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A Two-Option Compromise for Intangibles Pricing Guidelines

By Michael C. Durst

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In this article, Durst notes that the question whether transfer pricing guidelines should permit taxpayers to shift income to low- and zero-tax countries through intangibles licenses and other risk-shifting contracts is likely to divide OECD member countries from some nonmember countries. Durst suggests that transfer pricing guidelines contain optional language that countries could incorporate into their domestic transfer pricing legislation to allow them to apply the transfer pricing methods generally contained in the guidelines, without giving effect, for tax purposes, to contracts that shift the ownership of interests in intangibles or the bearing of business risks between commonly controlled taxpayers.

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The OECD is reviewing its transfer pricing guidelines as they relate to the taxation of intangibles, and it hopes to recommend solutions that will be helpful to both OECD member countries and nonmember countries at various stages of economic development. Devising guidelines acceptable to both groups is likely to prove difficult, however, because OECD member and nonmember countries tend to face different economic, fiscal, and political realities regarding pricing rules governing intangibles.

The OECD guidelines in their current form reflect that since the 1950s, multinational groups, which typically are based in OECD countries, have relied heavily on intragroup contractual arrangements — including both licenses to use intangible property and, more recently, risk-shifting and risk-stripping contracts — to move large amounts of taxable income to low- and zero-tax countries. The allowance of this income shifting has never been consistent with the theoretical underpinnings of the arm's-length standard and has cost OECD countries billions of dollars in lost revenue. Nonetheless, political resistance to curtailing income shifting within OECD countries has effectively caused the OECD to tolerate income shifting to issue any transfer pricing guidelines at all.[1]

In contrast, many non-OECD countries do not have political constituencies of home-based multinationals that have grown dependent on income shifting through intragroup contracts. These countries are nevertheless damaged by revenue losses from the use of intragroup contracts, and the precarious financial situations of many developing countries today can make the consequences of the revenue losses particularly severe. Therefore, these countries may well be resistant to signing on to transfer pricing rules that perpetuate income-shifting structures. Already, a perception of disparate interests between OECD and non-OECD countries has arisen over the topic of intangibles transfer pricing.[2] The difference of views is likely to be difficult to resolve: OECD member governments are unlikely to feel free to support rules that disallow income shifting through the use of agreements between commonly controlled entities, and many nonmember countries appear to have little reason to tolerate the practice. Some form of compromise may be necessary if revised transfer pricing guidelines with truly global appeal are to be adopted.

The kinds of intragroup contracts that are at issue include (1) licenses and other transfers of rights to intangible property in which a party agrees to bear the risk of further development and receives the right to income from future exploitation of the intangibles; and (2) contracts by which one affiliate transfers identified business risks, and hence the right to an increased allocation of income from the group's business activities. In both instances, the party to which rights to future income are transferred — typically a subsidiary located in a low-tax

[1] *See* Michael C. Durst, ''Fixing Double Nontaxation Under the Transfer Pricing Guidelines,'' *Tax Notes*, May 7, 2012, p. 785, *Doc 2012-7719*, or *2012 TNT 88-9*.

[2] *See* ''Indian Official Urges U.N. to Create Intangibles Guidance for Developing Countries,'' *Tax Mgmt. Transfer Pricing Rep.*, Mar. 22, 2012.

country — may agree to conduct little if any additional business activity. The additional contributions of the tax-favored party typically are limited to the making of financial contributions — such as contributions to fund research and development conducted by the parent company, or perhaps to maintain a financial reserve to insure against specified business risks — using funds contributed by the parent company. Sometimes, some actual business activities are shifted, possibly for the sake of appearances, but the amount of any business activity that is shifted to the low- or zero-tax subsidiary typically is tiny compared with the amount of taxable income that is shifted. In short, the transactions typically exist entirely or predominantly on paper; little happens under these contracts, save for tax avoidance.

One might wonder why transfer pricing guidelines that purport to be based on arm's-length principles would permit income shifting. After all, unrelated companies transacting at arm's length would never engage in largely gratuitous transfers of rights to future business income, and one would think that arm's-length rules would not give credence to those transfers. However, in response to the historical and political reality that transfers between related parties have been occurring for decades and need to be accommodated, transfer pricing law has developed the principle that transfers of business opportunity — sometimes called transfers of profit potential — do not constitute transfers of intangible property and therefore do not require compensation under arm's-length rules.[3] Tolerating tax-free transfers of business opportunity has no basis in economic logic and has resulted in hundreds of billions of dollars lost through tax avoidance, but, apparently because of political necessity, the OECD guidelines do not prohibit the practice. The governments of non-OECD countries, which aren't bound by the same political considerations as many OECD member states, would appear to have little incentive to adopt this component of the guidelines. Some form of compromise seems called for if a satisfactory global approach to transfer pricing law is to be developed.

Compromise might be reached by giving countries the option to accept the arm's-length principle as stated in the OECD guidelines, as well as most of the methods recommended in the guidelines, and also to add optional language that would apply the OECD methods regarding contracts between commonly controlled affiliates that purport (1) to shift the rights to earn income related to intangibles, or (2) to shift the bearing of risk. The placement and language of this sort of optional rule would depend on the language and structure of the revised guidelines. Something along these lines might be used:

> For purposes of determining the income subject to taxation of any party, these Guidelines may be applied without regard to the terms of any agreement, written or otherwise, between associated enterprises that transfers or purports to transfer the right to earn income from the exploitation of tangible or intangible property, or from the bearing of business risks of any kind. In addition, for purposes of determining the income of any party:
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> (i) A party shall be treated as performing functions only to the extent it performs such functions directly or with the assistance of persons that are not associated enterprises with respect to such party;
>
> (ii) A party shall be treated as bearing risks only to the extent such risks are incidental to business activities performed by such party directly or with the assistance of persons that are not associated enterprises with respect to such party; and
>
> (iii) A party shall be treated as bearing risks associated with the ownership or custody of property only to the extent

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[3]A commonly cited source of this rule in the United States is *Hospital Corp. of America v. Commissioner,* 81 T.C. 520, 590 (1983). The OECD's acquiescence in the rule is illustrated in chapter 9 of its guidelines, governing restructurings. *See especially* para. 9.65 of the OECD guidelines. The rule generally permits the transferor of intangible property, in the kind of tax-favored transfer typically engaged in by multinational companies today, to receive far less than arm's-length compensation in the transfer. For example, when a software company gives its Cayman Islands subsidiary the right to build a business by developing a market for a proven software product in new countries, the transfer pricing laws today require compensation for the value of the license to the copyright on the software, but they do not require the payment of compensation for the right to develop and carry out the business activities. Of course, it is impossible for courts to distinguish between the fair market value of the license and the presumably much larger value of the right to develop and conduct the business — a task that would test the wisdom of Solomon. The result is that under U.S. and OECD transfer pricing laws as they are now interpreted, taxpayers routinely transfer business opportunities to low- and zero-tax countries with what appears to be very little consideration. *See Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009), *Doc 2009-27116*, *2009 TNT 236-17*, *nonacq.* AOD 2010-005, *Doc 2010-24215*, *2010 TNT 218-15*. For recent descriptions of the shifting of businesses to low- and zero-tax countries, see, *e.g.*, Charles Duhigg and David Kocieniewski, ''How Apple Sidesteps Billions in Taxes,'' *The New York Times*, Apr. 28, 2012; and Jesse Drucker, ''IRS Auditing How Google Shifted Profits,'' Bloomberg.com (Oct. 13, 2011).

(Footnote continued in next column.)

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> such property is used in a trade or business which such party conducts directly or with the assistance of persons that are not associated enterprises with respect to such party.

Countries adopting this language would incorporate its principles into their domestic transfer pricing laws.

Companies that now make use of income-shifting opportunities can be expected to raise various arguments against including optional language of this kind. They might argue, for example, that disregarding specified intragroup contracts will limit the business flexibility of multinational groups. This argument, however, would be wide of the mark. Nothing in the suggested language would limit companies' ability to transact within their groups as they wish — all intragroup contracts, including those involving shifts of income from intangibles and from risk bearing, will continue to be fully respected for business purposes. Intragroup contracts will be disregarded only for purposes of determining a party's tax liability.

For example, companies will remain free to license rights in intangibles to overseas subsidiaries, if the companies perceive business advantage in doing so, but future income from the intangibles would be shifted to the licensee only if the income represents arm's-length compensation for business activities, such as research, manufacturing, and distribution, actually conducted by the licensee.[4] Similarly, companies would remain free to assign business risks to affiliates if it makes business sense to do so, but income would be shifted only if the assignee conducts actual business activities in connection with the risks — for example, by physically holding property to which the risks relate, or by actually conducting the risky activities, such as R&D, to which the assigned risks relate.

Opponents of the envisioned rule might also raise the familiar claim that allowing some countries to adopt one rule addressing income shifting by contract while permitting other countries to retain a different rule will result in that feared phenomenon: double taxation. However, enabling countries to disallow tax avoidance through income shifting would not appear to raise legitimate concerns regarding double taxation. Much of the income that would be taxed by countries adopting the new rule would be reclaimed by those countries from jurisdictions that impose taxes at very low and often even zero rates. Any double taxation that may occur will be substantially outweighed by a reduction of double nontaxation — a goal that is of critical importance to revenue-strapped countries. In short, neither business flexibility nor double taxation would appear to inspire serious arguments against allowing the envisioned compromise.

Like all compromise over difficult political and economic issues, adoption of the compromise proposed here is likely to be controversial. Many will claim that the approach raises insuperable technical issues — although because the compromise leaves most transfer pricing guidelines untouched, it is not at all clear that it would complicate the transfer pricing laws. To the contrary, eliminating opportunities for income-shifting should simplify transfer pricing compliance and enforcement. Of course, as is true of any proposal in this complex area of law, the proposal offered above should be reviewed carefully, and it may turn out that alternative approaches to resolving differences between OECD and non-OECD countries regarding intangibles pricing will appear more promising. However, the important differences between OECD and non-OECD countries should not be ignored; they need to be acknowledged and addressed if a workable global approach to the pricing of intangibles is to be developed. Any workable compromise, to be meaningful, must enable countries to adopt arm's-length transfer pricing rules while insulating the countries from the income shifting that has become commonplace under OECD guidelines.

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[4]Disregarding attempts by companies to shift income by means of related party contracts should not pose difficulties in applying the regularly applicable transfer pricing methods of the OECD guidelines. The methods in the guidelines are commonly applied in situations when no formal intragroup contracts are in place, and in those cases, they are applied based on functions actually performed by, and risks actually borne by, a party as the result of its business activities — just as would occur under the rule envisioned here.

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