The Transfer Pricing Profit Split Method After BEPS

Outline

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The OECD's Base Erosion and Profit Shifting report titled *Addressing Base Erosion and Profit Shifting*[1] identified the extensive tax avoidance practices used by multinational enterprise groups resulting in substantial revenue losses to national governments. Some multinational enterprise groups, such as Caterpillar Inc., have engaged in aggressive tax avoidance.[2] One of the pressure points identified in the report was transfer pricing manipulation and in particular the use of intangibles to shift profits to low-tax jurisdictions.[3] Base Erosion and Profit Shifting (BEPS) Actions 8-10, seeks to allocate profits to jurisdictions on the basis of value-creation.[4]

The *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*[5] (OECD Guidelines), based on the arm's length principle, are premised on comparing controlled transactions with comparable uncontrolled transactions. One of the few situations in which the arm's length principle may be applied is where an associated enterprise has internal comparable uncontrolled transactions. The Achilles heel of transfer pricing is the lack, in most situations, of comparable uncontrolled transactions. High-speed and high-quality business information systems and communications systems have enabled multinational enterprise groups to achieve high levels of integration making comparability a challenge. Moreover, multinational enterprise groups are organised along business lines rather than national borders. Multinational enterprise groups with common control and high integration have the goal of profit maximization which involves minimizing income tax.

The OECD's transactional profit split method provides the opportunity to move away from the uncertainty of the arm's length principle. But the OECD's revised guidance on the transactional profit split method has failed to pave the way for a move towards formulary apportionment and has maintained the rhetoric of the arm's length principle. The

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[1] OECD, *Addressing Base Erosion and Profit Shifting,* (Paris: OECD, 2013).
[2] Ibid., p. 6.
[3] Ibid.
[4] OECD, '*Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10*', 2015 Final Reports, (OECD, Paris, 2015)
[5] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, (OECD, Paris, 2017). First published in 1995.

transactional profit split method guidance was revised as part of the Inclusive Framework on BEPS: Action 10.[6] Although the revised guidance on the transactional profit split method provides the potential to be used when comparable uncontrolled transactions are unavailable, the OECD guidance expressly rejects the use of the transactional profit split method when comparables are unavailable.[7] Nevertheless, the three situations in which the OECD transactional profit split method is considered to be the most appropriate method (those involving high degrees of integration, the contribution of unique and valuable intangibles by the associated enterprises and when the associated enterprises share the same or closely related economically significant risks) are situations in which comparables are usually unavailable. The OECD Guidelines provide detailed guidance that the transactional profit split method may be the most appropriate method if, according to the accurately delineated transaction, the associated enterprises share the same economically significant risks or closely related risks.[8]

The alternative to the arm's length principle is formulary apportionment. The relative merits of the arm's length system and formulary apportionment approaches for allocating profits to members of a multinational enterprise group is a controversial topic. The OECD Guidelines reject formulary apportionment as being an arbitrary and inappropriate method for the allocation of profits between associated enterprises. However, the OECD appears to be shifting its view of formulary apportionment, claiming in 2018 that it is agnostic on the arm's length principle.[9] The revised guidance on the transactional profit split method makes repeated references to the arm's length principle despite the method being used because there are usually no comparable uncontrolled transactions.

It is argued that the revised guidance on the transactional profit split method has failed to take the opportunity to abandon the arm's length principle for the transactional profit split method and move towards using formulary apportionment factors to allocate profits within

[6] OECD, 'Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS: Action 10'. Inclusive Framework: 'The OECD established the IF on BEPS in June 2016 so that all interested countries and jurisdictions can work together. Over 115 countries and jurisdictions have already joined on an equal footing in developing standards on BEPS-related issues and reviewing and monitoring its consistent implementation.': https://www.oecd.org/tax/flyer-inclusive-framework-on-beps.pdf.
[7] OECD Guidelines, para. 2.128.
[8] Ibid., paras. 2.139-2.142.
[9] P. Saint-Amans (Director of the OECD Centre for Tax Policy and Administration) at the International Fiscal Association Congress in 2018, stated that the OECD was agnostic to the arm's length principle: Taxsustra, IFA Congress 2018, 5 September 2018, Seminar E: IFA/OECD. http://taxsutra.com/sites/taxsutra.com/files/webfor:/IFA%202018%20-%20Day%203_0.pdf

multinational groups. The dearth of comparable uncontrolled transactions has resulted in transfer pricing being arbitrary and creating substantial uncertainty for taxpayers and tax administrations. The apparent change in rhetoric by the OECD on the significance of the arm's length principle was not reflected in the revised guidance. The revised guidance has placed significant limits on the situations in which the transactional profit split method may be used. The revision of the transactional profit split method by the OECD was contentious; the OECD finalised its guidance in June 2018 rather than in 2017 following two discussion drafts and two rounds of public consultation. It was asserted by a US official that that the revised guidance ensured that the use of the transactional profit split method remained infrequent.[10]

The selection and weighting of the profit split factors is another contentious issue. It is argued that the payroll factor is a significant factor for the allocation of profits within a multinational enterprise group and should be a mandatory factor with a significant weighting. The use of a payroll factor is consistent with the OECD's move towards use of the significant decision-makers in the intangibles chapter of the OECD Guidelines. High value unique intangibles are now a significant source of profits within most large multinational enterprise groups. These intangibles, such as intellectual property and know-how, are created and maintained by high-value employees. It is asserted that these high-value employees are less willing to move to low-tax locations such as Switzerland to justify profit-shifting. The US Senate, Permanent Subcommittee on Investigations' examination of Caterpillar Inc. provides an illustration of the relative immobility of high-value employees.

The Caterpillar group business model is designed to make substantial profits from the sales of spare parts using software to predict when spare parts will be required. In 2009, Caterpillar implemented advice prepared by PWC, which meant shifting 85 per cent of its profits from the sale of spare parts outside the US from Caterpillar Inc to its Swiss subsidiary. But it failed to implement advice from PWC to relocate the key decision-makers in its spare parts business line to Switzerland to support the profit-shifting.

The US Senate, Permanent Subcommittee on Investigations, *Caterpillar's Offshore Strategy*, Majority Staff Report[11] (Report) revealed the challenge Caterpillar Inc encountered in failing

[10] C. Bello, branch 6 chief, IRS Office of Associate Chief Counsel (International): R. Finley, 'Narrower OECD Profit Split Guidance is a Result of U.S Efforts', (23 July 2018) *Tax Notes International*, p. 404.
[11] United States Senate, Permanent Subcommittee on Investigations, *Caterpillar's Offshore Strategy*, Majority Staff Report.

to move key decision-makers in its spare parts operations to Switzerland. Caterpillar Inc., prior to implementing its Swiss strategy, reported most of the profits from non-US sales of spare parts in the US. Following implementation of the Swiss profit-shifting strategy Caterpillar reported 15 per cent of these profits in the US and 85 per cent of the profits were shifted to Switzerland.[12] According to the Report, Caterpillar negotiated a 4-6 per cent tax rate with Switzerland.[13] The Subcommittee found that Caterpillar Inc.'s profit shifting strategy was implemented without any substantial changes in its business operations. The non-US spare parts sales were managed from the US. In relation to Caterpillar's spare parts operations, the Report states that Caterpillar had 8,300 employees, with 4,900 located in the US including almost all of its senior spare parts executives.[14] At that time the Swiss entity had 65 employees working on spare parts.

Caterpillar's Swiss strategy was prepared by PWC which suggested that Caterpillar move worldwide product managers and regional product managers to Switzerland. Caterpillar did not implement the advice to move these positions to Switzerland.[15] During this time, Caterpillar created a new worldwide parts manager in Switzerland. This position was allocated to a non-US employee.[16] A 2010 PWC draft report claimed that the parts manager was a global steward of a Worldwide Parts Strategy Roundtable which included senior personnel in the machine and engine divisions.[17] Highlighting the boldness of the strategy, the parts manager and the Roundtable were bereft of 'decision-making authority with regard to parts'.[18] The Roundtable, was able to provide advice but had no decision-making authority for spare parts margin targets, sales targets, cost targets, or pricing.[19] These facts infer that Caterpillar was either unwilling or unable to move senior US personnel to Switzerland to support its Swiss profit shifting strategy. If transactional formulary apportionment was used with payroll being a major profit split factor, Caterpillar's Swiss strategy would have been ineffective in shifting profits to Switzerland.

[12] Ibid., p. 1.
[13] Ibid., pp. 5-6.
[14] Ibid., pp. 5-6.
[15] Ibid. p. 76.
[16] Ibid.
[17] Ibid., p. 78.
[18] Ibid.
[19] Ibid.