OECD BEPS from an IP Management perspective

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OECD:

The Organization for Economic Co-Operation and Development (OECD) is at the forefront of efforts to improve international tax co-operation between governments to counter international tax avoidance and evasion.

OECD BEPS:

The OECD / G20 Base Erosion and Profit Shifting (BEPS) package of measures has been agreed upon with over 100 countries and jurisdictions confirming their commitment to consistently implement this comprehensive package. The package provides 15 Actions ranging from new minimum standards to revision of existing standards; common approaches which will facilitate the convergence of national practices and guidance drawing on best practices.

Described by the OECD as "the most significant re-write of international tax rules in a century," the BEPS package provides countries with the powerful tools to standardize compliance requirements and force firms to be transparent about where they generate income.

Simply put, more and more tax authorities now view OECD BEPS as their 'bible' when it comes to intergroup licenses and transfer pricing of intangibles between group members.

Terminology:

Although we use the term 'OECD BEPS Compliance' throughout this short paper, please be aware that others may use alternatives terms such as 'Transfer Pricing Compliance' or 'Double Taxation Risks'.

Background:

To better understand OECD BEPS, it is worthwhile noting that the chief goal of OECD BEPS is to stop tax avoidance by MNEs and in particular to stop tax avoidance using intangible assets like IP.

MNEs were using a variety of different approaches to do tax avoidance. Below I have identified some of these approaches.

a) The IP value approach

b) The IP risk approach

c) The IP financing approach

d) The low-balling R&D approach

The IP value approach:

This approach leverages intergroup licenses and transfer pricing. Firstly, a company establishes an IP Holding Company in a low-tax regime and moves all its IP into that entity, with legal ownership of the IP now resting with this IP Holding Company. However, the other parts of the company still need to use this IP in various ways so needs permission from the legal owner of this IP. So, the company has this IP Holding

Company license its IP to its operating companies (usually located in high-tax regimes) charging a high royalty rate, so much so that its operating companies make little if any profit. As the IP Holding Company is located in a low-tax jurisdiction, it therefore pays little tax.

The IP risk approach:

One may think of this approach as being like the IP insurance model, namely you pay someone else to take the IP risk, except here it is about self or captive IP insurance.

Firstly, the company sets up a legal entity in a low-tax regime to manage its IP. The company then identifies various IP related risks facing its group members located in high tax regime locations. The legal entity in the low-tax regime in essence finances the IP risk management activities of these group members (e.g. insuring these IP related risks. It will for example charge a sizeable premium for this insurance coverage, thus reducing the profit of the group members located in high-tax locations

The IP financing approach:

This basically involves the use of financial loans between group members. The company sets up a legal entity in a low-tax regime to manage its IP. This entity then provides financial loans to the other group members to cover all the costs of all their IP activities – IP creation, IP portfolio management, IP enforcement, IP exploitation, etc.

These loans from the entity in the low-tax regime to the other group members comes with an associated very high interest rate, thus helping to reduce the profitability of these group members and reducing their tax bills.

The low-balling R&D approach:

This approach tends to be used by MNEs with R&D activities located in high-tax jurisdictions. The company deliberately compensates the R&D unit on a cost-plus basis rather than compensating the R&D unit based on the true value of their output.

Given that the output of most R&D units tends to be IP in one form or another, I would argue that this is yet another example of IP being leveraged (or deliberating not considered from a finance perspective in this case) to reduce profit and thus reduce tax.

The main objective with each of the IP related tax avoidance approaches outlined above is to reduce or eliminate the profit in any group members operating in high-tax jurisdictions and increase the profitability of group members in low-tax jurisdictions.

Why the focus on IP with these various tax avoidance schemes. Well firstly because this is where the real value lies for many companies. Secondly, because we are dealing with intangibles, they are easily moved around and difficult for others to identify, track and trace. Last but last, little if any IP assets are recorded in the financial systems of companies so they are somewhat hidden away.

The OECD BEPS 15 actions:

These 15 actions were developed to address tax avoidance.

<u>Action 1 - Address the Tax challenges of the Digital Economy</u>

· "These measures are intended to level the playing field between domestic and foreign suppliers and facilitate the efficient collection of VAT due on cross-border business-to-consumers transactions."

Action 2 - Neutralise the Effects of Hybrid Mismatch Arrangements

· "Helps prevent double non-taxation by eliminating the tax benefits of mismatches"

· "Puts an end to costly multiple deductions for a single expense through deductions in one country without corresponding taxation in another"

· "Puts an end to the generation of multiple foreign tax credits for one amount of foreign tax paid"

Action 3 - Strengthen Controlled Foreign Company Rules

· "Ensures that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries"

Action 4 - Limit Base Erosion via Interest Deductions and Other Financial Payments

· "Ensures that an entity's net interest deductions are directly linked to the taxable income generated by its economic activities and fostering increased coordination of national rules in this space."

Action 5 - Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

· "Ensures that taxpayers benefiting from preferential IP regimes did in fact engage in research and development and incurred actual expenditures on such activities"

Action 6 - Prevent Treaty Abuse

· Treaty here refers to individually negotiated bargains between sovereign states

· "provides a minimum standard on preventing abuse including through treaty shopping and new rules that provide safeguards to prevent treaty abuse"

Action 7 - Prevent the Artificial Avoidance of permanent establishment status

· "These changes address techniques used to inappropriately avoid the tax nexus, e.g. companies doing business in a state to collect and pay taxes in that state"

Action 8 - Assure that Transfer Pricing Outcomes are in Line with Value Creation - the arm's length principle

· "Provides an approach to ensure the appropriate pricing of hard-to-value-intangibles has been agreed upon within the arm's length principle"

· An arm's length transaction is one in which the parties involved are independent and on equal footing

Action 9 - Assure that Transfer Pricing Outcomes are in Line with Value Creation - allocation of risk

· "Provide contractual allocations of risk with appropriate decision-making and control"

Action 10 - Assure that Transfer Pricing Outcomes are in Line with Value Creation - commercial IP movement for tax avoidance

· "Prevent profit allocations resulting from controlled transactions which are not commercially rationale"

· "Prevent the use of transfer pricing methods as a way of diverting profits from the most economically important activities of the MNE group"

Action 11 - Measuring and Monitoring BEPS

· "Provides better tax data and analysis to support the monitoring of BEPS including analytical tools to assist countries in evaluating the fiscal effects of BEPS and impact of BEPS countermeasures for their countries."

Action 12 - Require Taxpayers to Disclose their Aggressive Tax Planning Arrangements

· "Provides a modular framework of guidance for use by countries without mandatory disclosure rules which seeks to design a regime meeting the countries' need to obtain early information on aggressive or abusive tax planning schemes"

Action 13 - Re-examine Transfer Pricing Documentation

· "Requires MNEs to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies in a "master file" that is to be available to all relevant tax administrations."

· "Require that detailed transactional transfer pricing documentation be provided in a "local file" specific to each country"

· "Requires large MNEs to file a Country-by-Country annual report for each tax jurisdiction, which should contain the amount of revenue, profit before income tax, income tax paid and accrued and other indicators of economic activities"

Action 14 - Make Dispute Resolution Mechanisms More Effective

· "Provides a minimum standard for the resolution of treaty-related disputes."

Action 15 - Develop a Multilateral Instrument

· "Explores the technical feasibility of a multilateral instrument to implement the BEPS treaty-related measures and amend bilateral tax treaties"

Looking at these actions, it is obvious that these OECD BEPS guidelines are not just about tax, they can be seen as an IP management handbook, dictating how companies should behave when managing their intangible assets.

I suggest that OECD BEPS Actions #4, #8, #9, #10 and #13 are especially relevant from an IP Management perspective.

Emphasis on intangible assets:

An essential feature of the new regulations is an emphasis on intangible assets.

It is increasingly recognized that intangible assets create a substantial part of the business value. However, until now there has been no single definition of Intangible Assets in use by tax authorities or the OECD, and no proper guidance on how such assets should be reported.

The accurate and complete identification, taxation and valuation of intellectual property and other intangible assets is now recognized as one of the most important areas of the international tax reform and transfer pricing legislation.

Assessing compliance:

Compliance means conforming to a rule, and the OECD guidelines clearly define new rules as far as an MNE's IP management is concerned.

Assessing compliance is an activity to determine, directly or indirectly, that a process meets relevant standards and fulfils relevant requirements.

I suggest that such a conformity assessment may be broken down into at least 9 parts …

- Qualification
- Definition of intangible assets
- IP data management
- Maturity of the MNE's IP processes and systems
- Transfer pricing
- IP Risks
- The financing of IP activities
- Reporting
- Exceptions

Qualification:

The OECD guidelines apply to all multinational enterprises. An MNE is defined as an organization that owns or controls production of goods or services in one or more countries other than their home country.

Several of the OECD measures have been crafted in such a way as to minimize the impact on SMEs with negligible BEPS risks.

This part of the conformity assessment simply sanity checks if the company is a MNE as defined by the OECD and as far as OECD BEPS guidelines are concerned.

Certain tax jurisdictions may apply OECD BEPS guidelines to smaller enterprises, and there is evidence that this is certainly happening.

Definition of intangible assets:

In the OECD guidelines, it defines intangible assets as including the following categories

- Patents
- Know-how and trade secrets
- Trademarks, trade names and brands
- Rights under contracts and government licenses
- Licenses
- Goodwill

It is worthwhile noting the OECD BEPS defines intangible assets in broad terms and does not limit it to register forms of intellectual property.

The OECD guidelines also specifically exclude certain items from being considered as intangible assets as far as OECD BEPS compliance is concerned.

This part of the conformity assessment compares and contrasts the OECD's definition of intangible assets to that definition in active use within the company and identifies any differences which require further examination.

IP data management:

Within Action Plan #8, the OECD describes several IP data management related tasks required of the MNE.

- Identification of all intangible assets
- Ownership of all such assets
- Contribution by group members (i.e. MNEs must identify which group members performed functions, used assets and managed risks relating to the development, enhancement, maintenance, protection and/or exploitation (DEMPE) of the intangibles assets)
- Re-imbursement by the legal owner to other group members for their contribution
- Valuation of such assets
- Agreements in place between group members
- Arms-length fees and fee structures agreed

This part of the conformity assessment checks if the MNE has the skills and competencies, knowledge and experience, process and systems in place to enable the MNE to complete these IP data management related tasks, and if not, what actions need to be taken to remedy the situation.

Maturity of IP processes and systems to support OECD BEPS compliance:

Although perhaps not directly linked to OECD BEPS compliance as such, I suggest that an MNE will need to be at a certain level of IP maturity and sophistication in order to be able to properly and professionally help and support the finance and tax function with OECD BEPS.

This touches on such IP matters as ...

- IP awareness & education
- IP processes
- IP systems & tools
- IP data and metadata
- IP data integrity
- IP governance

Therefore, this part of the conformity assessment reviews the maturity and sophistication of the IP processes and systems in use for each category of intangible asset within the MNE and identifies any gaps that may cause issues when it comes to OECD BEPS compliance.

Transfer pricing:

Transfer pricing is the setting of the price for goods and services sold between controlled (or related) legal entities within an enterprise. As far as OECD BEPS is concerned, it is the setting of the price for intangible assets being licensed by one member of the group to other member(s) of the group.

The guidance on transfer pricing documentation requires MNEs to provide tax administrations high-level global information regarding their global business operations and transfer pricing policies in a “master file” that would be available to all relevant country tax administrations.

It also requires that more transactional transfer pricing documentation be provided in a "local file" in each country, identifying relevant related party transactions, the amounts involved in those transactions, and the company’s analysis of the transfer pricing determinations they have made with regard to those transactions.

MNEs will be required from an IP perspective to:

- Identify intangible assets linked to the licensing of intangible assets between group members.
- Determine the valuation given to such intangible assets and the valuation methodology used
- Gather details on all such licenses between group members.
- Demonstrate that they have used arms-length fees and fee structures when deciding on the pricing.
- Check that the IP terms and conditions in such agreements are reasonable, and not adversely impacting OECD BEPS compliance.

If there are significant numbers of such arrangements in place within the group, the conformity assessment will also review and check that the MNE has the following in place:

- Processes for creating and managing such agreements
- System(s) to underpin such processes
- Metadata associated with such agreements

- A governance structure in place

IP Risks:

OECD BEPS Action Plan #9 focuses on the issue of risk within an organization and given that such risks may include IP related risks, in this section, we focus on understanding IP Management within the company when it comes to IP related risks.

The focus is really only on economically significant IP related risks where various aspects (such as who controls the IP risk; who is managing the IP risk; who is mitigating of the IP risk; who is bearing the associated costs; who is financing the associated activity) of related risk may link to different group members.

The financing of IP activities:

OECD BEPS Action #4 aims to limit tax avoidance through the use of financial loan arrangements to achieve excessive interest deductions or to finance the production of exempt or deferred income.

MNEs may achieve favourable tax results by adjusting the amount of debt in a group entity. This may be achieved as follows

- Groups placing higher levels of third-party debt in high tax countries.
- Groups using inter group loans to generate interest deductions in excess of the group's actual third-party interest expense.
- Groups using third party or inter group financing to fund the generation of tax exempt income.

The use of third party and/or related party interest is perhaps one of the most simple tax avoidance techniques available in international tax planning. The fluidity and fungibility of money make it a relatively simple exercise to adjust the mix of debt and equity in a controlled entity.

This part of the conformity assessment reviews whether the company have any significant financial loan arrangements in place either between group members or with an independent external entity to finance any of its IP activities.

Reporting:

As indicated in Action #13, the BEPS Guidelines required companies to provide several reports to the Tax Authorities

- Master File
- Local File
- Country by Country Report

For example, the OECD specifically asks for the following information to be reported within a Master file:

- A general description of the group's overall strategy for the development ownership and exploitation of intangible assets
- A list of intangibles, or groups of intangibles, that are important for transfer pricing purposes

- Details of those entities that legally own the intangibles
- A list of important agreements among identified associated enterprises within the group related to intangible assets.
- A general description of the group's transfer pricing policies related to intangible assets.
- A general description of any important transfers of interests in intangible assets among associated enterprises within the group during the fiscal year concerned, including the entities, countries, and compensation involved.

This part of the conformity assessment checks if the MNE is capable of producing such reports in a proper and professional manner. It also identifies any gaps which need addressing. It should also assess what evidence logs that company maintains to back up the data in any such reports.

Exceptions:

There are several exceptions which need to be considered when conducting a conformity assessment.

- Exceptions outlined within the OECD BEPS guidelines
- Exceptions specified by national governments when they implement the OECD BEPS guidelines
- Exceptions due to corporate events of the MNE being assessed (e.g. M&A deals, JV projects, Investment rounds, etc.)

Summary:

The essence of OECD BEPS is the switch away from a focus on the legal ownership of the intangible assets (like patents, trademarks, trade secrets, etc.) within a corporate group to a focus on the economic ownership and usage of these intangible assets by the group members.

This is OECD BEPS's so-called DEMPE concept (where DEMPE stands for the Development, Enhancement, Maintenance, Protection and Exploitation of intangible assets).

This switch I suggest will have a major impact on IP management and the associated IP policies, IP processes, IP systems, IP data, IP governance, etc. within organizations.

I trust that the above information is of interest and of value, especially since this is "the most significant re-write of international tax rules in a century".

These OECD BEPS guidelines are not just about tax, they can be seen as an IP management handbook, dictating how companies should behave when managing their intangible assets.