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In this article, the second installment in a series, Sanschagrin and Schwerdt compare the U.S. and OECD guidance for applying the profit-split method and discuss two distinct types: the comparable profit-split method and the residual profit-split method.

Both the U.S. transfer pricing regulations[1] and the OECD transfer pricing guidelines[2] specify the profit-split method[3] as an appropriate method for allocating combined profits (or losses) in certain situations. However, while the U.S. regs and the OECD guidelines endorse the profit-split method, there are differences in their guidance regarding its application. When developing transfer pricing policy and documentation, a leading practice is to consider the guidance from all the tax authorities with an interest in claiming their fair share of taxable profit generated by a multinational enterprise's value chain. Examining the differences and similarities between the U.S. and OECD guidance provides important considerations on successfully applying the profit-split method.

Our prior article examined situations when the profit-split method should be used to help MNEs allocate profits or losses among controlled entities.[4] This article compares the U.S. and OECD guidance for applying the profit-split method, focusing on key areas like determining combined operating profit or loss, splitting profit at the gross or operating level, and determining whether to use actual or anticipated profits to apply the profit-split method. We note that there are two distinct types: the comparable profit-split method[5] and the residual profit-split method,[6] which we briefly describe.

The comparable profit-split method involves identifying one or more profit-sharing arrangements between two or more unrelated parties that are comparable to the subject transaction. For a profit-sharing arrangement to be comparable, the parties must make similar contributions to the relevant business activity as

[1] Reg. sections 1.482-1 to -9; and reg. section 1.6662-6.

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

[3] The OECD transfer pricing guidelines refer to the profit-split method as the "transactional profit split method" (see Chapter II, Part III, section C of the guidelines).

[4] *See* Guy Sanschagrin and Doug L. Schwerdt, "Introducing the Profit-Split Method: 'To Apply or Not to Apply, This Is a BEPS Question,'" *Tax Notes Int'l*, Mar. 27, 2023, p. 1803.

[5] OECD transfer pricing guidelines terminology is "transactional [profit-split method] using the contribution approach."

[6] OECD guidelines terminology is "transactional [profit-split method] using the residual approach."

the controlled parties. This method requires detailed data on the division of profits between unrelated parties, which can be challenging to obtain in practice. A three-part comparison is performed to determine if contributions are similar, evaluating the parties' functions, risks, and resources employed, like using intangible property (IP).[7] This functional analysis is a standard step in establishing arm's-length transfer pricing regardless of the method used. In practice, the comparable profit-split method is rarely used by MNEs because of the lack of reliable comparable data.

The residual profit-split method also allocates combined profit or loss, but in two steps rather than one. The first step is to determine the returns to routine activities under a specified transfer pricing method, like the comparable profits method.[8] The second step allocates the residual combined profit or loss based on the relative value of each related party's contributions to the business unit's nonroutine value chain contributions. These nonroutine (high-value) contributions often take the form of the MNE's IP, like proprietary technology. One approach for splitting residual profit is a contribution analysis — a process that assigns residual profit among related parties based on a detailed analysis of their respective nonroutine contributions, considering the functions performed, risks assumed, and resources employed. Under the OECD's base erosion and profit-shifting initiative, MNEs should consider important contributions to develop, enhance, maintain, protect, and exploit IP[9] within the business unit's value chain. Because of its broader applicability, the remainder of this article focuses on the residual profit-split method.

Although there are differences in the wording of the U.S. regs and the OECD guidelines, according to the IRS, "The Treasury and IRS consider Section 482 and the regulations to be wholly consistent with treaty obligations and the OECD Transfer Pricing Guidelines."[10] While the OECD guidelines do not constitute part of United States domestic law or authority for interpreting the U.S. regs, as a member of the OECD, the United States is bound to follow the OECD's authoritative formal recommendations, at least in interpreting its treaties in dealings with other OECD countries. Although specific differences exist, this "wholly consistent" view applies to the profit-split method guidance provided by the OECD guidelines and the U.S. regs.

When Profit-Split May Be the Best Method

The OECD guidelines state that when contributions made by two or more parties to a transaction are unique and valuable, the profit-split method will be the most reliable way to price the controlled transaction because it allows for the relative value of each party's contribution to be considered in the allocation of profits or losses. In its discussion on the strengths and weaknesses of the profit-split method, the OECD guidelines state that when "contributions are unique and valuable there 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."[11]

According to the U.S. regs, the residual profit-split method is acceptable, and likely the best, method in situations when nonroutine contributions — often, of IP[12] — are made by two or more parties. Also, "whether results derived from application of this method are the most reliable measure of the arm's-length result is determined using the factors described under the best method rule in section 1.482-1(c)."[13] The best method rule, which applies to all U.S. regs transfer pricing methods, states that "no method will invariably be considered to be more reliable than others." In contrast, the OECD guidelines convey preference for the transactional profit-split method[14] when one or more parties: (1) make unique and valuable contributions; (2) are highly integrated; or (3) share the assumption of

[7] Reg. section 1.482-6(b).

[8] The CPM is largely analogous to the OECD transfer pricing guidelines' transactional net margin method.

[9] In practice, we refer to these contributions as DEMPE functions.

[10] AM 2007-007.

[11] OECD transfer pricing guidelines, para. 2.119.

[12] Reg. section 1.482-6(c)(3)(i)(B)(2).

[13] Reg. section 1.482-6(c)(2)(ii)(A).

[14] The OECD guidelines' transactional profit-split method is akin to the U.S. regs' residual profit-split method.

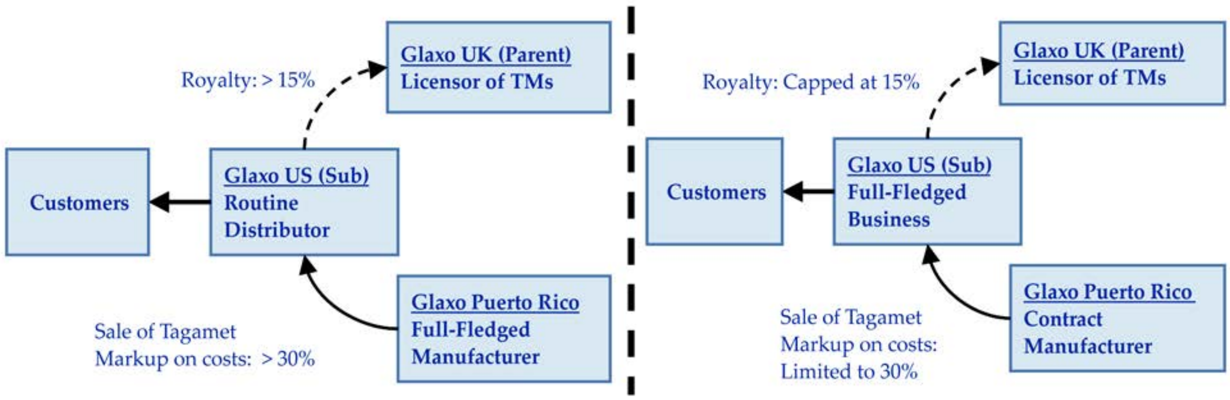
Divergent Positions

Glaxo Position

- Glaxo US is a *routine distributor* (consistent with the Tagamet APA).
- All marketing intangibles were owned by Glaxo UK.
- IRS was erroneous in allocating over 80% of its global profits to the U.S.

IRS Position

- Glaxo US was a *full-fledged business* and was not reimbursed for expenses that created IP.
- The U.S. market was an intangible due to its free market system, unlike other countries with price controls (thus lowering the relative value contribution of the U.K.-owned trademarks).



economically significant risks or separately assume closely related risks.[15]

The IRS uses the residual profit-split method to address nonroutine contributions by two or more parties. For example, in *Glaxo*,[16] the IRS commissioner argued that Glaxo US's investment in a marketing strategy conceived and directed by its executives made Glaxo US the economic owner of the related U.S. trademarks and other marketing IP. The IRS determined that as a result of this investment and its marketing, distribution, and related activities, Glaxo US owned valuable U.S. market intangibles, while Glaxo UK owned the MNE's technology IP and Glaxo Puerto Rico functioned as a routine "contract manufacturer" rather than a "full-fledged manufacturer."[17] Based on this integrated value chain, the IRS presumably used the residual profit-split method as one of the methods to develop the transfer pricing parameters to cap the Glaxo UK royalty payment at 15 percent and propose the relatively high 30 percent markup on product costs from Glaxo's Puerto Rico manufacturer. The figure provides an overview of Glaxo's related-party transactions from the perspective of Glaxo and the IRS.

The IRS and Glaxo reached a settlement in 2006, before trial. Under this settlement, Glaxo agreed to resolve the dispute for $3.4 billion.[18] Today, over 15 years later, this transfer pricing case remains the largest tax dispute in history.

Determining Combined Profit or Loss

The residual profit-split method examines the relative value of each party's contribution to the value chain to determine whether the allocation of

[15] For a more detailed discussion on these factors, see Sanschagrin and Schwerdt, *supra* note 4.

[16] *GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner*, No. 5750-04 (T.C. 2006).

[17] "Contract manufacturer" and "full-fledged manufacturer" are terms of art in the transfer pricing field. These terms are used to distinguish entities that contribute routine manufacturing versus manufacturing entities that contribute more high-value-add functions and assume entrepreneurial risks.

[18] Glaxo had undisclosed reserves of approximately $4.8 billion to account for this issue. Accordingly, its shares rose significantly as a result of this settlement.

combined residual profits or losses accords with the arm's-length standard.[19] As per reg. section 1.482-6(a), "The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity)." The first paragraph of reg. section 1.482-6 lays out definitive rules for how to determine combined profit based on the relevant business activity. This means the profits or losses to be split must be based on the business activity most closely related to the controlled subject transaction, like a specific division or product line.

By contrast, the OECD guidelines more generally discuss difficulties measuring "the relevant revenue and costs for all the associated enterprises participating in the controlled transactions."[20] Implicitly, the OECD guidelines refer to a need to use the financials of the business activity most relevant to the controlled transaction. Still, it does so in the context of transactional profit-split method weaknesses and emphasizes that comparable-entity financials "could require stating books and records on a common basis and making adjustments in accounting practices and currencies."[21]

Splitting Gross or Operating Profit

The OECD provides guidance on splitting profits at the gross or operating level in certain situations. According to the guidelines, it may be appropriate to split based on gross profits when the parties share market risk (when revenue is subject to changes in sales volume and prices), and production risk (when there are integrated or joint functions and assets relating to the cost of sales). Using gross profits captures market and production activity outcomes that the parties share along with associated risks and may be more reliable than using operating profits.

However, in scenarios where the parties have integrated or joint functions related to the entire value chain (and share market, production, and operating risk), the OECD guidelines suggest that operating profits are the most appropriate to split, because shared operational risks affect operating expenses.[22] For example, when two or more associated entities share production functions, like manufacturing, they usually jointly bear the costs and risks of operating those functions. These operating costs often include labor, utilities, maintenance, and repairs. The allocation of these costs and risks should align with each party's contribution to the combined operating profit or loss.

Unlike the OECD guidelines, the U.S. regs state that the residual profit-split method allocates the combined *operating* profit or loss[23] with no mention of splitting gross profits throughout reg. section 1.482-6. This may be because, in the Treasury and the IRS's view, applying transfer pricing methods at the operating profit level is more reliable and objective, because it can more closely reflect the profits directly linked to the related parties' activities. The operating profit level is also less susceptible to differences in accounting of costs between operating expenses and cost of goods sold. Additionally, an operating profit level analysis aligns with the CPM — a method applied at the operating profit level commonly used to determine the routine return of entities involved in step 1 of the residual profit-split method.

Actual or Anticipated Profits

The OECD guidelines distinguish when a split of actual or anticipated profits is more appropriate. Reg. section 1.482-6 does not make this distinction, and refers to actual profits. According to paragraph 2.159 of the OECD guidelines, in "business opportunities" (transactions) where the parties share the assumption of economically significant risks or separately assume closely related risks, the parties

[19] We note that the OECD guidelines refer to the arm's-length principle while the U.S. regs refer to the arm's-length standard. In practice, these terms are frequently used interchangeably within the field of transfer pricing and in this article — although the definition of arm's-length standard in the U.S. regs places more emphasis on *results* than the OECD guidelines' tendency to consider arm's-length *behavior* in addition to results.

[20] OECD transfer pricing guidelines, Chapter III, section C.2.1.

[21] *Id*. at para. 2.123.

[22] *Id*. at para. 2.163.

[23] *See* reg. section 1.482-6(c)(3)(i).

should share in the resulting (actual) profits or losses. Therefore, a split of actual rather than anticipated profits is warranted because the actual profits to be split will reflect the risks unfolding for each party. Alternatively, if one of the parties does not share in the assumption of the economically significant risks that might play out after entering into the transaction, the OECD guidelines contend that a split of anticipated profits would be more appropriate.[24] Therefore, a split of anticipated profits tends to concentrate the development of certain economically significant risks on certain parties. The transfer pricing outcome — a sharing of actual or anticipated profits — should align with the accurate delineation of the transaction.[25]

Irrespective of whether actual or anticipated profits are split, the basis for dividing profits (calculation of profit or loss, adjustments, profit-splitting factors, and so forth) must be determined based on information known or reasonably foreseeable by the parties at the time the transactions were initiated. However, in cases of significant unforeseen developments that would have resulted in a renegotiation of the agreement had it occurred between independent parties, the OECD guidelines state that the profit-split basis may be adjusted accordingly.[26]

The concept of "unique and valuable" contributions as a reason to use the transactional profit-split method relates to actual versus anticipated profits. According to paragraph 2.130 of the OECD guidelines:

> Contributions (for instance functions performed, or assets used or contributed) will be "unique and valuable" in cases where (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) they represent a key source of actual or potential economic benefits in the business operations.

Within this definition, the essential factor is not whether an economic benefit is realized, but whether the success of the contribution is critical to the business operation's success. Therefore, a contribution that is a crucial source of *potential* economic benefit could still be considered valuable to the transaction even if it is not realized.

Conclusion

Understanding the profit-split method and its nuances as articulated by the U.S. regs and OECD guidelines and applied in transfer pricing court cases is essential for MNEs with integrated global value chains when determining the appropriate transfer pricing method for their related-party transactions. While the U.S. regs and the OECD guidelines both recognize the profit-split method as valid, they suggest subtly different approaches to its application. This article identified some of the key differences, like determining combined profit or loss, splitting combined gross or operating profits, and considering whether to use actual or anticipated profits. Despite these differences, the U.S. regs and the OECD guidelines aim to ensure conformity with the arm's-length standard. By carefully considering the specific requirements for each approach, taxpayers can better apply the profit-split method in their transfer pricing analyses. This will reduce the risk of proposed transfer pricing adjustments by tax authorities as well as the associated risk of double (or more) taxation on their global profit. ■

[24] OECD transfer pricing guidelines, para. 2.160.

[25] *Id*. at para. 2.142.

[26] *Id*. at para. 2.161.