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Excerpt from Global Transfer Pricing: Principles and Practice – Chapter 7 – Profit split

Introduction

7.1

Although the profit split methodology is a long-standing method in the 'OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' (OECD Guidelines), historically it was not commonly applied by taxpayers as the 'appropriate method' to test the arm's-length nature of intra-group transactions. However, in recent years, interest in the profit split method has increased and this trend has continued in the light of the work of the OECD and G20 countries under the Base Erosion and Profit Shifting (BEPS) project. It is therefore important to understand when profit split may be relevant and, if it is, how it is applied in practice.

7.2

The 2018 revision to Section C of the OECD Guidelines[1] state that 'the transactional profit split method is particularly useful when the compensation to the associated enterprises can be more reliably valued by reference to the relative *shares* of their contributions to the profits arising in relation to the transaction(s) than by a more direct estimation of the value of those contributions'.

7.3

The profit split methodology is considered to be particularly relevant to transfer pricing analysis where more than one party makes a significant contribution to the generation of profits, ie where both parties to a transaction make unique and valuable contributions; as noted in Chapter 6, an example might be in the licensing or transfer of intangible assets. In such a case, independent parties might determine a price for a transaction between them on the basis of their relative contributions, making a two-sided transfer pricing analysis more appropriate than a one-sided method. Furthermore, as noted in the revised OECD Guidelines, the fact that both transacting parties make unique and valuable contributions will mean that, by definition, no reliable external comparable data will be available; consequently, it will not be possible to use another transfer pricing method.

7.4

A profit split is a methodology often applied by the commercial courts dealing with disputes over intangible property. A UK case in point is *Ultraframe (UK) Ltd v Eurocell Building Plastics Ltd* [2006] EWHC 1344 (Pat), where the High Court considered damages for infringement, of a patent and unregistered design rights, based on the concept of the royalty which would have been agreed to allow use of the IP. Is this relevant for transfer pricing practitioners? The judge in that case noted:

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[1] Revisions to Section C, Pt III, Ch II, of the OECD Transfer Pricing Guidelines, published on 4 June 2018.

> ‘The reasonable royalty is to be assessed as the royalty that a willing licensor and a willing licensee would have agreed. Where there are truly comparable licences in the relevant field these are the most useful guidance for the court as to the reasonable royalty. Another approach is the profits available approach. This involves an assessment of the profits that would be available to the licensee, absent a licence, and apportioning them between the licensor and the licensee.’

7.5

This confirms that what a commercial court seeks (the value of a licence between a willing licensor and licensee) and what transfer pricing practitioners seek (the licence that would have been agreed between unconnected parties) is actually the same; that was a point taken in the 2018 US Appeal Court decision in *Medtronic Inc & Consolidated Subsidiaries v Commissioner of Internal Revenue* [No 17-1866 United States Court of Appeals, Eighth Circuit]. Hence these commercial courts provide insight into how a court might view a transfer pricing case, which valuation methodologies are acceptable and which fall short of evidential quality. The excerpt quoted above confirms both a preference for using comparable licences and, where they are not available, the appropriateness of the profit split methodology for determining a reasonable royalty for the use of intangible assets in case of dispute between unconnected parties.

7.6

The minimum standards agreed as part of the BEPS Final Reports on transfer pricing reduce the possibility of using inappropriate comparable uncontrolled price (CUP) or comparable uncontrolled transactions (CUT) for the transfer pricing of intangibles by stressing the need to show comparability. Consequently the use of profit split for pricing intangible asset transactions is likely to continue and, indeed, increase. At the time of writing, this trend has already been observed; the use of a profit split method to price intercompany transactions involving intangible assets is becoming increasingly common amongst taxpayers and tax authorities.

7.7

The driver for selecting an appropriate methodology for transfer pricing purposes is the functional analysis; the analysis of the relevant contribution to the value of the transaction by each party. There is no industry or transaction type where profit split cannot potentially be the most appropriate transfer pricing methodology. For example, this method may be used in situations as diverse as insurance arrangements where control over risk is shared, or for pricing the sharing of savings generated by centralised activities such as procurement.

Overview of profit split

7.8

The profit split method seeks to test or establish the arm’s-length nature of pricing by determining the overall profit from a transaction and its division between the parties, based on what unconnected enterprises would expect to realise from engaging in those transactions.

7.9

The OECD’s revised guidance on profit split also identifies three particular situations in which the use of a profit split method may be appropriate:

1. where both parties to a transaction contribute unique and valuable intangibles in relation to the transaction;
2. where two transacting parties are engaged in highly integrated operations; and

3. where there is a high degree of uncertainty for each of the parties to a transaction, for example in transactions involving the shared assumption of significant risks, or the separate assumption of closely related risks.

7.10

Where both parties make unique and valuable contributions to a transaction, a 'one-sided' transfer pricing analysis, such as cost-plus or the transactional net margin method (TNMM), does not take into account the balance of risk and the contributions of the parties. It would therefore be inappropriate to treat one of the transacting parties as the 'tested party', receiving a relatively 'fixed' remuneration; it would be more likely that, in these circumstances, unrelated parties would share in the profits (or losses) of the venture. Hence a profit split approach, which explicitly considers both transacting parties (ie a two-sided analysis), would be more likely to be an appropriate method.

7.11

There are many circumstances in which profit split might be considered an appropriate methodology for transfer pricing purposes. Some examples are provided below but this list is by no means exhaustive:

- Where there is insufficient reliable data to analyse comparability so as to determine an arm's-length outcome by any method other than profit split, noting the point set out in the revised OECD Guidelines that 'a lack of closely comparable, uncontrolled transactions…should not *per se* lead to a conclusion that the transactional profit split method is the most appropriate method'.
- Where the nature of the business arrangements means that both parties to a transaction are performing highly valuable functions and bearing significant risks such that appropriate comparables cannot be identified to price one end of the transaction.
- Where there are a variety of transactions (eg transfers of tangible assets, the licensing of intangible assets and the provision of services) between the associated enterprises, some of which may involve overlaps, and there are no comparables for the combination of transactions. In these cases, profit methods may be a more reliable way to set or review the transfer pricing used in the dealings between the associated enterprises, or to check the findings made using traditional methods if there is doubt about the reliability of the data used or the outcome produced.
- Where the supply chain is highly integrated and the parties to the transaction share the key risks or provide the key intangibles. This situation may arise, for example, where product development risk is genuinely shared between associated manufacturing entities, one of whom supplies highly specialised components to another group company.

7.12

One of the strengths of the profit split method is that all relevant parties to a transaction are directly evaluated as part of the pricing methodology. Contrast this with one-sided methods which, by definition, consider only one of the parties to a transaction and might, therefore, lead to a result which is inconsistent with arm's-length behaviour, ie an unexplained result for the party not being analysed.

7.13

The profit split method does, however, suffer from notable weaknesses which need to be considered and overcome in a proper application of this method. These weaknesses include:

- the fact that the profit split method does not directly rely on information about independent enterprises (except for one aspect of the residual profit split discussed below);
- difficulties, for both associated enterprises and tax authorities, in obtaining the detailed information required for a proper application of the profit split method; and
- challenges with identifying and supporting the appropriate profit splitting factors (also considered below).

Although the profit split method is rarely applied by independent enterprises as a means for establishing pricing arrangements, it is worth noting that this, in itself, is not a reason to consider the profit split as inappropriate. The revisions to the OECD Guidelines, helpfully, confirm that 'transfer pricing methods are not necessarily intended to replicate arm's length behaviour but rather to serve as a means of establishing and/or verifying arm's length outcomes for controlled transactions'.

7.14

Care should be taken to record the reasons why profit split (or, indeed, any chosen method) is selected as the most appropriate transfer pricing methodology. The reasons, and the recording of those reasons, should be undertaken in a manner that would be considered to be 'evidential'. Referring to another UK case, *General Tyre & Rubber Co v Firestone Tyre & Rubber Co Ltd* [1975] WLR 819, the judge commented that it is for the plaintiff to adduce evidence which will guide the court. The ruling notes as follows:

> 'This evidence may consist of the practice, as regards royalty, in the relevant trade or in analogous trades; perhaps of expert opinion expressed in publications or in the witness box; possibly of the profitability of the invention; and of any other factor on which the judge can decide the measure of loss.'

For more information about Global Transfer Pricing: Principles and Practice: