Special Meeting of ECOSOC on "International Cooperation in Tax Matters"

New York, 22April 2015

Newsletter of FfDO/DESA

Number 2015/2, April 2015

Taxation of Intellectual Property Rights and Other Intangibles: Issues for Developing Countries

Introduction

Pursuant to its resolution 2014/12, ECOSOC will hold, on 22 April 2015, a one-day meeting to consider international cooperation in tax matters including its contribution to mobilizing domestic financial resources for development and the institutional arrangements to promote such cooperation, with the participation of the representatives of national tax authorities.

An interactive discussion on the taxation of intellectual property rights and other intangibles will highlight how current rules in international taxation may give rise to base erosion and profit shifting and try to discern solutions to this problem for developing countries.

What are Intangibles?

Literally "intangibles" refers to property that cannot be touched, as distinct from "tangible" property such as property or consumer goods. A recent OECD proposed definition describes an "intangible" as "something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances."[1]

Intangibles include the important sub-category of "intellectual property" which, according to the World Intellectual Property Organization (WIPO), refers to "creations of the mind, such as inventions; literary and artistic work; designs; and symbols, names and images used in commerce. Intellectual property is protected in law by, for example, patents, copyrights and trademarks, which enable people to earn recognition or financial benefit from what they invent or create."[2]

The definition of intangibles for tax purposes has been difficult, as the OECD wording shows. While some items are well accepted as intangibles that are not intellectual rights (such as the "goodwill" attached to a firm, customer databases and "know how"), there have been differences about the coverage of the term "intangibles". This can have important tax consequences as to whether, where and how the profits of Multinational Enterprises (MNEs) are taxed.

Why is the Taxation of Intangibles a Development Issue?

The taxation of intangibles is growing in importance as business models increasingly rely on intellectual property and a growing percentage of business assets take the form of often extremely valuable intangibles. Intangibles are seen as the main driver of value for many companies, a process aided by advancements in information and communication technologies.

One idea of what the protection of intellectual property entails is that "by striking the right balance between the interests of innovators and the wider public interest, the IP system aims to foster an environment in which creativity and innovation can flourish" (again quoting WIPO). However, the taxation aspect needs to be part of that balance and those profiting by engaging with an economy and creating value there should not be able to escape legitimate taxation given the serious consequential impact that tax evasion and avoidance has on country development. The same applies for other forms of intangible that are created within that economy.

1 OECD (2014), Guidance on Transfer Pricing Aspects of Intangibles, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing. http://dx.doi.org/10.1787/9789264219212-en at p.29.

2 http://www.wipo.int/about-ip/en/

A Hypothetical Least Developed Country Example

Eastopia is an LDC emerging out of conflict and has vast reserves of gold that lie very deep in the earth. Techniques to extract the gold in the most economic and safest manner have been pioneered and perfected in the Eastopian mines by the Goldmountain group, and are beginning to be used in other countries. Goldmountain's subsidiary in Eastopia pays large fees to an affiliate in a no-tax jurisdiction where the patents and related intangibles for the deep mining are held, as do companies in other countries where the techniques are used. Goldmountain claims that all the real design and analytical work was done overseas, with no value adding activities in Eastopia. How much if any of the value of Goldmountain intangibles, including intellectual property and know how, should be treated as created in that country?

For both of these examples, provided on this page, important (and in practice very complex) questions exist about:

- How much economic activity and value creation as part of the relevant global value chain is properly happening in the developing country?
- How is the contribution in each country valued?
- Is there relevance that a no or low-tax jurisdiction holds the rights to intellectual property, or claims to be the creator of other intangibles?
- How do we ensure that the group is not taxed on the same value creation in several countries?

Tax treaties between countries try to resolve these issues in a fair and balanced way that achieves proper taxation of profits from value creation and avoids double taxation of such profits. Many approaches taken by countries unilaterally also seek to achieve this balance, but it has proven difficult to achieve that balance in practice.

What are the Rules of the Game and why are they Scrutinized?

Current rules governing the taxation of value derived from intangibles have not generally been developed with complex modern global value chains in mind and many countries, both developing and developed, are concerned that they do not receive adequate compensation for intangibles, which were developed and received their value from economic and value-creating activities in their jurisdictions. There is particular concern about the extent to which multinational enterprises locate legal ownership intangible assets in no or low-tax jurisdictions with no real connection to value creation.

Shifting of intellectual property is especially problematic with regard to transfer pricing. Transfer pricing in and of itself is a normal incident of the operations of MNEs — transactions between parts of the MNE have to be valued in some way, including to gauge how the component parts are performing. However, if transactions between associated enterprises are mis-priced so that their true value is not reflected, profits might effectively be shifted to low-tax or no-tax jurisdictions and losses and deductions to high tax jurisdictions lowering the overall tax burden of the MNE. The generally accepted test of whether pricing reflects the true value of a transaction is whether it has occurred at "arm's length", that is whether the transaction was priced as it would be in a market with each participant acting independently in its own interest.

A Hypothetical Luxury Goods Example

A handbag from the top-tier European fashion house San Giacomo costs $4,000 in the Developing Country Ruritania, a 15 per cent premium to the price in many other markets because of the luxury taxes in that country. The handbag is largely made in Ruritania itself, and the Ruritanian Market has been booming for such goods, despite the luxury tax. In fact, the harder the handbag is to obtain, the more the rich in Ruritania and other countries seem willing to pay for it, as extra exclusivity creates extra value.

The gross margins on the handbag are 65 per cent of the $4000 because it costs $1400 to design, produce, market and sell the handbag. Such a figure is by no means unusual in the case of high fashion. Issues have arisen; however, as to how much of the profits on that sale belong to the European country where the group is headquartered, or to the various countries where operations such as design, manufacturing and marketing are carried out.

There is also debate as to how much of the profit should be attributed to the no-tax jurisdiction where the intellectual property of the brand name and trademarks relating to the handbag (the intangibles) are legally owned. Importantly, how much of the profit should be attributed to Ruritania? Should the group's assertion that no high level design or other function occurred in Ruritania be trusted, even though the handbag seems to have colours and other features adapted to that market?

Should the group's view that all the value-added aspects of marketing was organized from outside be taken on trust also, or has the brand been built up in Ruritania to such an extent that that work not only creates the demand in Ruritania but adds lustre to the brand internationally? In other words, the fashion brand might say little profit is made in Ruritania because the apparent profits are eaten away by costs the Ruritanian subsidiary must pay for the intangibles involved in the global value chain relating to the handbag, including rights to use the intellectual property and payments for marketing. The payments all go to subsidiaries in no or low tax jurisdictions.

Intangibles pose substantial challenges to arm's length pricing as they represent unique and often extremely valu-

able assets that, at the same time, may appear impossible to price with precision. In transfer pricing terms, there is often a lack of "comparables", i.e. evidence of comparable transactions relevant to the particular market. As intellectual property increases in value and complexity, identifying comparable transactions becomes increasingly difficult. Tax administrations also struggle with analyzing and valuing component parts of mixed contracts between domestic companies and fellow MNE group members abroad. Mixed contracts covering intangibles and other elements such as goods and services can make it hard to ascertain the true nature of transactions, let alone identify and value the intangible component(s). The frequent asymmetries of information and expertise between developing country tax administrations and MNEs exacerbate the difficulties and the concerns.

One solution has often been the use of the "profit-split" method in determining a fair transfer price. This method is used to analyze related parties transactions to determine if the allocation of profits and losses between them were conducted at arm's length based on the relative value of their contributions to the profits or losses. In essence, the profit-split method compares the division of profits with what independent enterprises would be expected to agree in similar situations, based not on comparable transactions but on their contribution to the value created by the transaction. While this is an important way of responding to a lack of comparables, this is not a panacea. It can also strain developing countries' tax administrations, depending on the split factors to be used, and has its own uncertainties. Moreover, this method also relies on information about the contributions of the parties in two countries to the transaction that may not be easily available.

The Key Questions and Possible Ways Forward

The questions to be asked, then, include:

- What has been the transaction and what part of it is an intangible?
- Where is the value creation occurring in relation to the identified intangibles?
- How is the contribution of each contributor to the value to be estimated?

In the past a great deal of deference has been placed on the legal ownership of intangibles as the basis of who is entitled to the return of intellectual property intangibles, in particular, but as part of the OECD/G20 Base Erosion and Profit Shifting initiative, legal ownership seems to be more clearly delineated as being but a starting point, with particular scrutiny of which part of the MNE performs and controls all the important functions, provides all assets and bears and controls all risks in relation to the development, enhancement, maintenance, protection and exploitation of the intangibles.

This is a positive development, but while the complexity of properly auditing MNEs and their use of intangibles is a daunting task for any tax administration, those administrations that lack resources, human, data and otherwise, are especially affected. There is also a potential for uncertainty among those taxpayers seeking to pay their taxes as they are also concerned at the possibility of double taxation of what are essentially the same profits by two countries. As much agreement as possible within and between international organizations will help give greater certainty for both administrations and taxpayers. Guidance will assist taxpayers seeking to be compliant and help them to assess the risky areas of non-compliance.

To be fully effective, relevant legislation must effectively address tax policy issues in a way that works for developing country tax administration and tax courts. Broad international acceptance of approaches to dealing with the taxation of intangibles that work for all countries will support improvements at the policy, legislative, administrative and judicial levels.

To achieve these challenges satisfactorily, two potentially competing trends have to be brought into balance. On the one hand, more guidelines are being developed—both on the national and the international level—that attempt to answer questions that arise due to changing business models and an increasingly digitalized and intangible-based economy. At the same time, many governments, especially from developing countries, are concerned that legislation is becoming too complicated and that solutions must be easier to work effectively on the ground.

This is a need that current initiatives such as the OECD/G20 work are cognizant of, and important work continues in the UN also. The next version of the *United Nations Practical Manual on Transfer Pricing for Developing Countries*[3] will, in particular, have a substantially expanded guidance on the issues and possible solutions for developing countries, drawing upon the experience of such countries and of developments in relevant fora.■

3 Current version available at http://www.un.org/esa/ffd/wp-content/uploads/2014/08/UN_Manual_TransferPricing.pdf