Melbourne Legal Studies Research Paper Series No. 898

The Transfer-Pricing Profit-Split Method After BEPS: Back to the Future

Michael Kobetsky

This paper was first published in
(2019) 67(4) Canadian Tax Journal/Revue Fiscale Canadienne, 1077-1105

Electronic copy available at: https://ssrn.com/abstract=3510267
The Transfer-Pricing Profit-Split Method After BEPS: Back to the Future

Michael Kobetsky*

PRÉCIS
En 2018, le Cadre inclusif sur l’érosion de la base d’imposition et le transfer des bénéfices (BEPS) de l’Organisation de coopération et de développement économiques et du Groupe des Vingt (OCDE/G20) : action 10 a publié des directives révisées sur la méthode transactionnelle de partage des bénéfices. Malheureusement, les directives révisées n’ont pas permis de faire en sorte que la méthode de partage des bénéfices soit plus souvent la méthode d’établissement des prix de transfert la plus appropriée. Les directives révisées indiquent expressément que l’absence d’opérations non contrôlées comparables ne justifie pas, en soi, l’utilisation de la méthode de partage des bénéfices. Dans les anciennes directives, la méthode de partage des bénéfices était peu souvent utilisée. Dans les directives révisées, le seuil d’admissibilité pour l’utilisation de la méthode de partage des bénéfices est encore restrictif. Il est donc probable que la méthode de partage des bénéfices sera rarement la méthode d’établissement des prix de transfert la plus appropriée. Néanmoins, la méthode de partage des bénéfices résiduels est envisagée par l’Action 1 du projet BEPS pour l’imposition de l’économie numérique. Deux des propositions dans le premier pilier de la courte Note politique de 2019 du Cadre inclusif portent sur l’utilisation de la méthode de partage des bénéfices résiduels pour répartir les bénéfices. Ces propositions impliquent de nouvelles règles de répartition des bénéfices qui vont au-delà du principe du lien de dépendance.

ABSTRACT
In 2018, the Organisation for Economic Co-operation and Development/Group of Twenty (OECD/G20) Inclusive Framework on base erosion and profit shifting (BEPS): action 10 issued revised guidance on the transactional profit-split method. Regrettably, the revised guidance failed to provide the opportunity for the profit-split method to be more often the most appropriate transfer-pricing method. The revised guidance expressly states that the lack of comparable uncontrolled transactions, by itself, is not a basis for the use of the profit-split method. Under the former guidance, the profit-split method was used infrequently. In the revised guidance, the threshold requirements for the use of

* Associate professor, Melbourne Law School, University of Melbourne; honorary professor, ANU College of Law, Australian National University.
the profit-split method are still restrictive. Consequently, it is likely that the profit-split method will rarely be the most appropriate transfer-pricing method. Nevertheless, the residual profit-split method is being considered for BEPS action 1, on the taxation of the digital economy. Two of the proposals under pillar 1 of the Inclusive Framework’s 2019 short policy note involve the use of the residual profit-split method to allocate profits. These proposals involve new profit allocation rules that go beyond the arm’s-length principle.

**KEYWORDS:** ARM’S LENGTH ■ BEPS ■ OECD ■ PROFIT-SPLIT ■ TRANSFER PRICING

---

**CONTENTS**

Introduction 1078
Background 1081
The BEPS Project 1081
Discussion Draft on BEPS Action 1 1083
Addressing the Tax Challenges of the Digital Economy (2014) 1084
2014 Discussion Draft 1086
The Final Two Discussion Drafts 1087
The 2018 OECD Revised Guidance 1087
The Transactional Profit-Split Method as the Most Appropriate Method 1088
Strengths and Weaknesses of the Transactional Profit-Split Method 1089
The Accurately Delineated Transaction 1091
When the Transactional Profit-Split Method May Be the Most Appropriate Method 1092
Unique and Valuable Contributions by Each Party to a Controlled Transaction 1093
Highly Integrated Business Operations 1093
Shared Assumption of Economically Significant Risks and Separate Assumption of Closely Related Risks 1095
Lack of Comparables 1096
The Shortcomings of the Arm’s-Length Principle 1096
Risks Assumed by Associated Enterprises 1100
The European Union’s Proposals To Simplify the Profit-Split Method 1101
BEPS Action 1: Pillar 1—Residual Profit-Split Proposal 1101
The User Participation Proposal 1103
The Marketing Intangibles Proposal 1104
Conclusion 1105

---

**INTRODUCTION**

The Organisation for Economic Co-operation and Development’s (OECD’s) base erosion and profit shifting (BEPS) report identified the extensive tax-avoidance practices that are used by multinational enterprise (MNE) groups and that result in substantial revenue losses to national governments. Some of these groups, according

---

1 Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013) (herein referred to as “the BEPS report”).
to the report, have engaged in aggressive tax avoidance.\textsuperscript{2} One of the chief tax-avoidance strategies identified in the report is the manipulation of transfer pricing and, in particular, the use of intangibles to shift profits to low-tax jurisdictions.\textsuperscript{3} The 2015 OECD final reports on actions 8-10 seek to allocate profits to jurisdictions on the basis of value creation.\textsuperscript{4}

The 2017 OECD transfer-pricing guidelines,\textsuperscript{5} which are based on the arm’s-length principle, are premised on a comparison of controlled transactions with comparable uncontrolled transactions. One of the situations in which the arm’s-length principle may be applied is one where an associated enterprise has internal comparable uncontrolled transactions. The Achilles heel of transfer pricing is the lack, at times, of comparable uncontrolled transactions. High-speed, high-quality business information systems and communications systems have, inter alia, enabled MNE groups to achieve high levels of integration, which makes comparability a challenge. MNE groups are organized along business lines rather than national borders. MNE groups have the goal of profit maximization, which involves minimizing income tax. Moreover, these groups often enter into transactions that are not reflected in transactions between independent parties.

The OECD’s transactional profit-split method (“the profit-split method”) represents an opportunity to move away from the uncertainty of the arm’s-length principle. But the 2018 OECD revised guidance on the profit-split method\textsuperscript{6} failed to pave the way for formulaic (that is formula-based) methods, maintaining the rhetoric of the arm’s-length principle. (This revision was undertaken as part of the Inclusive Framework on BEPS: Action 10.)\textsuperscript{7} The 2018 revised guidance claims that the profit-split method cannot be treated as the most appropriate method solely because comparable uncontrolled transactions are unavailable.\textsuperscript{8} Nevertheless, comparable

\textsuperscript{2} Ibid., at 6.

\textsuperscript{3} Ibid.

\textsuperscript{4} Organisation for Economic Co-operation and Development, *Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10—2015 Final Reports* (Paris: OECD, 2015).

\textsuperscript{5} Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, July 2017) (herein referred to as “the 2017 OECD transfer-pricing guidelines”). First published in 1995.

\textsuperscript{6} Organisation for Economic Co-operation and Development, *Revised Guidance on the Application of the Transactional Profit-Split Method: Inclusive Framework on BEPS: Action 10* (Paris: OECD, 2018) (herein referred to as “the 2018 OECD revised guidance”).

\textsuperscript{7} The OECD established the Inclusive Framework on BEPS in June 2016 so that all interested countries and jurisdictions could work together. Over 115 countries and jurisdictions have already joined on an equal footing in developing standards on BEPS-related issues and in reviewing and monitoring its consistent implementation. See Organisation for Economic Co-operation and Development, “What Is BEPS?” (www.oecd.org/tax/beps/beps-about.htm); and Organisation for Economic Co-operation and Development, “OECD/G20 Inclusive Framework on BEPS” (www.oecd.org/tax/flyer-inclusive-framework-on-beps.pdf).

\textsuperscript{8} 2018 OECD revised guidance, at paragraph 2.128.
uncontrolled transactions are usually unavailable in the three situations where the OECD profit-split method is considered to be the most appropriate method—that is, (1) situations involving high degrees of integration, (2) situations involving the contribution of unique and valuable intangibles by the associated enterprises, and (3) situations where the associated enterprises share the same economically significant or closely related risks. The 2018 OECD revised guidance states in detail that the profit-split method may be the most appropriate method if, according to the accurately delineated transaction, the associated enterprises share the same economically significant or closely related risks.9

For the allocation of profits to members of an MNE group, the alternative to the arm’s-length principle is formulary apportionment, or formulary methods. There is controversy over the relative merits of these alternatives. The 2017 OECD transfer-pricing guidelines rejected formulary apportionment as being an arbitrary and inappropriate method for the allocation of profits between associated enterprises. However, the OECD appeared to be shifting its view of formulary methods when it claimed, in 2018, that it was agnostic on the subject of the arm’s-length principle.10

In this paper, I argue that the 2018 OECD revised guidance on the profit-split method has failed to take the opportunity to move away from the use of the arm’s-length principle in allocating profits within MNE groups, and toward the use of formulary factors. The frequent lack of comparable uncontrolled transactions has made transfer pricing arbitrary, and it has created substantial uncertainty for taxpayers and tax administrations. The apparent change in the OECD’s rhetoric on the significance of the arm’s-length principle was not reflected in the 2018 OECD revised guidance, which placed significant limits on the situations in which the profit-split method may be used. The OECD’s revision of the profit-split method was contentious; the revised guidance was finalized in June 2018, following three discussion drafts. A US official asserted that the 2018 OECD revised guidance ensures that the use of the profit-split method will remain infrequent.11 Within months of the release of this guidance, the OECD, the Group of Twenty (G20), and the Inclusive Framework announced that two of the options being considered for BEPS action 1 (on measures for taxing the digital economy) involve the residual profit-split method that uses formulary methods.

---

9 Ibid., at paragraphs 2.139-2.142.
10 Pascal Saint-Amans, director of the OECD Centre for Tax Policy and Administration, stated at the International Fiscal Association (IFA) congress in 2018 that the OECD was agnostic with respect to the arm’s-length principle: See 72d Congress of the International Fiscal Association (IFA), Seoul, September 2-6, 2018, seminar E: IFA/OECD, September 5, 2018, available on Taxsutra.com (www.taxisutra.com/sites/taxsutra.com/files/webform/IFA%202018%20-%20Day%202018%20-0.pdf).
11 Christopher Bello, branch 6 chief, IRS Office of Associate Chief Counsel (International), referred to in Ryan Finley, “Narrower OECD Profit Split Guidance Is a Result of U.S. Efforts” (2018) 91:4 Tax Notes International 404.
In the next section of this paper, I provide background on the BEPS project and outline some of the proposed revisions to the profit-split method. I discuss the expectations that the profit-split method would become more widely used and that there would be a movement away from the arm’s-length principle. Following that discussion, I consider the stringent threshold requirements on the use of the profit-split method that are set out in the 2018 OECD revised guidance. I show that this guidance does not reflect earlier OECD proposals that the profit-split method be made a more frequently used transfer-pricing method, and this guidance does not contain the proposed deviations from the arm’s-length principle. In the final section of this paper, I consider the potential use of the residual profit-split method under BEPS action 1, which addresses the taxation of the digital economy.

BACKGROUND

In this section of the paper, I set out the proposals for the reform of the profit-split method—a reform that was eventually finalized in the 2018 OECD revised guidance. The OECD and the G20 had expected that the updated profit-split method would be able to be more widely used. One expectation was that this method could be applied when reliable comparable uncontrolled transactions were unavailable. Moreover, the aggressive tax-avoidance practices of certain multinationals were based on exploiting the flaws in the OECD guidelines that preceded the BEPS transfer-pricing revisions.

The BEPS Project

The BEPS action plan\(^{12}\) found that globalization has resulted in the integration of national economies and markets. The features of the globalized international economy are capital mobility, fewer trade barriers, substantial advances in telecommunications and business information systems, and the rapidly growing importance and value of intangibles in MNEs. These developments have allowed MNE groups to operate as unitary global enterprises rather than as separate entities in a global group. Moreover, globalization has resulted in increased intragroup trade, and MNEs now command a substantial amount of global gross domestic product (GDP).\(^{13}\) Because the services sector and digital products are increasingly available on the Internet, many MNEs maintain operations in several countries in order to exploit (1) economies of scale and (2) savings related to location, such as lower labour costs. From these countries, MNEs are able to provide services, digital products, and tangible products to their customers while maintaining a limited presence in the countries where their customers are located.\(^{14}\)

---

12 Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013) (herein referred to as “the BEPS action plan”), at 7 (https://doi.org/10.1787/9789264202719-en).

13 Ibid.

14 Ibid.
Concurrent with these developments has been the growth in aggressive tax planning by MNEs. Tax planners identified opportunities for tax arbitrage, and MNEs claimed that they were complying with existing tax laws despite the aggressive planning. In short, MNEs and their tax advisers were operating at a global level, and their aggressive tax planning was substantially eroding the tax bases of nation states. In response to these developments, the BEPS project was commenced, with the BEPS action plan setting out 15 actions to counter the tax-avoidance opportunities available to MNEs.

The International Monetary Fund (IMF) has asserted that, although it is too early to determine the impact of the BEPS measures, the scope for international profit shifting remains significant. The areas of concern identified by the IMF are (1) the allocation of risk within MNEs, (2) the valuation of intangibles, and (3) the avoidance or limitation of a physical presence. In support of its assertion that profit shifting has not been countered, the IMF cites the reliance on the “arbitrary qualitative limits” of the BEPS measures, such as the BEPS action 4 measures with respect to interest.

In 2019, the OECD, the G20, and the Inclusive Framework noted that MNEs’ unprecedented reliance on intangibles and intragroup services has exposed weaknesses in the existing international tax rules. MNE groups operating in the digital economy are able to make substantial profits from user or market jurisdictions (that is, the jurisdictions in which they have significant user participation or customers) without having a significant physical presence in these jurisdictions. The failure of the existing rules to allocate appropriate profits to user or market jurisdictions has caused dissatisfaction in several jurisdictions, some of which have enacted measures. This dissatisfaction has resulted in the consideration of the two basic measures for the allocation of profits to user or market jurisdictions. These measures are considered below, in the final section of this paper.

The BEPS action plan notes that a formula-based approach has the potential to deal with some of the types of tax avoidance engaged in by MNEs:

---

15 Ibid., at 8.
16 Ibid.
17 International Monetary Fund, Corporate Taxation in the Global Economy, Policy Paper no. 19/007 (Washington, DC: IMF, 2019), at paragraph 12 (www.imf.org/en/Publications/Policy-Papers/Pages/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650).
18 Ibid.
19 Ibid.
20 Organisation for Economic Co-operation and Development, Programme of Work To Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy: Inclusive Framework on BEPS (Paris: OECD, 2019), at paragraph 11 (www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf).
21 Ibid., at paragraph 7.
Alternative income allocation systems, including formula based systems, are sometimes suggested. However, the importance of concerted action and the practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries mean that, rather than seeking to replace the current transfer pricing system, the best course is to directly address the flaws in the current system, in particular with respect to returns related to intangible assets, risk and over-capitalisation. Nevertheless, special measures, either within or beyond the arm’s-length principle, may be required with respect to intangible assets, risk and over-capitalisation to address these flaws.\(^\text{22}\)

This statement is significant: it marks the OECD’s change of adherence with respect to the arm’s-length principle, a change made in response to the tax-avoidance opportunities that existed under the OECD guidelines prior to the May 2016 BEPS updates to the OECD guidelines.\(^\text{23}\)

BEPS action 10 sets out the following objectives:

Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: . . . (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains.\(^\text{24}\)

**Discussion Draft on BEPS Action 1**

The following statement in the OECD’s discussion draft on BEPS action 1\(^\text{25}\) reflects an intention to move away from the arm’s-length principle:

When the arm’s-length principle was initially devised, it was common that each country in which an MNE group did business had its own fully integrated subsidiary to carry on the group’s business in that country. This structure was dictated by a number of factors, including slow communications, currency exchange rules, customs duties, and relatively high transportation costs that made integrated global supply chains difficult to operate. With the advent of the development in information and communication

---

22 BEPS action plan, supra note 12, at 20.

23 On May 23, 2016, the OECD Council approved the updates to the OECD guidelines as contained in the 2015 OECD final reports on actions 8-10 (supra note 4). See Organisation for Economic Co-operation and Development, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report* (Paris: OECD, October 5, 2015). For further information, see Organisation for Economic Co-operation and Development, “OECD Council approves incorporation of BEPS amendments into the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” (www.oecd.org/tax/oecd-council-approves-incorporation-of-beps-amendments-into-the-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.htm).

24 BEPS action plan, supra note 12, at 20-21.

25 Organisation for Economic Co-operation and Development, *OECD’s Discussion Draft on BEPS Action 1: Addressing the Tax Challenges of the Digital Economy* (Paris: OECD, 2014).
technology (ICT), reductions in many currency and custom barriers, and the move to digital products and a service based economy, these barriers to integration broke down and MNE groups began to operate much more as single global firms. Corporate legal structures and individual legal entities became less important and MNE groups moved closer to the economist’s conception of a single firm operating in a co-ordinated fashion to maximise opportunities in a global economy. Attention should therefore be devoted to the implications of this increased integration in MNEs and evaluate the need for greater reliance on value chain analyses and profit-split methods. This work should also address situations where comparables are not available because of the structures designed by taxpayers and could also include simpler and clearer guidance on the use of profit splits along the lines that have been successfully applied in connection with global trading and other integrated financial services businesses.26

Commentators noted that there were concerns about the OECD’s proposed change of policy, which involved moving from the arm’s-length principle to formulary apportionment.27

Addressing the Tax Challenges of the Digital Economy (2014)
An OECD/G20 2014 report on the tax challenges of the digital economy28 identified topics related to the digital economy and transfer pricing that need to be examined. The 2014 report noted the importance of intangibles to MNEs, the monetization of data, the development of global value chains, and the consequences for transfer pricing.29 Moreover, the 2014 report pointed out that it would be appropriate to provide “simpler and clearer guidance on the application of the transfer pricing methods, including profit splits in the context of global value chains.”30

The 2014 report acknowledged that the transfer-pricing rules need to be revised to reflect the current integration of MNE groups made possible by high-speed, high-quality information and communications systems. It noted that when the arm’s-length principle was established, an MNE group had a subsidiary incorporated in the country in which the group operated.31 These subsidiaries, prior to globalization,
would have had to be autonomous because they would have had difficulty communicating with the parent company on a daily basis. Other factors that would have required a subsidiary to be autonomous were (1) currency exchange rules, (2) customs duties, and (3) transportation costs that would make a global supply chain uneconomic. Autonomous subsidiaries would be evaluated on the basis of their individual performance, and they would have the incentive to maximize their profits. In this separate accounting context, the arm’s-length principle would have been a realistic measure. Murphy and Baker have observed that in the 1920s and 1930s, consolidated accounting for an MNE group was rare, and that, in consequence, separate accounting provided support for the arm’s-length principle. For the past 70 years, however, company law and the accounting profession have recognized that MNE groups operate as unitary businesses; as a consequence, consolidated accounting has been the norm.

The creation of high-speed and high-quality information and communications systems, the reductions in the currency and customs restrictions, and the movement toward the provision of services and digital products provided a framework in which MNE groups could operate as integrated global entities. As global entities, MNE groups reflected the economic concept of a single firm operating to maximize its global profits. The 2014 report stated that the consequences of this integration by MNEs, which represents a paradigm shift, need to be examined, with a movement toward “greater reliance on value chain analyses and profit-split methods.” The 2014 report also noted that the proposed measures should deal with the situations in which—because of the structures implemented by some MNE groups—comparables are unavailable. In particular, the proposed measures “could also include simpler and clearer guidance on the use of profit methods, including profit splits along the lines that have been successfully applied in connection with global trading and other integrated financial services businesses.” In sum, the 2014 report contains a clear indication that the arm’s-length principle has shortcomings in the context of global supply chains and that the use of profit splits should be more widespread.

32 Ibid.
33 Richard Murphy and Andrew Baker, A Response to the Consultation of an IMF 2019 Analysis of International Corporate Taxation (London, UK and Sheffield, UK: City, University of London and Sheffield Political Economy Research Institute, December 2018), at 5 (www.taxresearch.org.uk/Documents/IMFSsubmission.pdf).
34 Ibid., at 5.
35 2014 report, supra note 28, at 119.
36 Ibid.
37 Ibid.
38 Ibid.
2014 Discussion Draft

In accordance with the mandate of the BEPS action plan and the 2014 report, the OECD issued the 2014 discussion draft. The 2014 discussion draft considers situations in which the profit-split method might be the most appropriate transfer-pricing method. One of the most significant challenges in transfer pricing is the lack of comparable uncontrolled transactions that are either identical or similar to the controlled transactions; the 2014 discussion draft mentions that one of the shortcomings of one-sided transfer-pricing methods is the lack of reliable comparables. The discussion draft claims that, if the lack of comparables is a major obstacle, the profit-split method may be useful if it can be used to “determine an arm’s length outcome in accordance with the functions of the parties.” It is incorrect, however, to assert that the profit-split method may be used to determine an arm’s-length outcome in a situation where there are no comparables. In this situation, the capacity to determine compliance with the arm’s-length principle is limited. Moreover, the compliance is based on a hypothesis that cannot usually be tested.

The 2014 discussion draft claims that in situations where comparable uncontrolled transactions do not reflect the functions or risks of the tested party, the profit-split method may “offer the means to vary or flex the results under a one-sided method.” The example provided in the draft states that a one-sided method results in the finding of an operating market range of 4-10 percent for one of the parties to the controlled transactions. In this situation, a baseline margin of 7 percent is used, which could be adjusted in a pre-determined computation up to 10 percent and down to as low as 4 percent depending on the levels of consolidated profits earned by the associated enterprises. The 2014 discussion draft includes a question about the example, seeking comments on the circumstances in which a profit-split approach would be useful in supporting the application of other methods.

The 2014 discussion draft considers the fragmentation of functions in an integrated value chain of MNEs. An MNE group creates a value chain in which group members are allocated functions such as logistics, warehousing, marketing, and sales. In this situation, it may be difficult to find comparable uncontrolled transactions that carry on identical or similar activities. Furthermore, this situation may

---

39 Organisation for Economic Co-operation and Development, *Public Discussion Draft BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains* 16 December 2014-6 February 2015 (Paris: OECD, 2014) (herein referred to as “the 2014 discussion draft”) (www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-profit-splits -global-value-chains.pdf).
40 Ibid., at paragraph 29.
41 Ibid.
42 Ibid., at paragraph 32.
43 Ibid., at 10, question 21.
44 Ibid., at paragraphs 26-28.
45 Ibid., at paragraph 26.
46 Ibid.
be complicated by a high degree of integration between the associated enterprises—a level of integration that would not be reflected in independent enterprises. The fragmentation in an MNE group makes it challenging to find comparable uncontrolled transactions, which will not contain the same function, asset, and risk profile as the controlled transactions.\textsuperscript{47} The 2014 discussion draft states that if fragmentation prevents reliable comparable transactions from being obtained, “it may be feasible to support the outcomes of pricing based on potential comparables with a transactional profit split approach.”\textsuperscript{48} The approach suggested in the discussion draft is one that may be used to identify comparables for some or all of the fragmented activities on a combined basis, and whose contribution analysis could be applied to allocate the combined profits.\textsuperscript{49} This proposal on fragmentation was not reflected in the 2018 OECD revised guidance on the profit-split method.

The Final Two Discussion Drafts

Before the finalization of the 2018 OECD revised guidance, the OECD issued two further discussion drafts. One appeared in July 2016,\textsuperscript{50} the other in June 2017.\textsuperscript{51} In total, the OECD published three discussion drafts concerning the revision of the guidance on the profit-split method. This extensive process indicates that the OECD and the Inclusive Framework faced challenges in establishing consensus on the matter.

THE 2018 OECD REVISED GUIDANCE

The 2018 OECD revised guidance, published in June 2018, states that the guidance on the profit-split method in the 2017 OECD transfer-pricing guidelines is deleted and replaced with sections C.1-C.5 and annex II to chapter II.\textsuperscript{52} The 2018 revised guidance is a response to the mandate under BEPS action 10. The profit-split method had been part of the OECD guidelines since 1995 and was initially a method of last resort. The 2010 OECD guidelines provided that all of the transfer-pricing methods have equal weight and that the most appropriate method should be used. This policy remained unaltered by the 2018 OECD revised guidance.\textsuperscript{53} As I discuss below, the profit-split method is rarely used and has remained, in effect, a transfer-pricing method of last resort.

\textsuperscript{47} Ibid., at paragraph 27.
\textsuperscript{48} Ibid.
\textsuperscript{49} Ibid.
\textsuperscript{50} Organisation for Economic Co-operation and Development, Public Discussion Draft: BEPS Actions 8-10, Revised Guidance on the Profit Splits 4 July-5 September 2016 (Paris: OECD, 2016) (www.oecd.org/tax/transfer-pricing/BEPS-discussion-draft-on-the-revised-guidance-on-profit-splits.pdf).
\textsuperscript{51} Organisation for Economic Co-operation and Development, Public Discussion Draft BEPS Action 10 Revised Guidance on Profit Splits 22 June-15 September 2017 (Paris: OECD, 2017) (www.oecd.org/ctp/transfer-pricing/Revised-guidance-on-profit-splits-2017.pdf).
\textsuperscript{52} 2018 OECD revised guidance, supra note 6, at 11-44.
\textsuperscript{53} Ibid., at paragraph 2.114.
The 2018 OECD revised guidance claims that it “clarifies and significantly expands the guidance on when a profit-split method may be the most appropriate method.”\(^{54}\) I would suggest, however, that this revised guidance has failed to expand the scope for using the profit-split method. In particular, it has left the profit-split method tied to the arm’s-length principle, given that comparable uncontrolled transactions are (paradoxically) unavailable for MNE groups that are highly integrated. The underlying policy, reflected in the threshold requirements, is that the profit-split method should continue to be sparingly used. Moreover, the profit-split method cannot be used because reliable comparables, per se, are unavailable.\(^{55}\)

The profit-split method set out in the 2018 revised guidance is based on the arm’s-length principle, notwithstanding initial suggestions of a move away from this principle. The revised guidance provides that the profit-split method seeks to “establish arm’s length outcomes or test reported outcomes for controlled transactions in order to approximate the results that would have been achieved between independent enterprises engaging in a comparable transaction or transactions.”\(^{56}\) The profit-split method involves two steps. First, one identifies the profits to be split from controlled transactions.\(^{57}\) Second, those profits are divided between the parties on an economically valid basis that approximates the division of profits that would be established between arm’s-length parties.\(^{58}\) The 2018 revised guidance claims that the profit-split method is best suited to situations where the profits to be allocated to the parties can be reliably valued on the basis of the parties’ relative contributions to the profits arising from the controlled transactions.\(^{59}\)

The 2018 OECD revised guidance notes that the references to “profits” should be treated as also applying to losses from controlled transactions.\(^{60}\) If the profit-split method is the most appropriate method, it should apply in the same manner to both profits and losses.\(^{61}\)

**The Transactional Profit-Split Method as the Most Appropriate Method**

The 2018 OECD revised guidance requires the selection of the transfer-pricing method that is the most appropriate for the tested party.\(^{62}\) The most appropriate method will be determined on the basis of

\(^{54}\) See ibid., executive summary.

\(^{55}\) Ibid, at paragraph 2.114.

\(^{56}\) Ibid.

\(^{57}\) Ibid.

\(^{58}\) Ibid.

\(^{59}\) Ibid.

\(^{60}\) Ibid., at paragraph 2.115.

\(^{61}\) Ibid.

\(^{62}\) Ibid., at paragraph 2.116, referring to paragraph 2.2.
the respective strengths and weaknesses of the methods;
- the degree of appropriateness in view of the accurately delineated controlled transactions;
- the availability of reliable information; and
- the degree of comparability between the controlled and uncontrolled transactions.\(^63\)

The basis for using the profit-split method is the following: the result that it provides reflects the result that independent parties would have reached in the same or similar circumstances. In the absence of comparables, the arm’s-length principle is merely a hypothesis; it is difficult to determine objectively what independent parties would have done. It can be argued on this basis that formulary approaches, such as the profit-split method, result in the same profit allocations to jurisdictions that independent parties would have made.\(^64\) Moreover, it has been asserted that the arm’s-length principle and formulary methods should be viewed as being part of a continuum of methods.\(^65\) Nevertheless, the 2017 OECD transfer-pricing guidelines treat formulary apportionment as an inappropriate method of allocating profits within an MNE group.\(^66\)

**Strengths and Weaknesses of the Transactional Profit-Split Method**

The key advantage of the profit-split method is that it provides solutions for cases in which both parties to a controlled transaction make unique and valuable contributions, such as unique and valuable intangibles.\(^67\) In these circumstances, it is highly unlikely that comparable transactions are available for the application of a one-sided method. This point is noted in the 2018 OECD revised guidance: “[T]here will be no reliable comparables information which could be used to price the entirety of the transaction in a more reliable way, through the application of another method.”\(^68\) The revised guidance provides that in such a case, profits may be allocated, under the profit-split method, on the basis of the parties’ contributions, which are determined by reference to the relative values of their respective functions, assets, and risks.\(^69\)

The 2018 OECD revised guidance treats the profit-split method as potentially the most appropriate method for highly integrated operations when a one-sided method

\(^{63}\) Ibid.

\(^{64}\) See Reuven S. Avi-Yonah, “The Rise and Fall of Arm’s Length: A Study in the Evolution of U.S. International Taxation” (1995) 15:1 Virginia Tax Review 89-159, at 94.

\(^{65}\) Ibid., at 158-59.

\(^{66}\) See the 2017 OECD transfer-pricing guidelines, supra note 5, at paragraphs 1.15-1.32.

\(^{67}\) 2018 OECD revised guidance, supra note 6, at paragraph 2.119.

\(^{68}\) Ibid.

\(^{69}\) Ibid.
would not be appropriate. The guidance recognizes that the advantage of the profit-split method is that it provides flexibility through its ability to take into account the specific and usually unique facts and circumstances of the parties to a controlled transaction. These facts and circumstances are unlikely to be replicated in uncontrolled transactions. If a high degree of uncertainty for the parties to a controlled transaction arises from their shared assumption of economically significant risks (or from their separate assumption of closely related economically significant risks), the profit-split method provides flexibility to allow for a profit split that provides each party with a so-called arm’s-length profit that is based on the results of the risks in the controlled transaction.

The 2018 OECD revised guidance notes that another strength of the profit-split method is that the contributions of the parties to the transaction are directly tested. The method provides for the identification of the contributions of the parties to the controlled transactions and for the calculation of the respective values of these contributions, such that the appropriate arm’s-length compensation for the parties can be determined.

A weakness of the profit-split method, according to the guidance, is the difficulty of applying it. The method may appear accessible to taxpayers and tax authorities because its application relies less than other methods on comparable uncontrolled transactions between independent entities. However, as the guidance argues, both taxpayers and tax authorities may have difficulty in obtaining the necessary information to apply the method.

The 2018 OECD revised guidance points out several further challenges that the profit-split method may pose. First, there may be difficulties in measuring the income and costs for the parties to the controlled transaction. Such measuring requires that the accounting information for the controlled transactions be produced on a common basis, with adjustments for differences in accounting standards and currencies. Second, in applying the profit-split method to the parties’ net profit from the controlled transaction, it may be difficult to determine the appropriate expenses involved in the transaction and then to allocate these costs to the controlled transactions and the other transactions of the parties. Third, it may be difficult to determine which profit-splitting criteria should be applied. Moreover, the process involves various other demands: (1) the exercise of judgment and the documenting

70 Ibid., at paragraph 2.120.
71 Ibid., at paragraph 2.121.
72 Ibid.
73 Ibid., at paragraph 2.122.
74 Ibid.
75 Ibid., at paragraph 2.123.
76 Ibid.
77 Ibid.
78 Ibid.
of the reasoning involved in the application of the profit-split method; (2) a determination of how the profits from the controlled transactions were calculated; and (3) an identification of the basis on which the profit-splitting factors were selected.79

The 2018 OECD revised guidance acknowledges the claim that, because independent parties rarely use the profit-split method, the use of this method by associated enterprises should be similarly rare.80 The guidance notes, however, that if the profit-split method is determined to be the most appropriate method, the infrequency of its use by independent parties is not an obstacle to its application by others;81 its use is not restricted to situations that replicate the arrangements of independent parties. The profit-split method is based on “verifying arm’s length outcomes for controlled transactions.”82

The Accurately Delineated Transaction

An accurate delineation of the controlled transaction is an important part of the process for determining whether the profit-split method is the method most appropriate for that transaction.83 This accurate delineation will involve a determination of the commercial and financial relations between the parties to the controlled transaction, an analysis of the contributions of the parties, and an identification of the context of the controlled transaction.84 The 2018 OECD revised guidance states that the existence of unique and valuable contributions by each party may be the most important factor in determining whether the profit-split method is the most appropriate method for a controlled transaction.85 When it comes to evaluating whether the parties’ contributions are unique and valuable, a relevant factor is the context of the controlled transaction, including the industry involved.86 The existence of a high level of integration between the parties or the parties’ shared assumption of economically significant risks would also be a factor supporting the use of the profit-split method.87 The more of these factors that are present in a particular case, the more compelling the support for using the profit-split method.

The profit-split method is not appropriate, according to the 2018 OECD revised guidance, if the accurate delineation of the controlled transaction reveals that one of the parties (1) performs only simple functions; (2) does not assume economically

79 Ibid.
80 Ibid., at paragraph 2.124.
81 Ibid.
82 Ibid.
83 Ibid., at paragraph 2.125.
84 Ibid.
85 Ibid., at paragraph 2.126.
86 Ibid.
87 Ibid.
significant risks; and (3) does not make a contribution that is unique and valuable.\textsuperscript{88}

The basis for this conclusion is that, given the relative contributions and assumption of risk by the parties, it is unlikely that the share of profits from such a controlled transaction would reflect the outcome of an arm’s-length transaction.

The 2018 OECD revised guidance notes that a lack of closely comparable uncontrolled transactions should not be the basis, per se, for determining that the profit-split method is the most appropriate method.\textsuperscript{89} The guidance claims that, subject to the circumstances, if there exist uncontrolled transactions that are “sufficiently comparable” but not identical to the controlled transactions, a one-sided method is more reliable than the use of the profit-split method.\textsuperscript{90} The unequivocal point made in the guidance is that a lack of close comparables cannot be the only basis for the use of the profit-split method. Nevertheless, the three-part restriction that I cite in the previous paragraph is substantial, given that comparability is the main challenge when it comes to transfer pricing.

Surprisingly, the 2018 OECD revised guidance asserts that if information is available that independent parties in certain industries “commonly use profit splitting approaches” in situations similar to that of the controlled transaction, then the profit-split method may be the most appropriate for the controlled transaction.\textsuperscript{91} The profit-split method is rarely used for controlled transactions, and it is likely that its use in uncontrolled transactions would be even more infrequent. Curiously, the 2018 OECD revised guidance claims that industry practices may indicate that each party makes unique and valuable contributions to the controlled transactions and that the parties are highly interdependent.\textsuperscript{92} Transfer pricing requires a case-by-case analysis, and determinations as to contributions and interdependence are based on the accurate delineation of the controlled transaction. This raises the question of how industry practices will affect the accurate delineation of the controlled transactions.

**When the Transactional Profit-Split Method May Be the Most Appropriate Method**

In this section of the paper, I set out the conditions in which the profit-split method may be the most appropriate method for the allocation of profits among members of an MNE group. According to the 2018 OECD revised guidance, the profit-split method may be the most appropriate when

- each party to the controlled transactions makes unique and valuable contributions;
- the business operations are highly integrated; or,
- the parties share economically significant risk.

\textsuperscript{88} Ibid., at paragraph 2.127.
\textsuperscript{89} Ibid., at paragraph 2.128.
\textsuperscript{90} Ibid.
\textsuperscript{91} Ibid., at paragraph 2.129.
\textsuperscript{92} Ibid.
Although the profit-split method provides a viable alternative for allocating profits, its future use in transfer pricing is not likely to become widespread.

**Unique and Valuable Contributions by Each Party to a Controlled Transaction**

Contributions that parties may make to a controlled transaction include the functions performed and the assets used or contributed. Such contributions will be treated as unique and valuable if they are (1) not comparable to contributions made by parties to uncontrolled transactions in comparable circumstances, and (2) an important source of actual or potential benefits that arise from the controlled transactions. The 2018 OECD revised guidance claims that these factors are often connected; comparables for these contributions are rarely available because they are an important source of economic advantage.

The guidance notes that risks arising from the respective unique and valuable contributions cannot be controlled by “the other party” and that the existence of such control may affect the accurate delineation of the controlled transaction. The guidance provides the following example. One party to a controlled transaction is the developer and manufacturer of a significant component of a product. The other party to the transaction is the developer and manufacturer of another important component of the same product. Both parties make valuable and unique contributions that are reflected in valuable intangibles that provide substantial economic benefits to the parties. Although neither party is able to control the development risk for the product, the parties are jointly able—through working together in the controlled transactions—to control risks and share the profits arising from their collaboration.

The 2018 OECD revised guidance claims that if it is not possible to obtain reliable comparable uncontrolled transactions, the profit-split method may be the most appropriate method for controlled transactions involving the transfer of fully developed intangibles. The profit-split method may also be the most appropriate method for controlled transactions involving partially developed intangibles.

**Highly Integrated Business Operations**

The 2018 OECD revised guidance claims that if an MNE group is highly integrated, the profit-split method may be appropriate. A substantial degree of integration is

---

93 Ibid., at paragraph 2.130.
94 Ibid.
95 Ibid.
96 Ibid.
97 Ibid.
98 Ibid.
99 Ibid., at paragraph 2.132.
100 Ibid.
101 Ibid., at paragraph 2.133.
required for this to be the case. The threshold set out in the guidance is as follows: one party’s contributions (determined on the basis of functions performed, assets used, and risks assumed) to the controlled transactions are so closely connected to the other party’s contributions that the individual contributions of each party cannot be reliably determined. The guidance acknowledges that most MNEs operate in an integrated manner but that there are “many instances” of integrated operations in which the contributions of one of the parties to a controlled transaction can be evaluated on the basis of comparable uncontrolled transactions.

For example, according to the guidance, if the parties to a controlled transaction provide complementary activities that are discrete, comparable transactions may be available. The basis for this claim is that if each contribution to the controlled transaction in each stage can be measured on the basis of functions performed, assets used, and risks assumed, these contributions may be comparable with those for comparable uncontrolled transactions. However, this restriction on the use of the profit-split method appears to be misguided. First, transfer pricing is based on an analysis of the party that makes the simplest contributions to the controlled transaction. As a result, the tax authority for the party that makes the more complex contributions has to rely exclusively on a transfer-pricing analysis that has taken place in the other jurisdiction and that is based on information located in that jurisdiction. This is an important limitation of the arm’s-length principle: it cannot usually be applied to the party that makes the more complex contributions to controlled transactions. The critical challenge is being able to find comparable uncontrolled transactions for the purposes of a comparability analysis. It will often be difficult to find reliable comparables.

The 2018 OECD revised guidance notes that for some controlled transactions, the contributions of the respective parties may be so highly integrated that it is impossible to evaluate the individual contributions. In such cases, the profit-split method may be the most appropriate method of allocating income among members of the MNE group. The example provided is that of the global trading of financial instruments by associated enterprises. Another example provided is one in which the integration of the contributions takes the form of a high degree of interdependency between the associated enterprises—for example, when the associated enterprises have long-term arrangements whereby each party has made significant contributions, and the business advantage of the arrangements depends on the continued participation of each associated enterprise, the profit-split method may be the most appropriate method. In this example, the parties have made significant

102 Ibid.
103 Ibid.
104 Ibid.
105 Ibid., at paragraph 2.134.
106 Ibid.
107 Ibid., at paragraph 2.135.
contributions and are dependent on each other. The 2018 OECD revised guidance states that in such a case, a profit-split method provides flexibility for dealing with the outcomes of the risks of the controlled transactions arising from the interdependence of the parties.

In highly integrated business operations, the associated enterprises may share economically significant risks or may independently assume closely related and economically significant risks.\textsuperscript{108} The revised guidance provides that in such cases, the profit-split method may be the most appropriate method.\textsuperscript{109} An important question is whether the method should be applied to anticipated or actual profits.\textsuperscript{110}

Another controlled-transaction situation in which the profit-split method may be the most appropriate method, according to the guidance, is a situation where one party to the transaction contributes to the control of economically significant risk that is assumed by the other party to the controlled transaction.\textsuperscript{111} In this situation, the party contributing to the control of the risk would be able to share in any returns arising from the risk or would be required to bear any losses that result from the risk being realized. But the mere contribution of the party to the control of risk does not by itself justify the use of the profit-split method.\textsuperscript{112}

**Shared Assumption of Economically Significant Risks and Separate Assumption of Closely Related Risks**

The profit-split method may be the most appropriate method when the accurate delineation of the transaction establishes that the parties to the controlled transaction share the assumption of associated, economically significant risks.\textsuperscript{113} Even if the accurate delineation discloses that both parties assume separate risks associated with the transaction, the profit-split method may be found most appropriate if the results of the risks cannot be isolated.\textsuperscript{114}

The use of the profit-split method in the case of the shared or interrelated risks of associated enterprises depends on whether these risks are sufficiently significant, from an economic perspective, to warrant the parties’ sharing of the profits associated with the risks.\textsuperscript{115} The economic significance of these risks should be determined by reference to their status in the actual or anticipated profits and the status of the risk for one of the parties where that party’s business extends “beyond those covered by the relevant profits.”\textsuperscript{116}

\textsuperscript{108} Ibid., at paragraph 2.136.
\textsuperscript{109} Ibid.
\textsuperscript{110} Ibid.
\textsuperscript{111} Ibid., at paragraph 2.137.
\textsuperscript{112} Ibid.
\textsuperscript{113} Ibid., at paragraph 2.139.
\textsuperscript{114} Ibid., at paragraph 2.140.
\textsuperscript{115} Ibid., at paragraph 2.141.
\textsuperscript{116} Ibid.
If the profit-split method is the most appropriate method when the parties share economically significant risks or when each party separately assumes interrelated, economically significant risks, the profit being split, according to the 2018 OECD revised guidance, should probably be actual profits and not anticipated profits.\textsuperscript{117} The basis for this claim is that a split of actual profits will reflect the actual outcomes of the risks for each party to the controlled transaction, whereas a split of anticipated profits will focus on the outcome of the risks for only one party.\textsuperscript{118}

**Lack of Comparables**

The 2018 OECD revised guidance notes that the situations where the profit-split method is the most appropriate method are usually situations where the elements needed for other transfer-pricing methods are absent.\textsuperscript{119} Other transfer-pricing methods rely on comparable uncontrolled transactions. The revised guidance claims that if reliable uncontrolled comparable transactions are available, it is less likely that the profit-split method will be the most appropriate method.\textsuperscript{120} Nevertheless, the guidance also states that if the profit-split method is used when reliable comparables are unavailable, information from independent parties “may still be relevant to the application of the method.”\textsuperscript{121}

At the same time, the revised guidance claims that a lack of reliable uncontrolled comparables cannot be the only basis for resorting to the profit-split method.\textsuperscript{122} This qualification is significant, given that the most significant challenge in transfer-pricing analysis is finding reliable comparables. The 2014 discussion draft suggested that the use of the profit-split method should be increased in situations where reliable comparables are unavailable.\textsuperscript{123} I would suggest that the 2018 OECD revised guidance should expressly state that the profit-split method may be used if reliable comparables are unavailable. The profit-split method has the capacity to be used on an objective basis to allocate the profits from controlled transactions to the members of the MNE group.

**THE SHORTCOMINGS OF THE ARM’S-LENGTH PRINCIPLE**

Transfer pricing is premised on separate accounting and on the arm’s-length principle. According to the 2017 OECD transfer-pricing guidelines, the arm’s-length principle is used by MNE groups and by tax administrations in OECD countries.\textsuperscript{124}

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{117} Ibid., at paragraph 2.142.
\item \textsuperscript{118} Ibid.
\item \textsuperscript{119} Ibid., at paragraph 2.143.
\item \textsuperscript{120} Ibid.
\item \textsuperscript{121} Ibid., at paragraph 2.144.
\item \textsuperscript{122} Ibid, at paragraph 2.143.
\item \textsuperscript{123} 2014 discussion draft, supra note 39, at paragraph 29.
\item \textsuperscript{124} Ibid., at supra note 39, at paragraph 1.1.
\end{enumerate}
\end{footnotesize}
The principle is based on uncontrolled transactions between independent parties. When independent parties enter into contracts, the conditions of their financial and commercial relations involve the operation of market forces. The arm’s-length principle is effective if a market exists for goods, assets (such as intangibles), or services that are being transferred within an MNE group. In the case of unique intangibles, however, it is a significant challenge to find comparable items being sold in uncontrolled transactions. In addition, the substantial size and centralized control of MNE groups may give these groups efficiency advantages over independent entities. Accordingly, the transfer prices for such controlled transactions will be different from the arm’s-length prices used by parties to an uncontrolled transaction. The US General Accounting Office (GAO) has noted that tax authorities and MNE groups will face significant problems in applying the arm’s-length principle to intangibles involved in controlled transactions by associated enterprises.

When transfer prices for parties to a controlled transaction do not reflect the arm’s-length principle, the tax liabilities of the parties and the tax revenues of their respective jurisdictions may be distorted. OECD countries have agreed that the taxable income of associated enterprises may be adjusted to correct any distortions arising from controlled transactions. The resulting adjustment should be based on the conditions of the commercial and financial relations that would be found between independent parties in comparable transactions and comparable circumstances. Accordingly, as the 2017 OECD transfer-pricing guidelines state, the arm’s-length principle is founded on comparability: “comparability analysis... is at the heart of the application of the arm’s-length principle.” Strikingly, these 2017 guidelines assert that “[t]he arm’s-length principle has also been found to work effectively in the vast majority of cases.” The veracity of this statement is now questionable, in light of the BEPS project.

The OECD has historically adhered to the arm’s-length principle. However, as discussed above, it has recently indicated that it is willing to consider formulary methods when the arm’s-length principle is ineffective in allocating profits to the

125 United States, Government Accountability Office, *International Taxation Information on the Potential Impact on IRS and U.S. Multinationals of Revised International Guidance on Transfer Pricing*, report to the United States Senate, Committee on Finance, document no. GAO-17-103 (Washington, DC: GAO, January 2017), at 23; and see François Vincent, “Transfer Pricing and the Attribution of Income to Permanent Establishments: The Case for Systematic Global Profit Splits (Just Don’t Say Formulary Apportionment)” (2005) 53:2 *Canadian Tax Journal* 409-16, at 410.

126 See United States, Government Accountability Office, supra note 125, at 23.

127 Ibid.

128 2017 OECD transfer-pricing guidelines, supra note 5, at paragraph 1.3.

129 Ibid.

130 Ibid., at paragraph 1.6.

131 Ibid., at paragraph 1.9.
jurisdictions in which MNE groups operate. As stated above, the OECD and the Inclusive Framework are no longer limited by the arm’s-length principle. The arm’s-length principle, as set out in the OECD guidelines, is both flexible and ambiguous. Transfer pricing often involves uncertainty: it relies on the identification of comparable uncontrolled transactions in identical or comparable circumstances, but the controlled transactions in which MNEs engage with associated enterprises are often not replicated in uncontrolled transactions. Moreover, for many MNE groups, intangibles—for example, trademarks, patents, marketing intangibles, and knowhow—are becoming increasingly important. The existence of high-value or unique intangibles makes comparability a challenge in transfer pricing.

The first step in transfer pricing is the accurate delineation of a controlled transaction, which involves identifying the relative contributions of the parties to the transaction. The relative contributions are determined on the basis of the functions performed, the assets used, and the risks assumed by the respective parties. The second step in transfer pricing is to identify comparable uncontrolled transactions and the most appropriate transfer-pricing method that may be used to determine whether the controlled transaction satisfies the arm’s-length principle.

The reform of the profit-split method became a debate about the viability of the arm’s-length principle and about whether deviations from this principle that are based on formulary methods are justified. As discussed above, there was expectation that, because of the shortcomings of the arm’s-length principle, the profit-split method might become more widely used. The current and former guidance on the profit-split method, however, set out high threshold requirements for its use, ensuring that it is rarely applied. Others have argued that the arm’s-length principle is not under threat and that the revisions to it should therefore be modest. The 2017 OECD transfer-pricing guidelines acknowledge that the separate-entity approach does not take into account economies of scale and the integration of MNE groups. These guidelines acknowledge that there exist no generally accepted objective criteria by which to allocate between associated enterprises the benefits that MNEs, by being part of a group, reap from economies of scale or integration.

132 See Yariv Brauner, “Tax Treaties in the Aftermath of BEPS” (2016) 41:3 Brooklyn Journal of International Law 973-1041. The article notes that country-by-country (CbC) reporting, according to the OECD, may be used only for the purposes of risk assessment in transfer-pricing enforcement. But there is a concern that some countries, particularly small developing countries, may use CbC reporting to apply formulary methods to allocate profits to a resident MNE.

133 Helen Rogers and Lynne Oats, “Emerging Perspectives on the Arm’s-Length Principle and Formulary Apportionment” [2019] no. 2 British Tax Review 150-65, at 152.

134 See Brauner, supra note 132, at 1037-38.

135 See Christian Kaeser, Jeffrey Owens, and Sam Sim, “Going the Way of the Polaroid: Digital Taxation and the End of the Arm’s-Length Principle” (2019) 95:3 Tax Notes International 211-19.

136 2017 OECD transfer-pricing guidelines, supra note 5, at paragraph 1.10.

137 Ibid.
analysis (considered in more detail below) claims that risk is another area in which
the arm’s-length principle faces problems, “because risk cannot be allocated between
associated entities.” 138

Some commentators have called for the retention of the arm’s-length principle, 139
claiming that in the context of the proposals for BEPS action 1 (considered below),
this principle should survive as a “broad church” that countries can continue to
adopt.140 These commentators claim that a movement toward formulary apportion-
ment, as anticipated in the 2014 discussion draft’s proposed revision to the guidance
on the profit-split method, would result in the misuse of the profit-split method by
tax authorities and (as a consequence of this misuse) in double taxation.141 Brauner
has contended that the OECD has resisted suggestions that it should re-evaluate the
arm’s-length principle, despite a gradual move away from the arm’s-length prin-
ciple.142 He claims that both the OECD and the United States, prior to the BEPS
project, deviated from the arm’s-length principle while remaining strident support-
ers of it.143 The OECD’s continued support of the arm’s-length principle is reflected
in the 2018 OECD revised guidance.

A US Internal Revenue Service (IRS) official has stated that the proposals in the
2018 OECD revised guidance were significantly more limited than the proposals in
the 2014 discussion draft.144 This official claimed that the 2014 discussion draft
reflected the view, shared by several countries, that the profit-split method should
be applied more broadly than it is, in order to prevent aggressive tax avoidance by
MNE groups.145 The official noted that the use of the profit-split method could not
be based on a lack of comparables per se, because there will often be “challenges in
identifying good comparables.”146 The official also noted that threshold require-
ments for the use of the profit-split method are high in order to ensure that its use
is limited.147 A senior US Treasury official has claimed that the profit-splitting meas-

138 See United States, Government Accountability Office, supra note 125, at 14.
139 See Kaeser et al., supra note 135; Jefferson VanderWolk, “The Arm’s-Length Standard Enters
Its Second Century” (2019) 93:9 Tax Notes International 961-68; Robert Robillard, “BEPS: Is
the OECD Now at the Gates of Formulary Apportionment?” (2015) 43 6/7 Intertax 447-53;
Robert Robillard, “ ‘Profits’ in Profit-Split Methods: Hazardous Crossovers on the Way to
Global Formulary Apportionment” (2017) Tax Notes International 167-73; and Finley, supra
note 11.
140 Kaeser et al., supra note 135, at 212.
141 Robillard, supra note 139, at 167.
142 Yariv Brauner, “Formula Based Transfer Pricing” (2014) 42:10 Intertax 615-31, at 625.
143 Ibid., at 626.
144 Finley, supra note 11, at 404.
145 Ibid.
146 Ibid.
147 Ibid.
the arm’s-length principle. But a former US Treasury official (the former co-chair of the OECD Work Party 6 on transfer pricing), noted that the OECD’s proposals for taxing the digital economy “would radically depart from the arm’s-length principle.” The former Treasury official claimed that what had been a debate over the interpretation and application of the arm’s-length principle between countries has become a debate over the viability of the arm’s-length principle.

**Risks Assumed by Associated Enterprises**

A transfer-pricing analysis is required to determine which associated enterprise to a controlled transaction bears economically significant risks and whether that party has the financial capacity to assume the risk. As discussed above, one of the situations in which the profit-split method may be used is a situation where the parties share economically significant risks or where each party’s risks are interdependent with the other party’s risks.

The GAO has argued that the guidance in the 2017 OECD transfer-pricing guidelines creates problems for tax authorities and MNEs because it is inaccurate in its account of the way risks are assumed by associated enterprises. The GAO’s premise is that the transfer of risk within MNE groups cannot replicate the way in which risks are transferred between independent parties. Because of the differences between an MNE group and unrelated parties, the GAO’s premise holds even if the associated enterprise has the ability to control risk and the capacity to assume risk. The GAO claims that if a parent company and its subsidiary enter into a transaction in which the economically significant risks are transferred to the subsidiary, the parent company cannot transfer all the risk because any losses incurred by the subsidiary from those risks will be reflected in the market value of the parent company. The example provided shows that if a parent transfers to a subsidiary an intangible and its associated, economically significant risks, the parent, through its equity interest in the subsidiary, will have either a gain or a loss from any anticipated or unanticipated profits and losses arising in the subsidiary. Consequently, according to the GAO’s analysis, the arm’s-length principle is limited in its ability to deal with the allocation of risks in controlled transactions.

---

148 Ryan Finley, “Harter Says Tax System Will Not Abandon Arm’s-Length Principle” (2019) 95:4 Tax Notes International 354, at 354. The official is Lafayette G. Harter III, US Treasury deputy assistant secretary for International Tax Affairs.

149 Ryan Finley, “OECD Digital Tax Proposals Are Latest Threat to Arm’s Length Concept” (2019) 93:8 Tax Notes International 873, at 873. The former Treasury official is Michael McDonald.

150 Ibid.

151 See United States, Government Accountability Office, supra note 125, at 9.

152 Ibid.

153 Ibid.

154 Ibid.

155 Ibid., at 11.
The GAO considers that these shortcomings have consequences for economic efficiency and equity in relation to transfer pricing.\textsuperscript{156} If profit allocations are based on an incorrect analysis of risk within MNE groups, the allocations may be inequitable if the parties assuming the risk are not actually bearing those risks. It is widely accepted that one feature of a good tax system is equity between taxpayers. Moreover, the GAO asserts that the reforms proposed in the 2017 OECD transfer-pricing guidelines may not be effective: if risk is not effectively considered in transfer pricing, the resulting uncertainty may create the potential for profit shifting through transfer-pricing manipulation.\textsuperscript{157}

**The European Union’s Proposals To Simplify the Profit-Split Method**

The European Union (EU) has noted that the “clarification and standardisation” of the profit-split method would result in benefits for both tax authorities and taxpayers through reduced compliance costs, simplified audits, and increased predictability and certainty.\textsuperscript{158} The EU reached consensus in 2018 on a two-stage process: the first stage would concentrate on clarifying certain concepts related to the use of the profit-split method; the second stage would explore ways of simplifying the profit-split method.\textsuperscript{159} This work reflects the residual profit-split proposals in BEPS action 1 (discussed in the next section of this paper). I would argue that these measures should have been considered before the 2018 OECD revised guidance was finalized. The EU survey, completed in 2018, found that the profit-split method was rarely used and that its use was usually limited to advance pricing agreements.\textsuperscript{160} The survey did not find an industry in which the profit-split method was widely used.\textsuperscript{161} Although it had been applied in some sectors (the finance sector, the industrial equipment sector, the automotive industry, the information technology sector, the consumer goods sector, the pharmaceutical industry, the chemical industry, and the food sector), it was used sparingly.\textsuperscript{162}

**BEPS ACTION 1: PILLAR 1—RESIDUAL PROFIT-SPLIT PROPOSAL**

It is my contention that the 2018 OECD revised guidance fell short of providing allocation methods that can be applied when comparables are unavailable or unreliable.

\textsuperscript{156} Ibid.
\textsuperscript{157} Ibid., at 11 and 19.
\textsuperscript{158} European Commission, Joint Transfer Pricing Forum: The Application of the Profit Split Method Within the EU, document no. JTPF/002/2018/EN (Brussels: EC, March 2019), at 3.
\textsuperscript{159} Ibid., at 10.
\textsuperscript{160} Ibid., at 15.
\textsuperscript{161} Ibid., at 3-4.
\textsuperscript{162} Ibid.
Under this guidance, the situations in which the profit-split method may be used are limited. The OECD and the G20, under the Inclusive Framework, took considerable time to finalize the revisions concerning the profit-split method, and this lengthy process, involving multiple discussion drafts, indicates that the use of this method is a controversial topic. Within months of the finalization of the 2018 OECD revised guidance, the residual profit-split method was being considered as a potential policy measure for BEPS action 1.

There are two approaches to splitting profits under the profit-split method. The first approach is based on a contribution analysis, which involves determining the relative contributions of each party. The other approach is the residual profit-split method. The residual profit-split method uses a two-step process. First, the less significant contributions are determined through a one-sided transfer-pricing method that uses comparable uncontrolled transactions. Second, the residual profit is allocated on the basis of whether the party’s contributions are unique and valuable or are attributable to a high level of integration, or whether there is a shared assumption of economically significant risks.

On January 23, 2019, the OECD and the G20, under the Inclusive Framework, published a policy note on the tax challenges of the digitalization of the economy. The policy note provides a brief background to the BEPS action 1 report, which concluded that the digitalization of the global economy would make it impossible to develop measures restricted to the digital economy. Under the mandate given by the G20 ministers in March 2017, the Inclusive Framework’s Task Force on the Digital Economy delivered, in March 2018, an interim report on the tax challenges arising from digitalization.

The policy note states that under the approaches of both BEPS action 1 and the interim report, an agreement was reached to consider, and reach consensus on, proposals under two “pillars.” Pillar 1 deals with the “broader challenges of the digitalised economy” and focuses on the allocation of taxing rights. The second pillar addresses other BEPS issues.

---

163 2018 OECD revised guidance, supra note 6, at paragraphs 2.149-2.152.
164 Ibid., at paragraph 2.152.
165 Ibid.
166 Organisation for Economic Co-operation and Development, Addressing the Tax Challenges of the Digitalisation of the Economy—Policy Note: As Approved by the Inclusive Framework on BEPS on 23 January 2019 (Paris: OECD, 2019) (herein referred to as “the policy note”).
167 Ibid., at 1.
168 Organisation for Economic Co-operation and Development, Tax Challenges Arising from Digitalisation—Interim Report 2018: Inclusive Framework on BEPS (Paris: OECD, 2018) (herein referred to as “the interim report”).
169 Policy note, supra note 166, at 1.
170 Ibid.
With respect to the first pillar, the OECD and G20 again indicate that the proposals, which are being considered on a “without prejudice” basis, require a deviation from the arm’s-length principle:

The Inclusive Framework recognises that the implications of these proposals may reach into fundamental aspects of the current international tax architecture. Some of the proposals would require reconsidering the current transfer pricing rules as they relate to non-routine returns, and other proposals would entail modifications potentially going beyond non-routine returns. In all cases, these proposals would lead to solutions that go beyond the arm’s-length principle.171

In February 2019, the OECD and G20 issued a consultation document on the tax challenges of digitalization.172 This document’s proposals regarding, respectively, user participation and marketing intangibles involve the use of the residual profit-split method in circumstances that call for deviations from the arm’s-length principle.

The User Participation Proposal

The 2019 consultation document includes a “user participation” proposal with respect to the value that certain businesses create through the participation of an active user base that enables data and content to be exploited.173 Under this proposal, the current rules would be modified to allocate profits to jurisdictions in which the businesses have “active and participatory user bases.”174 The jurisdictions in which the users are located would be allocated profits under a residual profit-split analysis.

The routine profit of an MNE group would be determined on the basis of the transfer-pricing rules.175 The proposal in the 2019 consultation document acknowledges that the value created through user participation is not allocated to user jurisdictions under the existing transfer-pricing methods, which are premised on the physical presence of an MNE.176 This proposal would allocate some of the non-routine profit to the jurisdictions in which the users are located. The proposal provides the opportunity to use formulas to “approximate the value of users, and the users of each country, to a business.”177

---

171 Ibid., at 2.
172 Organisation for Economic Co-operation and Development, Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy 13 February-6 March 2019 (Paris: OECD, 2019) (herein referred to “2019 consultation document”).
173 Ibid., at paragraph 17.
174 Ibid., at paragraph 22.
175 Ibid., at paragraph 25.
176 Ibid., at paragraphs 20 and 23.
177 Ibid., at paragraph 27.
The Marketing Intangibles Proposal

The “marketing intangibles” proposal in the 2019 consultation document deals with the ability of certain MNE groups to operate in a jurisdiction, either remotely or through a limited local presence, to develop a customer base and other marketing intangibles. Under this approach, a functional link is considered to exist between the market jurisdiction and marketing intangibles. This proposal would alter the existing transfer-pricing rules to provide for the allocation to the market jurisdiction of profits from marketing intangibles and the associated risks.

One way of allocating profits from marketing intangibles to market jurisdictions would be under a revised residual profit-split approach that uses approximations. This approach would require various steps: the determination of the relevant profits, the determination of routine functions, and the subtraction of the routine profits from the total profits. The final step would be the division of the non-residual profits. The routine profits could be determined through transfer-pricing analysis or through what the 2019 consultation document describes as a “more mechanical approach,” such as a markup on costs or on tangible assets. The “more mechanical approach” is designed to simplify the routine-profit calculation approach, and it is a move away from the comparability analysis required under the 2017 OECD transfer-pricing guidelines. To determine non-routine profits, several approaches may be used, including (1) the cost-base method; (2) an approach based on the costs incurred in developing the marketing intangibles; and (3) formulaic approaches. A formulaic approach could use fixed contribution percentages based on the business model employed by the MNE group. After the profit attributable to marketing intangibles is determined, the profits would be allocated to market jurisdictions on the basis of an agreed-upon factor such as sales or revenue.

A movement away from the arm’s-length principle offers the advantage of increased certainty and simplicity, and it recognizes the limitations of the arm’s-length principle. The 2019 consultation document outlines as follows the proposed simplifications to the profit-split method:

178 Ibid., at paragraph 30.
179 Ibid.
180 Ibid., at paragraph 32.
181 Ibid., at paragraph 47.
182 Ibid.
183 Ibid.
184 Ibid.
185 Ibid., at paragraph 48.
This proposal would involve the following steps:

1. the determination of the total or combined profits to be split;
2. the identification of the residual (i.e. non-routine) portion of this total or combined profits by subtracting the returns allocable to routine functions; and
3. the determination of the portion of the residual profit to be re-allocated.

While this proposal would retain many similarities to the existing profit-split method, it may apply to a broader aggregate—combined profit of multiple entities—and introduce simplifying conventions that are intended to make the calculations easier. This is because the more the above steps are based on detailed and factual determinations (e.g. conventional transfer pricing analysis), the greater is the risk of disputes and uncertainty in the outcome produced by the proposal. Reducing complexity in the implementation of the various above steps, while at the same time making sure that any approximation is principle-based, will thus be a key policy consideration.186

CONCLUSION

In this paper, I have argued that the 2018 OECD revised guidance on the profit-split method failed to meet the expectations that the method could be more widely used and could provide flexibility through the use of formulary methods. The proposals in the revised guidance were premised on the fact that the arm’s-length principle is subject to limitations in certain situations. The guidance, although it marginally increased the situations in which the profit-split method might be considered the most appropriate method, intended that this method would be infrequently used. The guidance set out high threshold requirements for the use of the profit-split method, such that it is usually not viewed as the most appropriate method. One shortcoming of the guidance is its suggestion that the method cannot be used solely because reliable uncontrolled transactions are unavailable. Given the extent of intragroup trade and the integration of MNE groups, such comparables are often unavailable. Nevertheless, unless the integration of such groups reaches the substantial threshold requirements, the profit-split method will continue to be, in practice, the method of last resort.

The policy note and the 2019 consultation document included the use of the residual profit-split method as one of the potential measures for allocating profits to countries under BEPS action 1 (on the taxation of the digital economy). The proposal that the residual profit-split method be used in this situation brings to mind the proposals for the reform of the profit-split method. Again, the proposed use of the residual profit-split method is premised on deviating from the arm’s-length principle and using simplified formulary measures. It is a pity that these reforms were not included in the 2018 OECD revised guidance on the profit-split method.

186 Ibid., at paragraphs 74 and 75.

Electronic copy available at: https://ssrn.com/abstract=3510267
