

Introducing the Profit-Split Method: 'To Apply or Not to Apply, This Is a BEPS Question'

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Guy Sanschagrín



Doug L. Schwerdt

Guy Sanschagrín is principal in charge of transfer pricing and international valuation services and Doug L. Schwerdt is a transfer pricing and valuation services specialist at WTP Advisors. Sanschagrín is also the CEO of TransPortal, a global transfer pricing management platform. The authors thank Kash Mansori for his contributions to this article.

In this article, Sanschagrín and Schwerdt consider the profit-split method and argue for using it to determine arm's-length pricing and evaluate transfer pricing results.

Organizations engaged in cross-border intercompany transactions are required to operate at arm's length. According to the OECD's 2022 transfer pricing guidelines,¹ "transfer pricing methods are intended to serve as a means of establishing and verifying arm's-length outcomes for controlled transactions."² Analogously, the U.S. transfer pricing regulations³ (U.S. regs) state,

"A controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's-length result)."⁴ Both the OECD guidelines and U.S. regs aim to promote arm's-length outcomes.

Transfer pricing regulations, legislation, and guidelines around the world typically stipulate several specific methods. The OECD guidelines and U.S. regs prominently include the profit-split method as a specified approach to determine arm's-length pricing and evaluate transfer pricing results. This article focuses on the profit-split method, which is based on the concept that combined profits of a multinational enterprise, or an operating unit within an MNE, are split in proportion to the relative value the controlled parties contribute. The objective of this method is to demonstrate the fair allocation of profits among controlled parties in accordance with the arm's-length standard. Since it considers the contributions of the controlled parties in a value chain, many practitioners who embrace the OECD's base erosion profit-shifting initiative view the profit-split method favorably. There are some very good reasons to apply the profit-split method, and this article provides enough basic information to encourage further consideration.

Origins of the Profit-Split Method

The profit-split method has been used for years to allocate combined profits and losses between related parties and to reflect their relative contributions. Applying methods based on a split

¹ OECD, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022" (2022).

² *Id.* at para. 2.124.

³ Reg. sections 1.482-1 through -9; reg. section 1.6662-6.

⁴ Reg. section 1.482-1(b)(1).

of profits began as a solution to disputes and court cases when it was impossible to identify comparable transactions.⁵ The profit-split method was first introduced as a specified transfer pricing method in the United States via the 1988 IRS notice, “A Study of Intercompany Pricing Under Section 482 of the Code,”⁶ which is widely known to practitioners as the “1988 White Paper.” It was introduced into the U.S. (temporary) regs in 1993 as reg. section 1.482-6T. This motivated adoption by the OECD in its 1995 guidelines, which discussed the profit-split method (“contribution” approach and “residual profit” approach).⁷ It has since been formally adopted in reg. section 1.482-6 and the OECD guidelines.⁸

More recently, the OECD’s BEPS initiative⁹ has had a significant impact on the transfer pricing landscape. The BEPS initiative emphasizes the close alignment of transfer pricing results with the economic activities and value-add (or value creation) of controlled parties operating within MNE value chains. One key aspect is the implicit encouragement to use the profit-split method. Since it considers the contributions and risks of two or more parties to the associated business operations and transaction, the profit-split method is viewed by many as more holistic and comprehensive than one-sided methods.

When to Apply the Profit-Split Method

Practitioners have often shied away from the profit-split method in developing and defending transfer pricing systems for some very good reasons. There is concern that using the profit-split method opens up difficult questions and assumptions that do not arise when using a one-sided method. Moreover, the profit-split method provides more transparency than one-sided methods on the allocation of profits across MNEs.

However, the profit-split method can be useful for integrated MNE value chains that employ unique intangible property (IP) and in which entrepreneurial-type risk is shared among controlled parties.

Understanding when to use the profit-split method is critical because some of the largest transfer pricing adjustments are the result of tax authorities challenging the application of a one-sided method. One-sided approaches effectively allocate residual profit to an entrepreneur party by providing a routine return to “tested parties.”¹⁰ Tax authorities may challenge a taxpayer’s method that provides the tested party with a routine return if the controlled party performs high-value functions or if it contributes unique and valuable IP. In these cases, authorities may apply the profit-split method as a basis to propose transfer pricing adjustments.

The profit-split method is often used in cases in which the contributions of each party to a transaction are not easily quantifiable or cannot be accurately determined using other methods. It can also be used to evaluate whether the allocation of combined profit or loss aligns with value creation by the parties, a cornerstone of the OECD BEPS initiative. Value creation is the process by which a firm creates value through its activities and assets, like research and development, manufacturing, distribution, and technology. Many of these activities create valuable IP that MNEs exploit globally.

The OECD guidelines provide that the profit-split method is often most appropriate when one or more of the following indicators exists:

- a unique and valuable contribution¹¹ is made by two or more parties to the transaction;
- there exists a particularly high degree of integration in certain business operations; and

⁵ Early notable cases involving profit splits include *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985), and *G.D. Searle & Co. v. Commissioner*, 84 T.C. 252 (1987), among others.

⁶ Notice 88-123, 1988-2 C.B. 458.

⁷ The authors note that the 1979 OECD Committee on Fiscal Affairs report, “Transfer Pricing and Multinational Enterprises,” which was the precursor to the 1995 OECD transfer pricing guidelines, does not mention profit splits.

⁸ See paras. 2.114-2.187 and examples provided in Annex II to Chapter II.

⁹ OECD, “Aligning Transfer Pricing Outcomes With Value Creation, Actions 8-10 – 2015 Final Reports” (2015).

¹⁰ It is sometimes debatable that a one-sided tested party analysis truly represents “routine returns” since comparable companies identified in an underlying benchmarking study sometimes represent higher (“nonroutine”) returns associated with their high-value add functions, technologies, and know-how.

¹¹ The U.S. regs analogue to the OECD transfer pricing guidelines’ “unique and valuable” is the term “nonroutine,” as in “significant nonroutine contributions.” For example, reg. section 1.482-9(g)(1) states, “The residual profit split method may not be used where only one controlled taxpayer makes significant nonroutine contributions.”

- parties share the assumption of economically significant risks or separately assume closely related risks.

The above three indicators are not mutually exclusive and may often be found together in a single fact pattern. In fact, these indicators are quite common, which leads to the logical advice that the profit-split method should probably be considered more often than it is. There is often an overlap in a highly integrated value chain in which multiple parties make important contributions and share the assumption of economically significant risks or separately assume closely related risks. The most common of the three shared indicators is the first listed above — unique and valuable contributions by the parties.

The existence of one or more of these indicators pointing toward profit-split being the most appropriate method is not exhaustive or prescriptive guidance. The presence or absence of one or more indicators will not necessarily lead to the conclusion of the most appropriate method. A method's applicability should be evaluated on the facts and circumstances of each situation, like the availability and reliability of data.¹² The profit-split method has been especially prevalent in the pharmaceutical and technology industries to allocate combined profits or losses between parties involved in the development and commercialization of pharmaceuticals or technology products and services (for example, a software company and a licensing partner).

¹²OECD transfer pricing guidelines, para. 2.145.

The OECD's BEPS initiative aims to allocate the combined profits (or losses) generated by MNEs to the controlled parties in proportion to the value they contribute. This approach takes into account the functions, assets, and risks of each controlled party. In fact, under BEPS, MNEs should perform an analysis to recognize important contributions to develop, enhance, maintain, protect, and exploit IP within the MNE value chain. BEPS suggests that controlled parties that perform these functions should earn a fair share of the MNE's combined profit (or loss).

Conclusion

The profit-split method is not one-size-fits-all. It can be adapted to accommodate complex transactions. The profit-split method appeals to MNEs striving to develop a robust transfer pricing approach that thoroughly examines the division of combined profits among controlled parties interacting in their value chains. MNEs can use this method to enhance their ability to withstand transfer pricing examinations and audits and effectuate tax planning.

The profit-split method is a flexible and adaptable approach to transfer pricing that can be applied in a wide range of situations. It enables companies to determine the split of profits between controlled parties based on the specific circumstances of the transaction and considers the contributions and risks of each party, potentially leading to a more equitable distribution of profits than a one-sided transfer pricing method. The profit-split method can be customized to fit the specific circumstances and needs of a transaction and can be updated as the parties' circumstances change over time. ■