A NEW WAY TO DO THE SPLITS: B.E.P.S. GUIDANCE FALLS SHORT OF ENABLING GLOBAL FORMULARY APPORTIONMENT

It takes considerable training and the right physical conditioning to successfully do the splits and avoid injury or embarrassment. For those who view transfer pricing as a gymnastics sub-discipline, applying a profit split method is often an approach of last resort and is arguably as difficult to accomplish in a graceful manner as the gymnastic feat. Since the B.E.P.S. (Base Erosion and Profit Shifting) Project began in 2013, a key focus has been the revision of the O.E.C.D. guidance that multinational companies and tax authorities use to apportion income resulting from the joint commercialization of intangible assets within a multinational group. The unwelcome, and potentially widespread, ex-post use of profit split methods as proxy for global formulary apportionment was viewed by corporate taxpayers and commentators with the same sense of dread as a surprise gymnastics skills test.

However, it would appear that companies can relax somewhat after the July 4 publication of the O.E.C.D. Revised Guidance on Profit Splits discussion draft. The discussion draft links other transfer pricing developments in the B.E.P.S. Project to the guidance on the application of the transactional profit split method, but it does not propose to place an over-broad profit apportionment tool in the hands of tax authorities.

Like a gymnastic maneuver, successful application of the transactional profit split method requires a full understanding of risk – in this case economically significant risk incurred by the participants in the relevant business opportunity. The transactional profit split method is one of five transfer pricing methodologies set out in Chapter II of the O.E.C.D. Guidelines. In cases where controlled taxpayers participate in highly integrated operations and contribute valuable intangible assets in respect of a joint business opportunity, the profit split method is used to split the profits or losses from the combined activity on an economically valid basis to approximate an arm’s length return to the respective contributors.

Not unlike the provisions of Treas. Reg. §1.482-6, the transactional profit split may be applied using either the more direct contribution analysis or the more indirect residual analysis (i.e., routine profits to the associated enterprises are determined first, and then deducted from the actual pooled profit to determine the residual profit to split). The transactional profit split method can also be used in conjunction with a valuation method to estimate the value of an intangible asset transferred from one controlled taxpayer to another.

In contrast to the Treas. Reg. §1.482-6 method, the O.E.C.D. Guidelines allow for the splitting of either anticipated or actual profit. The discussion draft adapts the

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O.E.C.D. Guidelines profit split by incorporating the changes to Section D.2.6.2 of Chapter VI that discuss how to reliably estimate anticipated profit from an intangible asset. The draft properly points out that appropriate use of the transactional profit split method uses a profit split metric determined in advance of the knowledge of the actual profit to be divided between the two parties. This serves as a reminder to companies of the evidentiary value of intercompany agreements – used in this instance to demonstrate taxpayer intent and to clearly set out the way in which a split of unanticipated profit will be calculated in the future. The fact that an agreement is required to manage the uncertain outcome of a business activity where risk is shared, in and of itself, reinforces the appropriateness of a profit split method.

The use of the transactional profit split method based on the combined actual profits of the contributing parties is linked to the control exercised by those parties over the economically significant risks associated with the combined business. The transactional profit split method may, therefore, not be appropriate in circumstances where the risks of the combined business are not separately or collectively controlled by the participants, or where each party does not have the financial capacity to assume its proportional share of the risk. The evaluation of control over risk should be carried out annually, as actual profits are intended to be split each taxation year under the transactional profit split method.

This limiting control condition arises from the work completed by the B.E.P.S. Project, to date, on transfer pricing issues relating to intangible assets. Interestingly, this new limitation on attribution of profit from intangible assets to only those entities exercising control over risk and possessing sufficient financial resources to mitigate risk circumscribes the authority of tax administrations to use the transactional profit split method in a formulary way, as was feared by many B.E.P.S. Project observers.

Some useful guidance appears in the discussion draft to differentiate a reliable profit split from a less graceful version. Parties must “share the same economically significant risks”\(^2\) associated with the combined business activity or “separately assume closely related risks”\(^3\) associated with the same activity.

The term “economically significant risks” is explained in the revised Chapter I of the O.E.C.D. Guidelines\(^4\) as being those factors that cause the anticipated objectives or outcomes of the business activities for the contributing parties to vary to the greatest degree. Strategic risks, marketplace risks, infrastructure risks, operational risks, financial risks, transactional risks, and hazard risks are suggested as the principal (though not the only) types of risk to consider.

There is, therefore, a less reliable profit split where

- the economically significant risks have not been specified,
- the nature of the contributions of the parties has not been accurately determined,
- an evaluation of how those contributions influence profit outcomes has not been made,


\(^3\) Id.

\(^4\) Supra note 1, Section D.1.2.1.1, pp. 25-28.
• the profits to be split have not been reliably identified, and
• the basis for splitting the profits has not been reliably determined.

In certain cases, tax authorities (and sometimes companies) choose to skip the difficult work of comparability analysis or comparability adjustments, and apply the profit split method. The discussion draft acknowledges a shortage of comparables may exist in practice, but it warns that a lack of comparables alone does not justify the use of the transactional profit split method. Rather than stretching to apply the transactional profit split method, the discussion draft suggests that the use of a different method (inexact comparables) and well-supported comparability adjustments may result in a pricing outcome that better approximates an arm’s length result.

Similarly, the discussion draft sets out limitations, concerning integrated operations, unique and valuable contributions of intangible assets, and group synergies to the use of the transactional profit split method, in order to promote the responsible use of this transfer pricing method. The mere appearance of integrated operations is stated as an insufficient condition for the application of the profit split method. A careful functional analysis and an understanding of the company’s value chain is required to establish whether it is truly the case that the functions of company participants are so integrated that an intercompany transaction cannot be reliably delineated and perhaps priced using a more reliable methodology.

Finally, the discussion draft clarifies that treatment accorded to profits resulting from group synergies should differ from the treatment of profit resulting from the commercialization of intangible assets. The benefits or cost savings connected with group synergies are termed “marginal system profits,” which should not be included in the “total system profits” to be divided using the transactional profit split method.

Room for disagreement exists with regard to the definition of a unique or valuable intangible asset, the degree to which a risk is economically significant, the importance of location savings, and the way market characteristics figure into a profit split analysis between a company based in a country with a developed economy and a related party with operations in a country with an emerging economy. Nonetheless, the focus of the O.E.C.D. guidance on intangible assets has been sharpened significantly, thereby reducing uncertainty for all.