2010 guidelines.

A properly conducted profit-split analysis in the transfer pricing context is rooted in projected or anticipated arm’s-length profits. There is no

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¹ This section expands the discussion in Robert Robillard, “Profit-Split Methods and the OECD: Leaning Toward Formulary Apportionment?” Tax Notes Int’l, Sept. 4, 2017, p. 1005.

room for hindsight. The split of actual profits, the method that the OECD now advocates, is grounded in a philosophy of global formulary apportionment. This directly contravenes the arm’s-length principle.

Paragraph 1.17 of the 2017 guidelines states that “accurately determining the global profits” is an essential component in global formulary apportionment. This specific statement is also found in paragraph 3.59 of the 1995/1997 edition of the guidelines and paragraph 1.17 of the 2010 edition of the guidelines.

As indicated in paragraph 2.108 of the 2010 guidelines:

[the] transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction . . . by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions. [Emphasis added.]

Identical guidance is found in paragraph 3.5 of the 1995/1997 edition of the guidelines.

In advocating for the use of actual profits instead of anticipated profits in the profit-split method, the OECD’s 2017 PSM draft breaks with a long-standing tradition in transfer pricing. It indicates a hazardous crossover toward global formulary apportionment, which, by definition, intends to split profits after the fact (that is, actual profits instead of anticipated profits).

**Determining the Split of the Profits**

**Accurate Delineation of the Transaction**

As paragraph 3.5 of the 1995/1997 guidelines explains, and as is detailed above, applying the transactional profit-split method requires first identifying the total amount of profits to be split arising from the controlled transactions involving the associated enterprises. This is reiterated in paragraph 2.108 of the 2010 guidelines. The split of profits between the related parties follows from this initial determination of the total profits.

Paragraph 42 of the 2017 PSM draft underlines the overarching principle governing the split of profits, suggesting that the split of profits should be:

made in accordance with the accurately delineated transaction(s) so that the profits relating to the combined contributions made by the parties are identified.

Paragraph 51 of the 2017 PSM draft further states that:

profits should be split on an economically valid basis that reflects the relative contributions of the parties to the transaction and thus approximates the division of profits that would have obtained at arm’s length.

This guidance originates from paragraph 3.5 of the 1995/1997 guidelines, and substantially similar wording also appears in paragraph 2.108 of the 2010 guidelines.

While the foundational principles have remained the same, it is in the practical application of this guidance that the OECD has begun crossing over to global formulary apportionment.

**The Profit-Splitting Factors**

On one hand, paragraph 56 of the 2017 PSM draft highlights that:

profit splitting factors based on assets or capital (operating assets, fixed assets (e.g. production assets, retail assets, IT assets), intangibles, capital employed), or costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) are often used where these capture the relative contributions of the parties to the profits being split.

Paragraph 57 of the draft suggests other profit-splitting factors, including incremental sales, employee compensation, and time spent, which may be relevant depending on the circumstances of the case and the correlation between the item and the creation of value. Section C5.3 of the draft (paragraphs 64-68) lists examples of profit-splitting factors, similar to the so-called allocation keys found in paragraphs 2.134-2.140 of the 2010 edition of the guidelines.

On the other hand, paragraph 58 of the 2017 PSM draft stresses that, in addition to the local
file, the master file might be a useful source for identifying appropriate profit-splitting factors since it includes:

- information on the important drivers of business profit, the principal contributions to value creation by entities within the group, and key group intangibles.

But, as the OECD also points out in the same paragraph, the master file is only intended to serve as a high-level overview of the entire MNE group.

This begs the question: How should the profit-splitting factors be selected and used? Paragraph 54 of the 2017 PSM draft indicates that:

- the determination of appropriate profit splitting factor(s) should . . . reflect the key contributions to value in relation to the transaction.

This is similar to the guidance found in paragraph 32 of the draft, cited above. Therefore, the appropriate use of profit-splitting factors or allocation keys in the profit-split determination should be guided by the contribution analysis, broadly defined in the 2017 PSM draft as considering the relative contributions of each party into the controlled transaction. This holds true whether the split of profits is performed using a typical one-step process or carried out through a two-step residual analysis.\(^3\)

Surprisingly, paragraph 54 of the 2017 PSM draft then submits to the reader that:

- [the] functional analysis and an analysis of the context in which the transactions take place (e.g., the industry and environment) may be helpful in the process of determining the relevant factors to use in splitting profits, including determining the weighting of applicable profit splitting factors, in cases where more than one factor is used. [Emphasis added.]

In a nutshell, this guidance, also found in the 2010 guidelines, is incompatible with the conditional tone of paragraph 54 of the 2017 PSM draft.

Further, taken at face value, the conditional guidance on the functional analysis in paragraph 54 of the 2017 PSM draft contradicts the arm’s-length principle. It undermines the guidance put forward by the OECD transfer pricing guidelines as early as 1979 and suggests a major shift toward global formulary apportionment. It explicitly suggests that the functional analysis may be ignored in some instances when arriving at an alleged arm’s-length profit-split method. At best, in the words of the OECD, the functional analysis may be helpful. Also, this conditional guidance on the functional analysis implicitly suggests that the profit-split method may be used without relying on external market data and, in other words, without requiring a comparability analysis. Paragraph 53 of the draft goes one step further, indicating that “external market data can be relevant in the profit-split analysis to assess the value of contributions that each associated enterprise makes to the transactions” (emphasis added).

Importance of the Comparability Analysis

To be loyal to the arm’s-length principle of transfer pricing, profit splits must always be grounded in the comparability analysis. As

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\(^3\) See para. 37 of the 2017 PSM draft and Annex II to Chapter II of the 2017 guidelines for a practical example of the residual profit-split method.
discussed in the subsection titled “A Functional Analysis” above, the comparability analysis is at the “heart of the application of the arm’s length principle.” Without it, profit-split methods become global formulary apportionment methods. This is a fundamental principle that has been safeguarded by the OECD since the dawn of the transfer pricing guidelines.

The 1979 guidelines did not mention the profit-split method by name. At the time, the arm’s-length principle was meant to be applied through traditional transaction methods, namely the comparable uncontrolled price method, the resale price method and the cost plus method. However, paragraph 14 references “so-called ‘global’ methods” stating that:

A number of such methods are sometimes advocated, allocating profits in some cases in proportion to the respective costs of the associated enterprises, sometimes in proportion to their respective turnovers or to their respective labour forces, or by some formula taking account of several such criteria . . . are all . . . to some degree arbitrary . . . . To allocate profits by such methods in a way which reduced the arbitrariness of the results to a negligible degree would necessitate a complex analysis of the different functions of the various associated enterprises and a sophisticated weighing up of the different risks and profit opportunities in the various stages of manufacturing, transportation, marketing and so on. [Emphasis added.]

This statement may well be considered the conceptual origin of the profit-split method, although at the time it was stripped of any arm’s-length component.

In 1984 the OECD acknowledged the relevance of the functional analysis in the determination of the shares of the profits to allocate to each entity. A report titled “Transfer Pricing and Multinational Enterprises — Three Taxation Issues” highlighted the potential usefulness of the functional analysis for the allocation of profits to the PEs of a global bank. In the second part, titled “The Taxation of Multinational Banking Enterprises,” paragraph 86 indicated that one of the decisive factors for allocating profits was:

whether the income produced by the relevant assets can be regarded as having been substantially generated by the activities of the permanent establishment. This will depend on the extent to which the negotiation and conclusion of the transaction has been the work of that permanent establishment.

The same paragraph went on to identify and characterize the importance of a series of functions and activities that could lead to a share of the profits. In short, by 1984 the allocation of the profits to be split was already based on a functional analysis.

The 1995/1997 guidelines went further, setting out a series of instructions for properly applying the profit-split method. Regarding the significance of the functional analysis, formally identified as a factor in the comparability analysis, the OECD indicated that associated enterprises were expected to “achieve the division of profit that independent enterprises would have realized.” Furthermore, according to paragraph 3.16, if a contribution analysis was selected:

[the] combined profit . . . would be divided between the associated enterprises based upon the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances.

Breaking it down further, the 1995/1997 guidelines suggested that the “relative value of the contribution” of the parties would be based on a relative comparison of the contribution and external market data. As it was summarized in paragraph 3.23, the overriding objective was to:

approximate as closely as possible the split of profits that would have been realised had the parties been independent enterprises operating at arm’s length.

In other words, the profit-split method was implemented in a way that made it a logical extension of the comparability analysis findings.
Although these instructions were reproduced in the 2010 edition of the guidelines, some cracks in the armor of the arm’s-length principle started to appear. Paragraph 2.111 of the 2010 edition of the guidelines provided that:

where there is no more direct evidence of how independent parties in comparable circumstances would have split the profit in comparable transactions, the allocation of profits may be based on the division of functions (taking account of the assets used and risks assumed) between the associated enterprises themselves.

According to paragraph 2.119, the contribution analysis would still lead to a split of profits that would reasonably approximate the split between independent enterprises. This is debatable, if not outright contentious, since the division of profits is potentially being performed without any reliance on external market data.

In the same vein, paragraph 2.132 of the 2010 edition of the guidelines suggested that the criteria used in the profit split could be comparables, internal data, or both. Thus, reliance on data from comparable uncontrolled transactions became just one possible approach rather than a prerequisite. Paragraph 2.141 further indicated that under some circumstances, internal data “may provide a reliable means of establishing or testing the arm’s length nature of the division of profits” in and by themselves. These data would, according to the same paragraph, “frequently be extracted from the taxpayers’ cost accounting or financial accounting.” The comparability analysis appears to have departed. At best, the cost accounting might have involved a representation of the functions performed by the parties. No reference to external market data was required.

The crescendo sounded with paragraph 2.144 of the 2010 guidelines. It was a perfect illustration of the conceptual tension arising between guidance modeled on the comparability analysis and the concept of global formulary apportionment. Paragraph 2.144 posited that:

internal data are essential to assess the values of the respective contributions of the parties to the controlled transaction. [Emphasis added.]

The OECD seems to suddenly pivot, twisting logic when it goes on to emphasize that:

[the] determination of such values should rely on a functional analysis that takes into account all the economically significant functions, assets and risks contributed by the parties to the controlled transaction.

The paragraph continues its odd journey, indicating that:

in those cases where the profit is split on the basis of an evaluation of the relative importance of the functions, assets and risks to the value added to the controlled transaction, such evaluation should be supported by reliable objective data in order to limit arbitrariness. [Emphasis added.]

Suddenly, we are back to 1979 with the arm’s-length principle still holding the fort!

**Conclusion**

The hazardous crossovers from profit splits toward global formulary apportionment reviewed in this article will likely not come as revelations to seasoned practitioners or regular readers of OECD material. In fact, these hazardous crossovers double down on the accelerating trend launched by the OECD’s “BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains” in 2014 and “BEPS Actions 8-10: Revised Guidance on Profit Splits” in 2016.

There is now very little doubt that a slow but progressive move toward acceptance of global formulary apportionment in lieu of profit-split methods is happening in the OECD circles. Whether this tendency toward global formulary apportionment will translate into a bad omen for the future of transfer pricing in the BEPS era remains open for debate. However, for many MNEs that are nowadays perceived guilty of tax evasion before any actual transfer pricing audit, the deck seems stacked.