

Key advisory issues

Inter-company pricing of intangibles – global developments and their impact on your business

The transfer pricing of goods and services between companies and across borders is fundamental to the taxing rights of different countries. The potential for tension and conflict among countries is therefore high. To mitigate the risks this entails, the Organisation for Economic Cooperation and Development (OECD) operates a set of guidelines on the subject (the Transfer Pricing Guidelines for Tax Administrations and Multinational Enterprises), and has recently issued a series of notes regarding profit methods and comparability. Among other things, these guidelines address intangibles and their impact on the pricing of inter-company transactions. In addition, the United States – one of the larger and more influential OECD member countries – has also issued new rules on services transactions, including discussions on certain services that may create intangibles; as well as detailed rules in relation to qualified cost-sharing arrangements (QCSAs) that exist (for US business) separately from the OECD guidelines.

Overall, the existing guidelines and rules are complex and somewhat confusing, and the impending changes introduce still further complexities and uncertainties. No matter where you do business, there is no clear formula to follow.

To make matters worse, the terminology used can vary. For example, the use of cost sharing in the United States has largely been restricted to activities that result in the creation of assets (eg, intangibles), whereas in OECD terms cost sharing is much wider and can be used to share the costs of providing any type of services where benefits, such as cost savings, are anticipated. The OECD version is therefore referred to as ‘cost contribution’.

All in all, despite the best efforts of the OECD, there is still significant potential for conflict, uncertainty and risk. Tax authorities around the world are stepping up their

efforts regarding intangibles, so it is a safe bet that they will focus on multinationals’ use of them – and in particular on the allocation of intangible value across the value chain.

For example, Germany has recently issued its own guidelines regarding business restructuring where business functions, including profit expectations and underlying intangible property, are transferred cross-border. The new law imposes an exit charge on moving functions rather than assets. Such reform has far-reaching consequences for multinationals, which may find that exit or closure costs become prohibitive. This should affect any plans to move or build functions – say, research and development (R&D) activities – in Germany: the cost of scaling them down or moving them out again may be prohibitive. A number of other countries, including Australia, are considering similar legislation.

Leading companies are taking a proactive stance, being quick off the mark to interpret the changing guidelines and rules, understand their actual requirements, anticipate and manage the related risk and prepare in advance for the potential impact – both positive and negative – on their business.

As with any change, there are both pitfalls to avoid and potential opportunities that may emerge. To navigate the regulatory maze and extract the value in your intangibles, it is important to tackle the challenges inherent in today’s shifting landscape early on.

A responsible approach to transfer pricing for intangibles is about three things:

- understanding the key intangibles driving your particular business;
- complying with your obligations in terms of appropriate compensation for those intangibles; and
- identifying available planning opportunities.

One of the best ways to deal with a complex tax system is to have a system or policy of your own in place. Building a sound policy depends on anticipating the requirements and implications of the impending changes, preparing in advance on how best to comply and recognising your intellectual assets for what they are – an integral part of your value chain.

The arm's-length standard

Within a multinational group, there are always two or more sides to every inter-company transaction, with two or more different tax authorities to satisfy. With the different sides in the same transaction having different views and different regulatory approaches, a natural tension between the parties arises. Businesses need a fundamental framework to follow worldwide. For tax authorities and taxpayers alike, the arm's-length principle is the governing standard. The underlying premise of the standard is that transactions within the same multinational group should be priced as independent parties in the open market would price them. Transactions must be unbundled throughout the value chain to demonstrate to the tax authorities that unrelated parties would transact under similar terms and conditions. Unfortunately, the documentary evidence required to honour the arm's-length standard and satisfy the tax authorities may not be readily available for the simple reason that nobody is required to account for it separately.

Significant guideline changes

Wherever in the world you do business, the first step is to understand what the key global developments are and what they can ultimately mean for your business. The new thinking of the OECD and the Internal Revenue Service (IRS) brings several changes, but these are the three that will have the greatest impact:

- the distinction between low and high-value intangibles;
- a greater focus on the profit-split method; and
- changes in US cost-sharing rules.

Distinguishing between routine, low-value and unique, high-value intangibles

Most value typically now resides in unique and high-value services and intangibles. More explicit recognition of this by the OECD and countries including the United States is the change that will have the most significant potential global impact, because it makes explicit concepts and distinctions that were previously downplayed.

All intangibles are not equal. While some are routine and have little or no differentiating value, others are unique or highly valuable to a business. Going forward, a main objective should be to distinguish these and focus on the latter. It is clearer than ever that you need to look at both the legal and the economic aspects of intangible assets.

These changes and developments raise the issue of public disclosure. In the United States, for example, the IRS often uses public pronouncements and discussions to ascribe high value to services or intangibles. This has important implications. Companies are justly proud of what they have spent on R&D, the contribution of their brands or how many patents they have registered, and actively communicate this information to potential investors and customers. The purchase price allocation on acquisitions and the tax relief you claim on R&D spend will also impact your position. This type of disclosure is unlikely to sit well with tax authorities where companies have not explicitly recognised these in their transfer pricing policies. Nor will an attempt to downplay their value be welcomed by lawyers engaged in defending the intellectual property concerned.

Shifting towards the profit-split method

Many countries are placing greater emphasis on the use of profit methods to test pricing – in particular, the profit-split method – and the recent OECD notes tend to support this. Tax authorities are challenging the reliability of comparable data where valuable intangibles exist and are using this to push for greater use of profit-split approaches. There is a significant risk that they will use the existence of valuable intangibles within a group as a reason to demand detailed data on income and profits from around the world.

Applying cost-sharing rules in the United States

The current and proposed US rules incorporate the concept of QCSAs between affiliates of a multinational group. These are designed to provide some benefits with respect to the areas on which the IRS will focus, along with some certainty on the treatment of intangibles development with a multinational group. Qualified cost sharing essentially provides protection during tax audits, but the United States has strict rules regarding the achievement of qualifying status. The devil is in the detail, but those complex and dense details are not easily deciphered.

For example, the IRS is modifying the existing cost-sharing rules to address the question of how intangibles are valued and how that value accrues to different jurisdictions. The proposed rules restrict the return that any party outside the United States can earn through

intangible-generating activities originating in the United States. However, the same will be true in reverse. Other jurisdictions should be able to flip that rule to limit what the United States can get when intangibles originate elsewhere. It is fair to say that the United States seems to have focused almost entirely on outbound transactions involving US intangibles.

Other than the issues around valuation, the 'proposed' nature of the updated US rules creates ongoing uncertainty for taxpayers, as they are unsure of the relevant economic framework they may use in valuing intangibles and pricing them for internal use.

Where do you go from here?

Once you have a reasonable picture of the regulatory requirements in the countries where you do business, it's time to set about developing compliance action plans for each. Here are some considerations to get you started.

Knowing what you have and what best to do with it

To meet the new requirements, a distinction should be made between routine, low-value intangibles and those that are highly valuable. How, then, are taxpayers to manage the process and identify which parties to a transaction own and use them?

Ask the business – for example, R&D or sales and manufacturing executives – to identify those intangibles that add the most value. Ask them: what provides competitive advantage? A unique selling proposition? A higher margin? It might be innovation and technology; it might be design; or it might be reliability and outstanding customer service. Whatever it may be, once you know what you have, you can make informed decisions.

Who owns the high-value intangibles?

Countries take different approaches to this issue; however, under the OECD guidelines legal ownership may be vested in one company, but others may have effective economic rights. Essentially, 'economic ownership' refers to those entities that financially contribute to the development of the intellectual property and bear the associated risks – this may be in complete contrast to the legal position. This non-legal distinction makes the concept of economic ownership difficult for many to apply. However, economic ownership is a cornerstone to determining where intangibles-attributable profits should arise and, since the concept is most definitely here to stay, it is imperative that companies acquaint themselves with it.

The profit-split method – is it right for you?

For the above reasons, greater care is needed in choosing transfer pricing methods and selecting and interpreting

comparable data. The profit-split method, which relies much less on comparable data, may look attractive at this point. It is important to know your options and their related risks and rewards before putting a plan in place.

Ask yourself: what would the outcome look like for our business if we used a profit-split? What data from overseas would we require if we were to apply the profit-split method and how difficult would it be to obtain the data? The required data will often be detailed and may not be readily available. If you were able to collate it, would you be anxious to share it with the tax authorities in all of the countries concerned?

It is important to invest time and effort in understanding the issues and their consequences before making a decision.

The challenges related to applying cost-sharing rules

Tax authorities have their perceptions about how these things should be done, but the rules are subjective. Again, a choice of methods can be adopted; it is important to take the time to understand and, if cost sharing seems attractive, to check the application of the cost-sharing rules in each of the countries affected.

Overall

It is imperative that a company prepare its own strong story around what its key valuable intangibles are and what management believes generates them, and then make a deliberate and considered choice of pricing methodology.

In putting together a viable story, it is important to know your organisation. It also pays to understand what is in the public domain. People are out there in the public arena making statements about your company. Yes, this is a tax issue; but your position needs to be consistent with what your public relations people are telling the world. The moral of the story is this: be aware of what is going on outside your functional area and ensure that the different functional areas within your business are coordinated on this.

Getting transfer pricing right – is it worth the time and effort?

The fundamental driver here is that ignoring or misinterpreting the rules can be costly in terms of additional taxable profits or exposure to 'painful' audits which consume valuable company resources or a damaged reputation with potential customers, investors and the tax authorities alike. On the other hand, although there is no guarantee of an easy ride, an effective IP tax policy will likely smooth the road, help to reduce costs and increase your chances of optimising your IP and intangible footprint within the group.

The sooner you tackle the challenges, the sooner you will be positioned to avoid the pitfalls, maximise the value of your intangibles and enhance your bottom line. Therefore, if nothing else, it is worth taking the time upfront to understand the guidelines and rules – what they actually require, what the tax authorities will be looking for and what the potential impact on your business might be. For example:

- identify the valuable intangibles and understand their impact on the business;
- use the arm's-length standard as your framework in pricing inter-company transactions;
- take the time to familiarise yourself with the choice of methods – know your options and their related risks and rewards;
- coordinate what the different areas of your business are doing in this area and the disclosures that they are making; and
- ensure that your transfer pricing policies reflect the economic realities of your business.

All of this requires discipline, foresight and a willingness to tackle what has always been recognised as a difficult issue. Your investment of time and effort on the front end will likely be repaid in terms of fewer and better-managed audits, fewer tax adjustments and penalties, less interest owed and greater optimisation with respect to inter-company intangibles planning.

The information contained in this document is provided 'as is', for general guidance on matters of interest only. PricewaterhouseCoopers is not herein engaged in rendering legal, accounting, tax, or other professional advice and services. Before making any decision or taking any action, you should consult a competent professional adviser.

© 2008 PricewaterhouseCoopers LLP. All rights reserved. 'PricewaterhouseCoopers' refers to PricewaterhouseCoopers LLP or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.

Andrew Casley leads the UK technology, info-communications, communications, entertainment and energy transfer pricing groups. For many years Mr Casley has been acknowledged as one of the world's leading transfer pricing advisers by the Legal Media Guide to the World's Leading Transfer Pricing Advisers. He leads global projects for multinationals across a range of industrial sectors. Mr Casley brings a depth of specialised knowledge in specific UK and European issues.

Andrew Casley
Partner, transfer pricing
Tel +44 20 7213 3685
Email andrew.j.casley@uk.pwc.com
PricewaterhouseCoopers LLP
United Kingdom

