# IC and the issue of transfer pricing: the EU/international guidelines and practices

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Intellectual Capital for Communities in the Knowledge Economy

# 1. Introduction

## *1.1 Background*

- IC is increasingly being recognised as a valuable business asset
- Multinational companies seek to reduce their cost of doing business by centralizing functions in lower cost locations
- Therefore many of the cross-border tax disputes involve issues relating to intangibles

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# 1. Introduction

## *1.2 Definitions around the concept of Intellectual Capital*

| Legal definition of IP | Accounting principles for intangibles | Tax principles for intangibles |
|---|---|---|
| Assets only including one/several identified or identifiable Intellectual Property rights:<br>- patent<br>- know-how<br>- plant breeders' rights certificate<br>- data bases<br>- software<br>- trademark<br>- designs/models<br>- copyright<br>- domain name?<br>And nothing else! | <u>Social accounting</u><br>Identifiable non monetary assets without physical substance:<br>- Identifiable element (*e.g.* it is separable of the business of the company or it results from a statutory or contractual right)<br>- element carrying future economic advantage<br>- controlled element (e.g. the company controls the advantages generated and assumes all or part of the related risks)<br>- element which cost is valued in a sufficiently liable manner<br><br><u>IAS 38</u>: no significant differences<br>- "identifiable" element<br>- "controlled" element<br>- carrier of future economic advantages | <u>French Tax authorities</u>: close to the accounting concept:<br>- source of future profits<br>- long term use<br>- identifiable distinctly from the activity and transferable, or must originate in a legal protection (legal or contractual)<br><br><u>OECD</u>:<br>- comments in force: include rights to use assets such as patents, manufacturing trademarks, trade names, designs or models and also copyright and intellectual property such as the know-how, and industrial and commercial knowledge<br>- **new trend: broader** |

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# 2. The transfer pricing issue

## *2.1 Definition of transfer pricing*

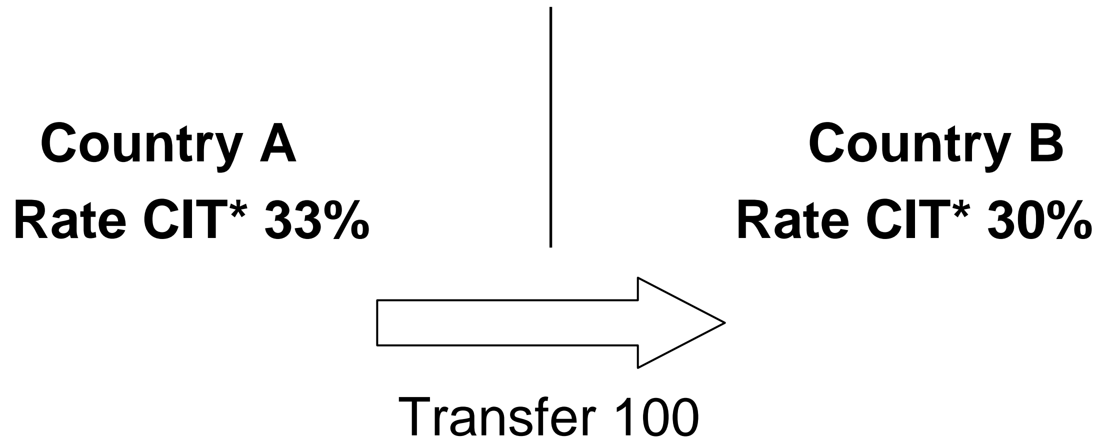
- Transaction price between companies belonging to a same group and residents of different states

- Concept of group
  - Legal dependency
  - De facto dependency

- Different from the legal concept of “transfer”, which only refers to a property transfer
  - Transfer of ownership (determination of an arm’s length price)
  - Licensing (determination of an arm’s length royalty rate)
  - Cost-sharing (determination of arm’s length buy-in payment)

# 2. The transfer pricing issue

## *2.2 Impact*




- ✓ Economy for the group = 3
- ✓ Loss of income for the Country A = 33

"*We have consistently said that transfer pricing is one of the most significant challenges for us in the area of corporate tax administration"* - (Mark W. Everson, Commissioner of Internal Revenue Service)

* CIT= corporate income tax

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# 2. The transfer pricing issue
## *2.3 One concrete example*

- In the United States, the Glaxo case
  - Solved by an arrangement into 2006 amounting to 3.4 billion dollars for the Internal Revenue Service for tax years from 1989 to 2005
  - Facts
    - The litigation related primarily to 6 out of the 20 principal drugs marketed by Glaxo, whereof patents owned by the UK parent company, and for which the US subsidiary acted as products distributor
    - The IRS considered that from a tax point of view, the US subsidiary was the “owner” of these trademarks and from other intangible marketing assets licensed by the UK company
  - Contributions of the case
    - Concrete example of the difference of the interpretation of role and functions of each company
    - The marketing as creator of intangible tax assets

# 2. The transfer pricing issue

## *2.3 Historical reminder*

- 1988: US White Paper
- 1995: OECD report on applicable principles with respect to transfer pricing
- September 7, 1999: Instruction of the French Tax authority on the Advance Pricing Arrangement procedure
- 2002: Informally creation of the EU Joint Transfer Pricing Forum (JTPF)
- 2003: Invitation to comment on comparability issues
- January, 2005: Roundtable of the CTPA (Centre for Tax Policy and Administration) focused on business restructuring
- June 24, 2005: Instruction of the French Tax authority on the unilateral Advance Pricing Arrangement procedure

# 2. The transfer pricing issue

## *2.3 Historical reminder (Cont'd)*

- February 27, 2006: Invitation to comment the application of transactional profit methods
- May 10, 2006: Discussion draft on comparability
- June 20, 2006: Code of conduct on transfer pricing documentation for associated enterprises in the EU
- October 20, 2006: Creation of a work group on business restructuring at OECD level
- November 28, 2006: practical guide intended for SME about transfer pricing
- March 1, 2007: Officialization of the JTPF (EU Joint Transfer Pricing Forum)
- January 25, 2008: Discussion draft on transactional profit methods

# 3. OECD Guidelines

## *3.1 General principles of 1995*

- International subject matter
  - Matter crossing many theoretical concepts and many practical implications
  - Transaction between different states => risk of double taxation

- Necessity to have principles recognized at an international level: “the transfer pricing guidelines for multinational enterprises and tax administration”
  - These principles do not have binding force
  - They constitute useful comments for experts, tax authorities and Courts
  - Evolving principles

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# 3. OECD Guidelines

## *3.1 General principles of 1995 (Cont'd)*

- The key principle: the arm's length principle
  - *"[If]…and either case conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly"*
- Consequences
  - Companies of a same group are treated as unrelated companies
  - Conditions of intragroup transactions must be compared with those that would have prevailed between independent companies for comparable transactions and under comparable conditions (*e.g.* in case of differences, it is necessary to be able to have sufficiently reliable corrective measures to achieve to a comparable situation)

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# 3. OECD Guidelines

## *3.1 General principles of 1995 (Cont'd)*

- The key factors for the comparability are in particular
  - Characteristics of goods or services
  - Functional analysis (assets used and assumed risks)
  - Contractual clauses (allocation of responsibilities, of risks and profits) or de facto behaviour
  - Economic situations (geographical situation, market size, competition, …)
  - Strategies of the companies

- In practice, different methods are used to reach arm's length principle, gathered in two categories

- All methods are not applicable to any products and services

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# 3. OECD Guidelines

## *3.1 General principles of 1995 (Cont'd)*

- Three traditional methods
  - Comparable uncontrolled price
    - Compare the price of a good or of a service transferred in a controlled transaction with the price of a good or a service transferred between independent companies under comparable conditions
    - Method to be privileged if it is possible to identify comparable transactions, but rarely possible in Intellectual Property
  - Resale minus
    - Price to which a good bought with an associated company is resold to an independent company – suitable gross margin – corrective measures related to the other associated costs with the purchase of the product
    - Method particularly useful for marketing operations
  - Cost plus
    - Costs supported by the supplier + margin (to an appropriate rate, taking into account the assigned functions and the market conditions)
    - Useful method when semi-finished products are sold between associated companies, when associated companies have concluded agreements with pooling from equipment or for provision of services

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# 3. OECD Guidelines

## *3.1 General principles of 1995 (Cont'd)*

- Two transactional methods
  - Profit split
    - Identification of global profits resulting from controlled transactions between associated companies
    - Profit split in-between associated companies according to an economically basis similar to profit split which would have been anticipated and reflected in an arm's length agreement
  - Transactional net margin
    - Determination of the net beneficiary margin realised by a company in a controlled transaction starting from a suitable base (*e.g.* costs, sales or assets)
    - The net margin obtained should in theory be determined by reference to the net margin that the same company makes for comparable transactions on the open market

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# 3. OECD Guidelines

## *3.2 Specific principles regarding intangibles (1996)*

- Assertion of the application of the arm's length principle
- Specificities regarding the comparability
- Specificities of the valuation at the time of transaction
- Specificities concerning "the activities of commercialisation done by companies which are not the owner of the trademark or of the commercial name"

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# 3. OECD Guidelines

## *3.3 Discussion draft on comparability (10 may 2006)*

- OECD questions (2003)
  - Need to rely on transaction that took place between independent enterprises?
  - Definition of comparability adjustment? When are they appropriate?

- OECD recommendations (2006)
  - General preference for internal comparables over external
  - Refuse to use controlled transactions as the basis for a transfer pricing adjustment
  - Refuse to provide an exhaustive list of all possible adjustments and how they should be calculated
  - Further developments in the guidelines: What is a reasonably accurate adjustment?

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# 3. OECD Guidelines

## *3.3 Discussion draft on transactional profit methods (25 January 2008)*

- OECD questions (2006)
  - What are the situations involving intangibles where a profit split or transactional net margin method would be particularly useful?
  - How a profit split or transactional net margin method may help taking into account the intangibles used in the controlled transaction?
- OECD recommendations (2008)
  - Transactional profit split method
    - Unique intangibles
    - Co-development or Co-exploitation
  - Transactional net margin method
    - Non-unique intangibles
    - Benchmarkable functions
    - One of the parties makes all the unique contributions
    - Licence fee

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# 3. OECD Guidelines

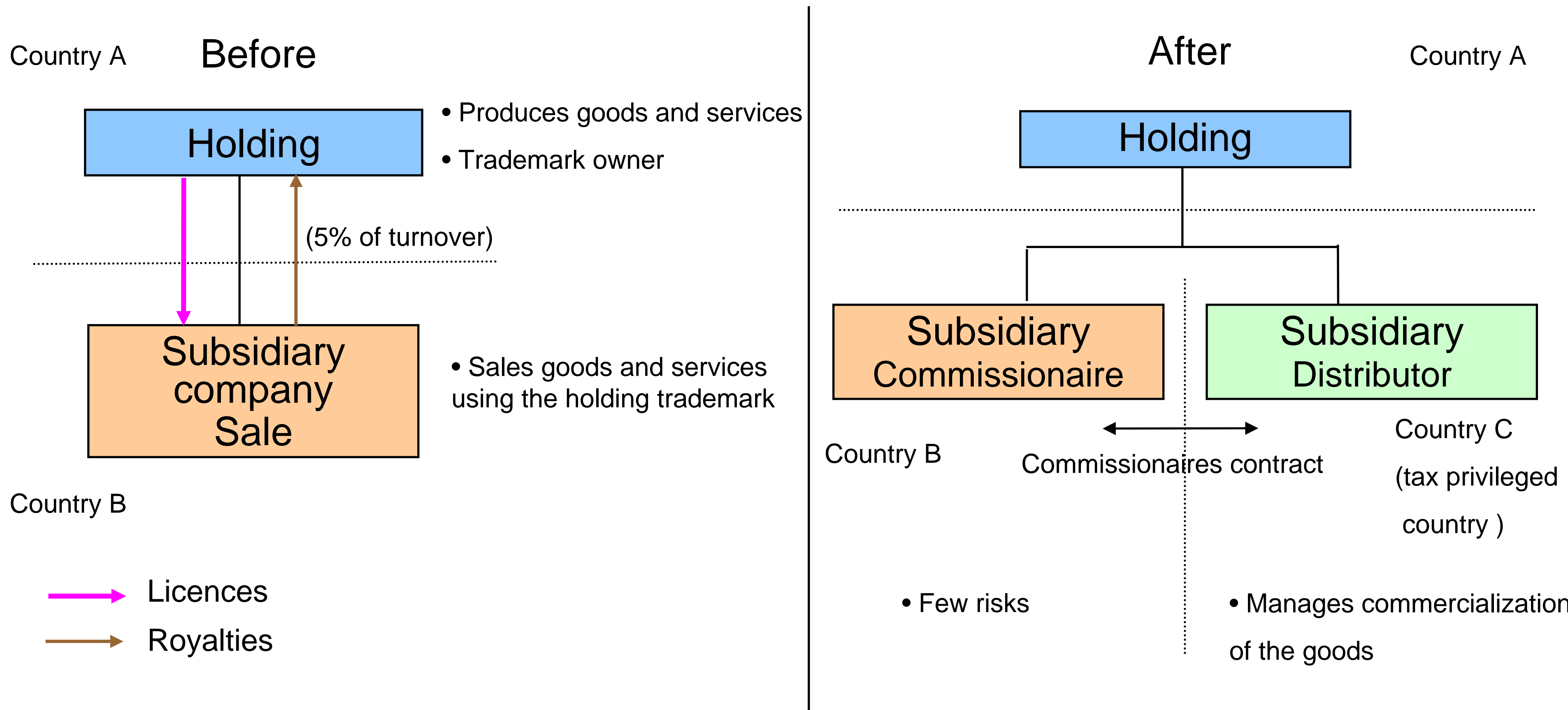
## *3.4 OECD joint working group on business restructurings*

- The operation as shown by the tax payer can be challenged when:
  - Economic reality differs from the legal qualification
  - No real “commercial motivation”
    - Can the amendment of the price solve the issue? Or is it a re-qualification case?
- Attempt to reconsider the legal property when economic property differs:
  - Quid for the trademark legal owner when local subsidiary companies have supported for many years local marketing costs?
- Prices readjustments:
  - Were the modifications of the assumptions used for the evaluation after the determination of the price really unforeseeable?
  - Would a third party have agreed not to have a clause of adjustment of the price?

# 3. OEDC Guidelines

## *3.4 OECD joint working group on business restructurings (Cont'd)*

*Example 1: transformation of distribution structures into commissionaire structures*



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# 3. OECD Guidelines

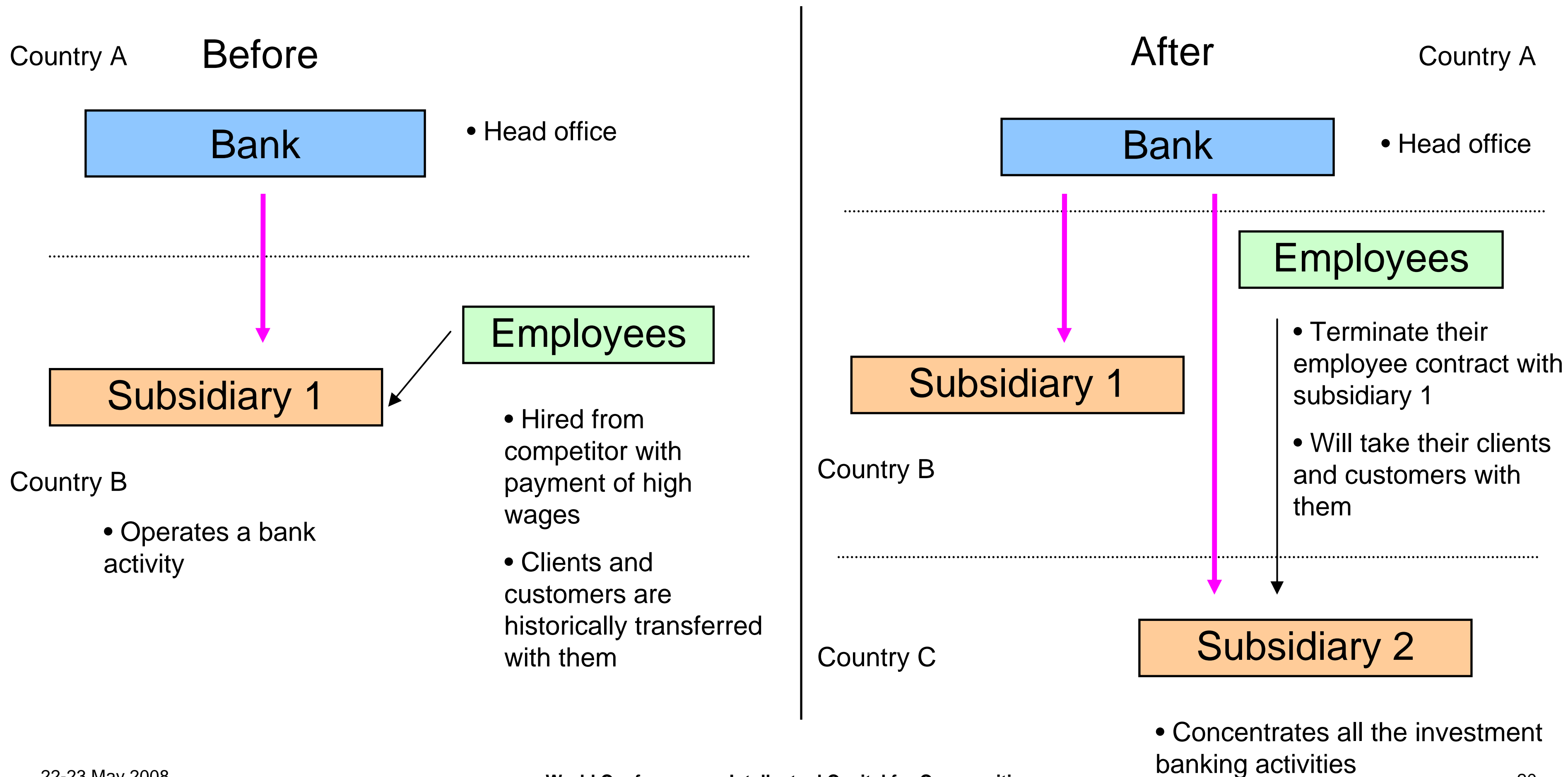
## *3.4 OECD joint working group on business restructurings (Cont'd)*

- Example 1: transformation of distribution structures into commissionaire structures
  - Does the seller subsidiary own an intangible?
    - Accrued expenses not re-invoiced to the holding company, but generate value for the development of the local customers. Do these accrued expenses constitute an intangible "tax" asset?
  - Should it be indemnified because of its transformation into a commissionaire and of the transfer of a tax intangible asset to the company centralizing the marketing (in Country C)?
  - Would a third party have agreed to distribute during years the products under these conditions? Would a third party have envisaged a compensation for the development costs of local customers and trademark in case of a breach of the contract?

# 3. OECD Guidelines

## *3.4 OECD joint working group on business restructurings (Cont'd)*

*Example 2: transfer of employees*



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# 3. OECD Guidelines

## *3.4 OECD joint working group on business restructurings (Cont'd)*

- Example 2: transfer of employees
  - Are the investment bankers to be considered as an intangible?
    - Does a transfer pricing need to be determine when transferring the employees from S1 to S2?
    - Do the employees constitute an intangible "tax" asset?
  - Does it make any difference if only one employee moves or if the entire department moves?

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# 3. OECD Guidelines

## *3.4 OECD joint working group on business restructurings (Cont'd)*

- Example 3: German Business Tax Reform 2008
  - Transfer of function: "*entrepreneurial functions including all opportunities and risks as well as assets and other advantages connected herewith*"
  - Calculation of the discounted value of the transferred earning potentials
    - Assets transferred in connection with the transfer of functions
    - Underlying benefits, *e.g.* location savings
  - Creation of a periodic adjustment clause limited to a 10-year period following the execution of the transfer
  - Comes into effect for fiscal years ending after December 31, 2007

# 4. The European Union contribution

- A dedicated work group: the EU Joint Transfer Pricing Forum (JTPF)
  - Assists the Commission in finding practical solutions compatible with the OECD Guidelines

- A "Code of Conduct" related to the transfer pricing documentation
  - Reasons
    - Ensures freedom of movements for goods and services
    - Reduces the costs related to the documentation of transfer pricing
  - Purposes
    - Determines a standard documentation (known as "EU TPD") applicable upon election to the multinational corporations, which contains a basic documentation and a specific documentation by country

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# 5. The solution of Advance Pricing Arrangement

- Evolution of the process
  - Bilateral agreements procedure introduced in France in 1999
  - In 2005, legalisation of such procedure (*i.e.* the Administration is authorized  to formally discuss the method price determination of transfer pricing applied ) and setting up of unilateral agreements
  - A specific procedure for small company businesses was also set up
- Description
  - The APP allows a multinational corporation, by the application of a method of transfer pricing negotiated with the tax authorities, to make sure that the pricing of its commercial and financial intragroup transactions does not enter into the scope of transfer of profits in the meaning of article 57 of CGI. It is an instrument of legal security.
  - The APP is concluded for a duration from 3 to 5 years. Once obtained, the tax payer must produce an annual report in order to check the conformity of the methods practiced under agreement terms

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