Determining Taxable Income According to the Profit Split Method ("PSM") for Financial Services Companies

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1. Overview
Use of the Profit Split Method (“PSM”)

Financial Services Companies

- Have similar characteristics to PEs when it comes to defining ownership of intangible assets. (branch structure)

- Intangible assets such as brand names, customer service models and templates, customer relationships and customer data, and IT systems, are operationally similar across tax jurisdictions.

- Assume that these intangible assets are jointly developed, revised, and extended by related affiliates whose taxable profits may be due primarily to intangible assets.

  Economic ownership of (valuable) intangible assets is distributed among foreign affiliates.
The relative value of each taxpayer’s contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity, consistent with the *comparability provisions* of Section 1.482-1(d)(3)\(^1\) {emphasis added}.

1. § 1.482-6(b).
The 2009 U.S. Section 1.482-9 Amendment

- Departing from a perceived prerequisite that the PSM is the best method only when the transactions are viewed as highly integrated or interrelated and of a high value, the 2009 amendment asserts that profit split methods are appropriate when controlled service transactions consist of “a combination of non-routine contributions by multiple controlled taxpayers.” A non-routine contribution is one for “which the return cannot be determined by reference to market benchmarks,” which does not necessarily mean a return is high {emphasis added}.

- One main purpose of the new regulatory language is to avoid giving taxpayers the impression that the profit split method is the default method for interrelated-controlled services that exhibit market prices substantially in excess of their costs. Instead, the PSM applies if at least one of the material contribution factors cannot be evaluated with market evidence.

2. The actual quote is from the preamble (Profit Split Method—Temp. Treas. Reg. §§1.482-9T(g) and 1.482-6T(c)(3)(i)(B)) to the Temporary Regulations of 2006 regarding Section 1.482T(g)(1), U.S. Treasury Department, Internal Revenue Bulletin: 2006-34.

3. This observation is also from the preamble (Profit Split Method—Temp. Treas. Reg. §§1.482-9T(g) and 1.482-6T(c)(3)(i)(B)) to the Temporary Regulations of 2006 regarding Section 1.482T(g)(1), U.S. Treasury Department, Internal Revenue Bulletin: 2006-34.
The combined profit may be the **total profit from the transactions** or a **residual profit** intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high-value, sometimes unique, intangibles {emphasis added}.\(^4\)

\(^4\) Id. chpt. III, ¶ 3.12.
A detailed functional analysis is necessary to correctly hypothesize:

The PE as a functionally separate entity, to identify the Significant People Functions (“SPF”) relevant to determining which part of the enterprise assumes and/or subsequently manages particular risks and/or economically owns particular assets (tangible and intangible), and to attribute to the PE as a hypothetically separate entity an appropriate amount of capital.\(^5\)

5. Id., Part I, ¶ 45.
Definition of Significant People Functions ("SPFs")
Attribution of Risks

- Attribution of Risks
- Ratification Process
- Active Decision Making
- Decisions that Affect Performance

Decision Hierarchy
Attribution of Tangible and Intangible Assets

- Attribution of Assets
  - Tangible Property
  - Intangible Property (Trade & Marketing)
- Functional Usage
- Entrepreneurial Management and Responsibility
- Main Part of Enterprise Value
Additional examples and further clarification as to what is meant by “active decision making” from the OECD cannot be readily found.

As pointed out carefully by practitioners, the OECD has not adequately elaborated on how taxpayers are to evaluate and measure the decision making process within an enterprise to establish economic ownership.
Application of Industrial Organization Theory

- Determine active decision making and ratification process by applying standard industrial organization theories from economics literature.

- Example; four states of decision making
  - Initiative (brainstorming: formulating the various alternatives)
  - Ratification (strategy: choosing from the alternatives)
  - Implementation (tactics: implementing the chosen strategy or decision taken)
  - Monitoring (monitoring implementation).
Difficult to Implement

- Constant change in business conditions shifts decision making hierarchies and accompanying decision making powers.

- Dynamic nature of companies also means that profit defining risks change rapidly too.

- Decision makers spend most of their time managing the present and planning for the future.

Ignores financial data that is readily available = Employee Compensation.
Determining SPF Payroll Costs

From the Pay Distributions and Organizational Performance Literature

- Horizontal Wage Dispersion Scale – dispersion within a single organization level or core group.

- Relationships between horizontal pay dispersion and firm financial performance.
Example. Eighty-four business managers (60 male, 20 female, 4nr) who were members of a large enterprise software corporation based in the eastern U.S. (Fortune 200 Corporation), the managers are stationed across the U.S. and were at middle levels of their organizations hierarchy – 97.6% held a B.A. or equivalent. 11.7 years in current position.

An Example of an Application of Transfer Pricing Methods

Assume an asset management MNE relies in part on a key marketing intangible – customer relationships managed by a large network of private bankers – as part of its activities. The intangible contributes significantly to the group’s success.

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Residual Profit Split Method Application Requires Two Steps

Starting point: A careful consideration of the group value chain and value drivers

**Step 1:** Determine routine remunerations for relevant functions (e.g., admin functions & support services)

**Step 2:** Entrepreneurial Remuneration for intangible building functions and intangibles

- Fund Design
- Distribution
- Portfolio Mgt.

Ability to define an economically robust split factor is essential to apply this method