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Rough Road Ahead for OECD Intangibles Project

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Summary by taxanalysts®

The OECD's recent transfer pricing guidance on intangibles, issued as part of the base erosion and profit-shifting project's deliverables, with large portions unfinalized, is unlikely to be finalized anytime soon; that was the takeaway from a seminar held October 15 at the 68th annual Congress of the International Fiscal Association in Mumbai.

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Disagreement on Fundamentals

A panel chaired by Ricardo Escobar of Bofill Escobar Abogados, a Chilean law firm, offered several different perspectives on the proper tax treatment of intangibles, with members often taking vastly different positions on some fundamental issues. Caroline Silberztein of Baker & McKenzie, Paris, summarized the OECD's BEPS action 8 report, released September 16, providing an institutional background to the report and strongly defending its content. Silberztein was head of the OECD's transfer pricing unit from 2001 to 2011. (Prior coverage.)

Silberztein pointed out that the OECD's intangibles report was a follow-up to the 2010 update to the agency's transfer pricing guidelines -- a project she had headed -- which added to the guidelines a new Chapter IX on business restructurings. That project had explicitly "parked" a few issues to be resolved later, including the definition and valuation of intangibles, Silberztein explained. The agency has now addressed that issue, she said.

What the OECD has served up is apparently not sitting well with developing countries. Sanjay Puri, director of income tax (vigilance) at India's Central Board of Direct Taxes, took issue with the OECD's exclusion of location savings in defining intangibles. Puri was advancing the view, often espoused by developing countries, that the economic gains from moving a multinational enterprise's existing operations to a low-cost jurisdiction should accrue at least in part to that new host country. According to this view, an MNE's ability to capture those savings constitutes an intangible asset that should be recognized for transfer pricing purposes.

Puri pointed to the U.N. Practical Manual on Transfer Pricing for Developing Countries, which discusses "location savings and location rents" in applying the arm's-length principle. He argued that "arm's-length compensation for cost savings and location rents should be such that both parties would benefit from participating in the transaction."

According to Puri, India's position is that the value of the intangible representing location savings "should not be less than zero and yet not greater than the value of cost savings and locations rents combined." He claimed that China subscribes to a similar view. China's position is "illustrated by an example about quantifying [transfer pricing] adjustment in 'location savings advantage' cases where markup on the location saving is to be added to [the arm's-length price] to arrive at [an] 'adjusted' arm's-length price," Puri said.

Good Weather as an Intangible

Puri's interjection makes it evident that India, and presumably China, will persevere with efforts to levy, in effect, "an entry tax" on foreign MNEs for the privilege of entering and doing business in the country. Silberztein suggested that the OECD is unlikely to be sympathetic to the argument advanced by India, China, and other developing countries that the definition of intangibles should explicitly include the concept of location savings.

However, that argument would seemingly have some support among OECD member countries. Manfred Naumann, head of division at the German Finance Ministry's International Tax Directorate, said Germany's position would favor allocating location savings to both parties but that "bargaining position matters." Naumann appeared to be endorsing the U.N. manual, which provides that "the arm's length attribution of location rents depends on . . . the realistic alternatives available to the associated enterprises given their respective bargaining power." That manual would allow location cost savings to be essentially treated as any other proprietary technology that the MNE owns in the host country. Chapter X contains an example in which China is permitted to tax an imputed return on the annual location cost savings resulting from a foreign MNE's decision to outsource research and development services to a Chinese affiliate.

The international business community is of course not enamored of that view. Jesper Barenfeld, director of international taxation at AB Volvo, seemed to sum up the frustration of the community. "Is good weather also an intangible?" he asked in jest. "If so, then global warming is a transfer of intellectual property."

Replacing Arm's-Length With Horse Trading

MNEs aren't thrilled with the OECD report on intangibles either. Barenfeld complained that the OECD seems to be abandoning the arm's-length principle in response to the BEPS project's dictates. Apparently, the report's discussion of alternatives to the comparable uncontrolled price method for when no comparable uncontrolled transaction exists has raised concerns about a move away from the arm's-length standard. "The BEPS project is taking transfer pricing from an already difficult concept to one that is impossible to apply in practice," Barenfeld said.

Silberztein reminded the audience that the report remains a work in progress. The OECD acknowledged on releasing the report that "some sections of this document are in intermediate form and will be finalised in 2015." Those sections, which appear in grey text in the report, cover some of the most difficult subjects in the transfer pricing of intangibles, Silberztein said.

Recounting the tortuous history of the 2010 update to the OECD's transfer pricing guidelines and surveying the level of disagreement among members during the panel discussion, Naumann repeatedly expressed skepticism that the OECD could produce a final report next year.

Adding to the sense of gloom, Barenfeld said he foresees the "arm's-length principle being replaced by the horse-trading principle." Andrew P. Solomon of Sullivan & Cromwell LLP responded that "if we are to buy and sell horses, then we should insist on mandatory arbitration to settle tax disputes."

The IFA panel made clear the absence of any measurable multilateral consensus on pricing intragroup transfers of intangibles. It would seem therefore that taxpayers can expect an increasing amount of effort devoted to bilateral negotiations -- whether over advance pricing agreements that precede contentious transactions or dispute resolution that follows the contention.

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