



Tax Notes Today

FEBRUARY 24, 2014

Intangibles and Controversy Top Taxpayers' Concerns About BEPS

by Marie Sapirie

Summary by **taxanalysts**

The changing landscape for transfer pricing as a result of the OECD's base erosion and profit-shifting project has far-reaching implications for the treatment of intangibles and transfer pricing audits, panelists said February 20 at the TP Minds Americas Transfer Pricing Summit in Coral Gables, Fla.

Full Text Published by **taxanalysts**

The changing landscape for transfer pricing as a result of the OECD's base erosion and profit-shifting project has far-reaching implications, said taxpayers and practitioners on February 20. Speaking at separate panels on the treatment of intangibles and transfer pricing controversy at the TP Minds Americas Transfer Pricing Summit in Coral Gables, Fla., panelists offered suggestions for improvements to the OECD's action plan and draft on intangibles, as well as practice points for companies involved in or anticipating transfer pricing audits.

Intangibles

The breadth of the definition of intangibles is troubling to taxpayers and practitioners. Mike Heimert of Duff & Phelps acknowledged that there is a lot of effort and good work put in by the OECD in tackling those highly difficult issues, but said taxpayers must now voice the need for a more precise definition of intangibles.

"If we have a more precise definition, you can start to build up techniques and analyses to value various intangibles," Heimert said, adding that that certainty would be beneficial to both taxpayers and the overall economy. The heightened emphasis in the transfer pricing guidelines and discussion drafts on functional analysis is fine, but

taxpayers need a concrete definition of exactly what constitutes an intangible, he said.

The revised discussion draft on transfer pricing aspects of intangibles "leaves too much openness," said Heimert, pointing to paragraph 36 of the draft, which allows items or activities not specifically mentioned in the draft to be evaluated for possible treatment as a valuable intangible. "Without very specific language, it leaves up to the discretion of any tax authority to determine what they believe is an intangible. It's going to lead to a lot of differing viewpoints, and I think we're certainly going to end up with a lot more issues of double taxation," he said.

Under the OECD's revised discussion draft on intangible property, taxpayers face the possibility of much more subjective criteria regarding transfer pricing documentation, said John Drewno of Caterpillar Inc. He noted that in the middle of the discussion draft on transfer pricing documentation, the OECD enumerated a list of various forms of intangible property, but at the beginning of the same document, the OECD explained that the objective of transfer pricing documentation is defending the value of their intangible property positions. "It's going to be much less objective for the taxpayer and much more subjective for the tax authority," said Drewno.

The relative lack of safe harbors in the OECD's draft is problematic because it adds to the enormous complexity of administering the rules, said Horacio Peña of PricewaterhouseCoopers LLP. "There is a role for safe harbors," he said, pointing to routine transactions involving not very valuable intangible property.

Heimert echoed that concern, saying, "Without safe harbors, the amount of audit activity is going to be so great, it's unsustainable." Heimert cautioned that unless safe harbors and other measures to increase certainty are added, the changes could lead to the collapse of the entire system and a movement toward formulary apportionment. "It is very important to get some of these issues fixed right away," he said.

The OECD revised draft proposed that the intangible property owner should perform all the important functions relating to the development, maintenance, and protection of the intangible property. "This is a completely unrealistic requirement diametrically opposed to how global business operates today. Multinationals outsource many important services and allocate many different IP related functions to related and unrelated parties alike. If implemented, this requirement will create a tremendous amount of controversy," Peña said.

The treatment of an assembled workforce is another area that panelists said needs to be considered further. "I think [the OECD's revised discussion draft on intangible property] kind of plays it both ways," Drewno said. "In one instance it could be classified potentially as an intangible, but on the other hand, if that workforce has to be retrained in another area, another location, then you need to rationalize whether it will be a benefit or a non-benefit situation."

Another potential source of transfer pricing disputes is a disconnect between the tax authority's perception of the types of activities that can create intangibles in highly competitive environments where many local taxpayers operate and the reality of the taxpayer's competitive conditions, Peña said. "We spend an awful lot of time talking about functions and activities in intangible property, but not enough time talking about economic conditions," he said. In the past 25 years, the biggest transfer pricing court cases from around the world have involved elements of intangible property, business opportunities, economic conditions, and high-value services, and "this configuration of overlapping areas has made it very difficult for taxpayers and governments to agree," he said.

Peña noted that in highly competitive conditions, taxpayers will have no valuable intangibles, or intangibles that generate only routine profits that are already reflected in the taxpayers' profits. This is in contrast to monopoly situations where taxpayers will have a much easier ability to generate economic rents and excess system profits. However, in the space in between those two extremes -- situations of near perfect or imperfect competition -- taxpayers may be able to generate more than routine profits from intangibles, but those extra profits are usually only temporary. "In those situations, it is critical to identify the specific IP that serves as the barrier of entry and generates the economic rents. Likewise, it is also very important to determine the actual useful life," Peña said. This framework is important to understand and explain to tax authorities, he said, adding that he thinks the economic conditions "will play a big part in the defense story."

Controversy

H. Todd Miller of Hogan Lovells LLP noted that one of the significant changes in transfer pricing in recent years is the increase in audit activities across jurisdictions. Panelists agreed that enforcement activities have increased. Bradley Shumaker of Zimmer Inc. said that compared with prior years, he is currently managing double the number of audits around the world.

To address the increased level of audits, taxpayers need to focus on presenting a compelling factual story to tax authorities, agreed practitioners and industry representatives. Building that story starts when the transfer pricing documents are being drafted and the documentation is prepared, Miller said. Shumaker said that in preparation for a future audit, he has compiled documentation, interviews with business people, and economic analysis regarding a large shared services arrangement into a report. The result of that report was a successful audit with no adjustments. "Telling your story is important," he said, noting that his team was able to answer all of the tax authority's questions on the arrangement by referring to the report.

Javier F. Suarez of Cemex Inc. said that it was imperative that taxpayers dot their i's

and cross their t's regarding the implementation of intercompany contracts. He said that the important question is, "At the end of the day, has what the agreement stated actually happened?" Tax professionals need to ensure that the transaction is substantiated in order to explain it to tax authorities, he said, adding that it is also important for taxpayers to ensure that there is consistency across transactions.

The prospects for increased information sharing between countries is troubling to taxpayers, said William Thompson of Brown-Forman Corp. Taxpayers need assurance that highly proprietary information like sales and cost data will be safeguarded, Thompson said. With the IRS's announcement of the first joint audits with foreign jurisdictions, "this is increasingly going to be an issue," he said.

Involving business people in the audit process can add credibility to the tax presentation because it eliminates the possible perception that information is being filtered through tax professionals, Thompson said. Management has also become more focused on transfer pricing recently because of a combination of the potential changes due to BEPS and the desire to avoid reputational risks, he said.

Tax Analysts Information

Code Section: Section 482 -- Transfer Pricing

Jurisdiction: United States

Subject Areas: Audits
Transfer pricing
Intangible assets

Author: Marie Sapirie

Institutional Author: Tax Analysts

Tax Analysts Document Number: Doc 2014-4016

Tax Analysts Electronic Citation: 2014 TNT 36-5
