Use of the profit split method in testing the arm's length character of royalty payments

I. What is royalty?

Royalty can be briefly described as amounts derived or paid in return for the transfer of a brand or license. Intangible rights are divided into two groups in terms of their properties: commercial intangible rights (patent, know how, design and models, computer software) and intangible rights for marketing purposes (trademarks, titles, customer lists, distribution channels, sui generis names, symbols or pictures).

Most detailed explanations about royalty are provided under the "General Communiqué on Disguised Profit Distribution through Transfer Pricing" series no. 1, published in the Official Gazette dated 18.11.2007. It is stated in the Communiqué that in cases where the transactions between related parties involve intangible rights, a comparability analysis should be conducted between the controlled transactions and uncontrolled transactions for the arm's length principle to be applicable.

Since the use of intangible rights such as licenses is allowed entirely between related parties most of the time, we are of the opinion that it would be almost impossible to apply the comparable uncontrolled price method in practice, due to the lack of internal benchmarks of comparable character and the difficulty to express factors such as brand value and business strategies numerically during the examination of external benchmarks, despite the theoretical interpretation in the Communiqué.

II. Profit split method and the "Rule of Thumb"

As explained both in the OECD Transfer Pricing Guidelines and our legislation, application of the profit split method first requires determination of the profit to be shared. This profit is the sum total of the operating profit generated through a company's routine business activities, and the residual profit resulting from the intangible assets used by the company.

Routine profit can be determined through databases such as Amadeus, which is used frequently in transfer pricing studies, or through publicly disclosed financial statements, taking into account the profit margins of comparable companies engaged in routine activities in similar sectors. If the tested company has, through its intangible assets' contribution to its business activities, derived a profit higher than the profit of companies that are engaged in routine activities and do not use any intangible assets, the difference would be treated as residual profit. This amount would have to be allocated among the company owning the intangible right and the company operating through the usufruct of that right, in accordance with the Rule of Thumb principle.

In his analyses performed on numerous trade license agreements, Robert Goldscheider observed that licensee companies aimed to increase their operating profitability by approximately 20% through the intangible rights they use and generally pay 5% royalty on their sales. In the light of this data, he formed the 25% rule (Rule of Thumb). In other words, the 25% rule means that 25% of the operating profitability derived through the use of intangible rights should be transferred to the license owner company as royalty.[1] Goldscheider stated that there were situations where the profit allocation ratios were 10/90 or 40/60 and the 25/75 rule is not a standard rate that can be applied internationally.

However, the relation between the licensee and license owner explains why this rule is used frequently in practice although it is not theoretically possible to prove it. Furthermore, courts, tax authorities and agencies also use this rule as reference.

III. Conclusion

In recent tax inspections, tax inspectors have been focusing particularly on intra-group services and consequently royalty payments. Both the transfer pricing legislation effective in Turkey and the OECD Transfer Pricing Guidelines on which the Turkish legislation is based state that methods other than comparable uncontrolled price method can also be used in the determination of the arm's length value in transactions involving a high level of intangible rights. OECD Transfer Pricing Guidelines are even more specific, recommending the use of profit split method in such cases.

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[1] Robert Goldschneider, Technology Management: Law/Tactics/Forms § 10.14 (1991)

Kuzey YMM A.Ş.
Büyükdere Cad. Beytem Plaza
No:22 K:2 - 8, 34381 - Şişli
İstanbul - Turkey
Tel: +90 (212) 315 30 00
Fax: +90 (212) 234 10 67
www.vergidegundem.com
www.ey.com

The profit split method essentially requires determination of how the profitability derived from the use of the licenses in question should be allocated among the licensee company and the license owner company. At this point, as a result of the analyses made previously, it was concluded that allocation of the profitability at a ratio of 25/75 among the license owner and the licensee could yield acceptable results. Known as “Rule of Thumb”, this approach has been observed to be used as reference in judicial decisions.

However, the method still has a limited area of use in our country, since Tax Authorities favor traditional methods based on price comparisons and transactions rather than profit based methods in the transfer pricing applications.

In this respect, we recommend that companies conducting such license transactions with group companies also benefit from transfer pricing analyses to be made in the scope of the profit split method from a different point of view, in order to establish a more solid documentation in regard of a potential tax inspection.