Initiatives in the transfer pricing area

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Krister Andersson comments on initiatives in the transfer pricing aspects of intangibles

In 2010, the OECD Committee on Fiscal Affairs launched yet another project in the transfer pricing area. This time it dealt with the transfer pricing aspects of Intangibles. On June 6, 2012, Working Party No. 6 issued for comments a discussion draft on this subject. This initiative followed the report on transfer pricing aspects of business restructurings (Chapter IX of the *Transfer Pricing Guidelines*) which was published on July 22, 2010.

In this article, I will comment on why these initiatives have been taken and also give some perspectives on the taxation of intangible assets.

Reasons behind the initiatives

The need for updated guidelines in a fast changing world clearly has its own merits. In a world of increased international activities and with business models changing, there is every reason for the OECD to take initiatives in this area. The risk of economic double taxation, or of unintended double non-taxation, is obvious. Both tax authorities and businesses need to have clear and uniform rules applied in as many countries as possible.

It appears, however, that the initiatives for a review of the rules often come from large member countries in the OECD area and not from the Secretariat of the OECD or from smaller countries. Large economies tend to have high statutory corporate tax rates and they may not always maintain their competitiveness in the global arena. Due to the relatively high corporate tax rates, they are also more susceptible to relocation pressures.

One such example is Germany which has been exposed to relocation of services and production to countries in Eastern Europe and also to Asian countries. Such relocation often entails business restructuring. Germany was therefore one of those countries that felt that the transfer pricing rules in connection with business restructuring should be reviewed in an OECD context.

In the German debate, arguments were presented that businesses should of course be allowed to structure their business activities as they see appropriate. The tax consequences might, however, entail taxation of profits forgone due to the relocation.

Such a taxation regime would certainly imply considerable obstacles to the relocation of production, and it would be a barrier to cross-border restructurings. The valuation methods were also discussed at length (as they are likely to be also in the project on intangibles) but any assessment of the impact of such tax rules or of valuation methods on investment, growth, and competitiveness was absent. Instead, arguments about the need to protect the revenue base were vocal.

After an extended period of deregulation and opening up of markets, taxation may perhaps be the only remaining instrument to impose barriers

We should not forget that when taxation started to gain attention at the OECD, some 45 years ago, it was basically handled as a trade issue. Clearly, taxation of profits forgone, however defined, would not promote cross-border activities, and it would lower the welfare for all countries involved. After an extended period of deregulation and opening up of markets, taxation may perhaps be the only remaining instrument to impose barriers. This is however, usually not openly discussed.

The outcome of the project of business restructuring refuted claims of taxation of profits forgone but the intentions from some governments in this process are reasons for continued concern about attempts to regulate markets and impose obstacles to a free flow of goods, services, and capital.

The new project, *Taxation of Intangibles*, raises similar concerns. For a country experiencing difficulties in its domestic tax rules for the taxation of international activities and income, it is always tempting to encourage the OECD to review transfer pricing rules in such a way that an onerous outcome for the individual country is mitigated if all countries can be persuaded to adhere to such rules.

It is of utmost importance that the OECD resists such demands and that the OECD Secretariat instead embarks on an open discussion of the implications for OECD countries and non-OECD countries of proposed tax changes. Here, an impact assessment of various proposals could serve as a useful tool for steering discussions in the right direction. A transparent and inclusive dialogue with all governments as well as stakeholders is essential in this respect.

Countries with numerous property rights and intangibles of significant value obviously fear that these rights could move to low tax jurisdictions. A country like the Netherlands has responded by allowing the so called Patent (Innovation) box and the UK is likely to follow suit. The US appears to see such large risks from relocation of intangibles that they would like to see also smaller countries engage in a project of how to handle taxation in connection with a transfer of intangibles.

In the discussion drafts, valuation technics once again has become a main issue. It is claimed that a particularly useful tool for assessing the value of the intangible is the discounted value of projected future cash flows attributable to the intangible or intangibles transferred. That would mean that the present value of future cash flows attributable to the intangible being valued, after proper adjustment for taxes, is assumed to be the value or arm's length transfer price of the intangible.

One must ask oneself what such a valuation would mean for cross-border activities and free trade. We witness such a valuation every day on the stock market. The stock price reflects the discounted stream of expected future dividends. Given the recent volatility of stock market valuations, one could assume that few individuals would like to pay tax on these values, in particular if there is no adjustment for next day losses. Taxation based on estimated future cash flows would at least require full loss-offset, perhaps even on a daily basis, but tax rules are not defined in such a way. If only value gains are taken into account, but with no downward revisions, the tax burden would be high.

How will intangibles be treated if assessed according to such a method? They are likely to be valued on transfer only and not continuously. The risk of assessing a wrong value is obvious and the risk would therefore serve as an obstacle to relocation of intangibles. If not properly designed and implemented, the OECD would add to cross-border obstacles and trade barriers. It is in every country's interest to ensure that the revised TP guidelines do not add to obstacles to free trade and cross-border activities. Short term revenue implications must not be allowed to result in a de facto reregulation of markets.

The two recent tax projects in the transfer pricing area, regarding business restructurings and intangibles, raise important issues of motivation and justification from member states in the OECD. Clear definitions and implementation are in everyone's interest but there are also aspects of inter-country allocations of production and property rights, and therefore tax revues, that need to be addressed and assessed. This has not always been the case in the OECD tax policy work.

Taxation of intangibles

Several aspects deserve special attention when reviewing the taxation of intangibles. The definition of an Intangible is one of these. It is very important to find a clear and generally accepted definition of what is an intangible property. Without such a definition, the risk of inconsistent interpretation and application of the arm's length principle is evident, with double taxation as the ultimate consequence. The arm's length principle as set out in Article 9 of the OECD Model Tax Convention (MTC) and the OECD Transfer Pricing Guidelines (TPG) is a natural starting point for identifying a suitable definition.

The arm's length principle seeks to mimic terms and conditions between independent parties. This suggests that any definition should try to capture value deriving from intangibles that constitute assets in the meaning that two independent parties would agree to transfer the ownership and control of them. A definition that does not evolve around the concept of an asset (or property) would deviate from what can be observed in the marketplace and would thus not be coherent with the arm's length principle.

On this basis, a definition of intangible assets that are to be recognized for TP-purposes ought to include three typical characteristics: ownership, control, and transferability.

Although business attributes or notions such as goodwill, going concern, synergies, location savings etc. may affect the valuation of a taxable transaction, ie. the value of the transfer of an intangible asset, such attributes or notions are not themselves assets which can be owned, controlled or transferred separately. Consequently, they should not be included in the definition.

It should be noted that such a definition of intangible assets does not include just those assets which can be registered or otherwise protected through a similar procedure (such as trademarks, patents, etc.) It also covers intangible assets where these characteristics can be manifested and upheld in a contractual arrangement between two parties (dependent or independent).

Goodwill, going concern, synergies, location savings etc., are not intangible assets themselves and should not be recognized for TP-purposes on a stand-alone basis. Instead they are elements connected to the valuation (and comparability) of such assets and may accordingly affect the transfer price of an intangible asset.

Thus, unless it is possible to identify the transfer of a tangible or intangible asset (either by way of a realization of such an asset or the right to use such an asset, purchase and sale), goodwill and similar value elements cannot by themselves trigger a taxable event.

Ownership issues are another important aspect. The owner should typically receive the economic benefits of the intangible assets as well as assume the risks related to the assets in question.

Legal ownership in terms of the contractual arrangement between the parties, including the allocation of rights and obligations, appears to be a sound starting point for the ownership analysis.

Administrations should be very careful when deciding to forgo and disregard what the taxpayer has clearly set out to accomplish. The legal ownership should be respected unless the economic substance and the conduct of the parties clearly deviate from the contractual arrangement. In line with chapter IX of the TPG, such actions from administrations should be allowed in exceptional cases only.

Reasonable efforts to centralize IP-rights must not be disregarded by administrations without there being substantial and significant factors to indicate that such efforts would in fact be incompatible with how business is actually performed.

Nevertheless, in cases where the intention of the parties cannot be determined and/or when the conduct of the parties clearly deviates from such an arrangement and the arm's length principle, the objective should be to determine what would be a reasonable allocation between independent parties given the facts and circumstances of the case.

The notion of control, as further developed in chapter IX, appears to have merits also for the purpose of allocating ownership of intellectual assets (intangible property). However, caution should be exercised when adopting the concept of control in this context since there may not always be a close proximity between control and an arm's length allocation of such ownership.

By way of example, outsourcing of R&D activities between independent parties is sometimes done because the principal does not have the resources or competence to perform these functions. This party might therefore not have the ability to control and/or manage the process in any detail but only in a high level management sense.

The meaning of control is therefore crucial. Any requirement in this context ought to be in the form of high level strategic and economic management and decision making, such as the right to "hire and fire", participation in and ultimate authority over budgets, key strategic decisions etc.

The fact that the contractor/service provider is using its particular competence to decide how to reach the objectives outlined, should not influence the allocation of IP-ownership.

The notion of funding (ie. which of the parties has funded the IP-development) equally seems to be a useful guide in determining ownership. It is indeed reasonable to assume that among independent parties the one that has funded the R&D-activities, whether the actual development work has been conducted by this party or not, will have a rightful claim to the benefits (and risks) related to the IP- so created.

Conclusions

It is positive that the OECD has decided to get involved and request comments/guidance from business at an early stage in the project. For this cooperation to be fruitful, it is equally important that the OECD process is transparent and that an economic analysis is presented at the same time as proposed tax changes are presented. There must not be any opportunities for some countries to claim that the changes of rules are made to disadvantage them.

The ideal situation would of course be designing guidelines that have a chance of gaining acceptance not only within the OECD but also in developing countries outside the OECD. Too many divergent views on these issues could, rather than leading to further guidance end up in increased complexity and ambiguity. We must not forget that the purpose of transfer pricing projects must be to eliminate (or at least mitigate) international double taxation in a timely manner.

Governments have a responsibility to ensure that tax rules applied do not act as a hindrance to a free flow of investment and trade. Furthermore, and in conclusion, the OECD governments have as an economic policy objective the development of high value businesses based on intellectual property. It would seem very strange if the OECD Intangible project resulted in a tax framework that does not support this economic policy and continued free movement of capital, goods and services. ■

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