Intangibles, a key source of growth

An article by the CMS Transfer Pricing Group

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2010 was an important year for the transfer pricing aspects of intangibles. On 22 July 2010, the OECD released a major revision of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The changes made to a number of chapters changes relate specifically to intangibles.

During the revision process, the need to clarify a number of issues regarding intangibles was recognized. This was identified as a key concern and the OECD therefore decided to launch a new initiative, inviting both interested parties and the Member States to provide comments on the scope of a potential project on the transfer pricing aspects of intangibles[1].

Accordingly, on 25 January 2011, the Committee on Fiscal Affairs approved the publication of a new document addressing the scope of the project in detail.

From the issues raised in the OECD programme of work for 2011, it is apparent that this area is extremely topical and delicate from both a theoretical and a practical perspective. With this in mind, CMS practitioners decided to address various scenarios which can give rise to transfer pricing issues relating to intangibles (Part I) as well as the criteria that should be taken into account when choosing the most suitable location for an IP Holding Company (Part II).

Issues raised by intangibles for transfer pricing purposes

The CMS Annual Tax Conference was especially important given that in January the OECD had approved a project which is intended to provide clearer international guidance on specific issues relating to intangibles and to avoid uncertainty. The major issues identified as needing OECD work include:

— The framework for analysis of intangible-related transfer pricing issues,

— Definitional aspects not clearly addressed in the current Chapter VI and VIII of the guidelines,

— Specific categories of intangibles, including differentiation between intangible transfers and services, marketing intangibles, and other intangibles and business attributes,

— Cost contribution arrangements in cases where the costs and risks of developing, producing or obtaining intangibles are shared,

— Intangible transfers,

— Valuation, and

— Economic ownership of intangibles.

During the conference, CMS practitioners provided practical illustrations of issues they had encountered with respect to intangible transfers (a), valuation (b) and the concept of economic ownership (c).

[1] As an example, see “comments on the scoping of OECD’s future project on the transfer pricing aspects of intangibles from the CMS organization”

a) Transfers of intangibles

The OECD identified transfers of intangibles as raising the issues of whether a transfer is considered to have taken place and what forms such a transfer may take, as well as recharacterisation issues. As an illustration, Angelika Thies described a particular type of transfer that is encountered in Germany.

The German case: the transfer of business functions

When it comes to intangibles in Germany, a particular issue that requires consideration is the transfer of business functions.

In 2008, Germany introduced tax legislation (Funktionsverlagerung[2]) designed to tax the entire value of business functions which are developed in Germany but subsequently transferred to a group company outside Germany.

WHAT IS A FUNCTION?

In approaching with the transfer of business functions, one might first want to know what is considered a function for these purposes. This question is not clearly addressed in the German legislation, which provides broad definitions that are confusing and difficult to apply in actual cases. One definition of a function is given in an 81-page guidance document published by the tax administration in October 2010, but other legislative documents provide distinct descriptions. Under the legislation, “a function is an organic part of an enterprise which does not qualify as a separate division of the enterprise for tax purposes”. In practice, the tax administration tends to break down the function to the lowest level possible so that, depending on the nature of the business, even a single activity or product may be considered a function.

WHAT IS A TRANSFER, AND WHAT CAN IT INCLUDE?

The transfer a business function may obviously involve – although it is not limited to – the transfer of intangibles. The law describes the transfer of business function as “including the opportunities and risks relating thereto, as well as the business assets transferred or leased in connection therewith or other advantages”. This is the general definition and it corresponds more or less to a specific aspect of a business such as production, R&D or sales. However it is always possible to break down the analysis a little further, for example by distinguishing between different types of sale as in the 2010 guidance document.

WHAT ABOUT DUPLICATION OF FUNCTIONS?

According to the tax administration, a duplication of functions can give rise to a transfer. Thus if a function is duplicated outside Germany, and the German function operates at a reduced level in the following five years, this will be treated as a relocation. The implication is that the principle will not apply where, for example, a factory is established outside Germany but no German plant is closed. The tax administration has indicated that the question of whether the German function is operating at a reduced level is to be addressed by reference to the turnover attributable to it. The 2010 guidelines have introduced an exemption, which applies where annual turnover falls by no more than the threshold of EUR 1 million.

b) Valuation

After identifying a particular type of transfer, the crucial issue of valuation should be discussed. In this regard, the OECD is seeking to provide clearer guidance on the selection of the appropriate method and on whether the valuation methods should include those used for non-tax purposes (financial valuation methods, aggregation of intangibles for valuation purposes, and valuations carried out at a time when the value is highly uncertain). Meanwhile, tax authorities sometimes adopt unexpected

[2] Funktionsverlagerung: section 1 paragraph 1 German Foreign Tax Act - Außensteuergesetz

approaches that raise challenging transfer pricing issues and create uncertainty for taxpayers.

The valuation of the transfer package under German law relating to the transfer of business functions

It is important to note that the value of the relocated function is not based on the value of an individual asset, but on the total value of the entire function. This is usually referred to as a “transfer package”.

When dealing with intangible assets, it can be difficult or impossible to find comparables. As a result, the German tax administration has introduced the hypothetical arm’s length price as a new pricing category, to be used if an adequate transfer price cannot be determined by applying the standard transfer pricing methods. To calculate the hypothetical arm’s length price of the assets, it is necessary to determine the range between the transferor’s minimum price and the transferee’s maximum price (assuming full information and an adequate interest rate). Within this range, if the price most likely to correspond to the arm’s length price cannot be readily assessed, the median value should be used.

The valuation is carried out on the basis of net profits, including any asset or benefit and any market advantages of the acquiring entity. As a consequence (and to the extent that it affects the transaction) the hypothetical arm’s length price takes goodwill into account. Additionally, the law assumes that independent parties would have agreed on a one-time price adjustment clause, which would bite in the event of a major change in price. A clause of this kind, applicable for a ten-year period, will be deemed to apply unless it can be demonstrated that such clauses are not common as between independent parties in the relevant sector. However, the relevant regulation limits the scope of the hypothetical arm’s length price so that valuation of individual assets will be allowed in cases where:

— Only single assets are transferred or leased,

— Only services are provided,

— The transaction does not fall to be treated as a transfer of a business function by an independent party,

— Only staff are transferred,

— The receiving entity is to perform the function only for the benefit of the transferring entity, and the remuneration is to be based on the cost-plus method,

— The intangible assets have a value less than 25% of the total value of all transferred assets (based on individual valuations),

— A relevant intangible asset forming part of the transfer package can be clearly distinguished and is exactly defined. “Relevant” means that the value of the asset is at least 25% of the total value of all single assets transferred (based on individual valuations).

As a result, overall valuation of the transfer package can be avoided if one of the (fairly numerous) conditions for exemption is met. The intangible asset in question may then be valued on a single asset basis, using a standard valuation method. Needless to say, this process must be properly documented.

Finally, the German regulation on the transfer of business functions may conflict with many double tax treaties and with European Union (EU) law, as, for example, there is a risk of double taxation. Therefore, the relatively new law on relocation of functions will be subject to further interpretation and should be monitored by German taxpayers and their advisers.

The French case: valuation for the purposes of determining a royalty rate[3]

The case detailed below illustrates valuation issues encountered in a French action.

THE FACTS

A French group called ABC acquired a foreign group, DEF, which owned a prominent international brand. Following the acquisition the parent company decided to rebrand some of its activities using the DEF brand.

The French company bore the cost of the rebranding process in part, but not in full as some of the marketing costs were borne by the foreign company which owned the knowledge and know-how. In order to use the DEF brand, the French company concluded a "brand licence agreement" with DEF, its legal owner. In addition to the right to use the brand, the licence gave ABC the benefit of DEF's foreign marketing expertise and know-how, and of the advice this enabled DEF to provide with a view to maximizing the impact of the rebranding exercise. Accordingly, the French company had to pay a minimal royalty fee (less than 2%) to DEF.

At the point of its acquisition by ABC, DEF had already entered into agreements of this type with various other parties, some related, some absolutely unrelated, and some practically unrelated. This latter category consisted of companies which were controlled by either ABC or DEF, but which had constitutional restrictions under which certain decisions could not be made unless (i) shareholders were unanimous, or (ii) a specific proportion of votes was achieved (with neither ABC nor DEF having sufficient voting rights for this purpose).

The need to persuade minority shareholders to approve the transaction meant that the negotiation was at arm's length when viewed from an economic perspective, even though from a legal perspective the licensor and licensee could be regarded as related parties.

THE DETERMINATION OF THE ROYALTY RATE

The determination of the royalty rate was based on a complex economic model. This had not been devised purely for tax purposes, and in fact the group intended to enter into royalty agreements with unrelated and practically unrelated parties. The nature of these transactions was therefore such that they were concluded at arm's length.

The model was primarily based on a profit split method. The added value the DEF brand could bring to the licensee was assessed and then split between licensee and licensor. A number of criteria were used to determine the split. These included various measures of the parties' respective bargaining power, and whether it was possible to capture the brand's potential added value.

A Comparable Uncontrolled Price (CUP) method was also used, under which there was direct reference to comparable uncontrolled price royalty rates which had been applied to transactions between unrelated parties. This was used as a supporting method to verify that the intended rate satisfied the arm's length principle. Reliable data was available for this purpose, since DEF had already granted licences of exactly the same type to unrelated parties in various countries. Accordingly, there was a relatively robust basis for the determination.

DISPUTE WITH THE TAX ADMINISTRATION

A tax audit took place in France a few years later. This was restricted to a certain number of years under a statute of limitation. In a first attempt to adjust the companies' results, the French tax administration (FTA) issued a reassessment notice based solely on the brand transfer. The FTA accepted in writing that the model had been suitable and that it had been appropriate to use the profit split method, stating that the CUP

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[3] Presented by Arnaud Le Boulanger

method was not robust enough to be used on its own. However, it disputed the royalty rate. In so doing it challenged almost all the variables on which the profit split had been based, resulting in a different split and thus a different royalty rate. The FTA provided quite a detailed economic analysis in support of position. It relied not only on information which the taxpayer, as a listed company, had made public, but also on external standards and material which did not always have a clear objective rationale.

One of these was the so-called “rule of thumb”. This derives from the judgment of a US tax court in the thirties, where a judge held that under a licence agreement, as a rule of thumb (or in other words a kind of reasonable guess), 75% of the profits should be retained by the licensee, and 25% should go to the licensor.

Although this hypothesis was purely speculative, a significant part of the tax administration’s analysis revolved around the rule, which it believed to be based on economic reasoning. The FTA also refused to accept the CUP method, stating that there were no comparable situations or markets. The company had such strong grounds for challenging the FTA’s position that it had no choice but to abandon its first attack. In spite of this, it decided to issue a revised reassessment notice based on a totally different approach. One of the arguments the FTA used was that the DEF brand had no value in France, and consequently there had never been any basis for royalties to be paid.

The underlying reasoning was that the replaced brand had had significant value and the taxpayer had not demonstrated that the new brand had brought any value into the French market. The challenge was therefore to the principle of royalty payments and not the royalty rate. Again, the taxpayer had strong counter-arguments. To mention only one, net profit in France had increased very significantly after the rebranding exercise, making it unreasonable for the administration to claim that the brand had no value.

This example shows how valuation can be approached differently by taxpayers and tax administrations, meaning that the taxpayer may need to produce very detailed economic analyses in order to defend itself against the administration. The taxpayer may also have the difficulty of facing an analysis by the tax administration which appears to be based on extensive and objective (since external) data, but which is actually invalid because the data has been misused. The sheer volume of data requiring analysis, and the sheer number of false claims, means that it is not always easy to show how wrong the tax administration’s position is. In this particular French case, valuation was not the only issue raised.

c) The concept of economic ownership

The question of economic ownership is of particular importance when it comes to the transfer pricing aspects of intangibles. Indeed, this issue is among those identified for the OECD programme of work for 2011. The OECD intends to provide guidance on the position where an enterprise is entitled to share in the return from an intangible it does not legally own.

Although there is no legal basis for this concept in French law, in the case in question the FTA relied on ABC’s economic ownership of the DEF brand within the French market as a basis for adjusting the company’s results. The brand was in fact sold to a related company located in the same foreign country as the previous owner. The capital gain resulting from the sale was significant. The FTA claimed that a substantial part of the capital gain was taxable in France because the French company “was the economic owner of the brand, as it had developed the associated brand awareness in the French market”. Completely overlooking the inconsistency this involved, and showing a serious misunderstanding of the actual facts (including what entity had borne marketing costs relating to the brand, and in what amount), the administration issued another massive reassessment notice.

Although the matter is not yet resolved, it is possible to make several interesting comments at this stage. If, in spite of the lack of any legal basis, the FTA is prepared to use economic ownership as the sole basis for determining where value is located, it could become relatively easy for a French taxpayer to move IP out of France. This could be done simply by moving the "economic" ownership.

From a practical standpoint, the case underlines the importance of sophisticated and complex economic analyses as the best defence against irrational attacks motivated by the amounts at stake. It also emphasizes the lack of any clear methodology for determining the existence and value of intangibles. The notion of economic ownership of an intangible, amongst other issues, is a delicate topic that will clearly need to be addressed in the foreseeable future.

Choosing the best location for an intellectual property (IP) holding company

Irrespective of the difficulties already described, when dealing with tax planning in relation to intellectual property, multinational groups will often, if not always, take steps to maximize the benefit of their intangible assets. From this perspective, and to the extent that companies are able to centralize ownership and control of the group's intellectual property, consideration needs to be given as to the most appropriate legal structure for ensuring ongoing benefits in terms of both tax and transfer pricing. Such structures, whose value is primarily constituted of intangible assets, are often referred to as Intellectual Property Holding Companies ('IPHC' or 'IP HoldCo').

Three working examples, provided by Nick Foster-Taylor (CMS Cameron McKenna, London), Tamás Fehér (CMS Cameron McKenna, Budapest) and Agnieszka Wierzbicka (CMS Cameron McKenna, Warsaw), identify the criteria to be taken into account in choosing the best location for a HoldCo.

a) The UK case

The first case involved a multinational group based in the UK that already had significant IP ownership and substance in other jurisdictions, specifically in the United States and in Belgium. Historically the group's strategy had been to acquire businesses in local jurisdiction in order to provide them with footprint, staff, brands and manufacturing capacity. However, those locations had different tax structures and the organic growth had not generally been integrated into an overall tax plan. It had subsequently been determined that the group needed to establish a clear IP strategy. And this would also be a good opportunity to positively influence their global tax position using the valuable intangibles owned by the group.

Several criteria were used in order to decide where the IPHC would be located, addressing a number of different commercial and logistic issues. In the first instance the primary driver was to maximize the effective tax rate management, addressing the immediate and long-term cash and tax costs and benefits that would result from the IPHC structure. A critical factor in this instance was the potential one-off tax cost of transferring key IP into the IPHC, and the extent to which ongoing inbound royalty revenue to the IPHC could be sheltered. (For TP purposes, any movement of an IP asset or an intangible generally needs to be remunerated at an arm's length rate and a capital gain will usually be generated in the jurisdiction selling the intangible.)

The combination of enduring tax losses in the target IPHC jurisdiction, and the potential to ultimately offset any capital gain on transfer of the existing IP against anticipated capital losses in the legal entity selling that asset, meant that the tax cash position on establishing the IPHC was extremely attractive to the group. Another significant aspect of the choice of jurisdiction is the issue of the legal protection of the IP in question. It is often an area which is marginalised in the process of tax and transfer pricing planning. Typically, an off-the shelf IPHC structure will concentrate on jurisdictions that are low tax, but the intricacies of legal protection of different types of intellectual property should not be neglected. There have been cases where clients have anticipated establishing their HoldCo in a typical low tax jurisdiction before realizing that they would have significantly reduced rights in contesting infringement, and the commercial risk ultimately negated any potential tax benefit. Underwriting any IPHC structure and minimizing the risks of tax authorities contesting the basis of any tax planning exercise of this kind is critical. With this in mind, the implementation of Advanced Pricing Agreement (APA) procedures is extremely attractive when considering the location of the IPHC. With more consistency on a European and global basis for bilateral and multinational agreements, choosing an IPHC location which has prescribed APA methods is always attractive.

Finally, an increasingly important element in IPHC location is the perception of the external market to any asset offshoring, highlighted by ongoing vehement criticism in the US of multinationals exporting key intangible assets to so-called tax 'havens'. Given this type of scrutiny, any IP management exercise that has a high-profile impact should be analyzed and managed accordingly. In this instance, to offer a combination of business substance and long-term tax cash benefit, and to satisfy commercial and regulatory requirements in relation to the group's IP, the location chosen for the IPHC was Belgium. The use of an apparently unusual jurisdiction in this exercise is a good example of how only detailed analysis of all current and future tax and business influences in each individual case will result in the most effective IPHC structure.

b) The Hungarian case

Tamás Fehér, of CMS Cameron McKenna's Budapest office, also presented criteria that might be taken into account when choosing a suitable jurisdiction for an IP holding company.

The first issue to be considered is the corporate tax rate. In Hungary, the rate is quite peculiar as it is progressive. The lowest tax rate is 10% and the highest is 19%. Then comes the issue of whether IP purchases or transfers are tax deductible. In Hungary, where intellectual property and royalties are concerned, 50% of gross royalty income is deductible from the tax base. Another point which should not be overlooked is that there is an unlimited tax loss carry forward regime, so that where a company uses tax losses or generates tax losses in any given year (observing the anti-avoidance rules) that company can carry those losses forward indefinitely. Another key factor is whether or not withholding tax applies on royalties. In Hungary, there is actually no withholding tax on outbound royalty, interest and dividend payments, as long as these are paid to non-individuals. This applies irrespective of the jurisdiction of receipt, which may be within or outside the EU, and may be a high or low tax jurisdiction.

Enhanced tax deductibility of R&D costs and deductibility of subcontracted R&D are also factors to be taken into account. In Hungary there are generous R&D incentives, and these extend to subcontracted R&D. Under this regime, it is possible to deduct 200% of the direct R&D costs from the tax base. The scope for optimizing the tax position is enhanced by the fact that, as long as the HoldCo does not subcontract its R&D activities to another Hungarian entity (which would be able to benefit from the same deduction) subcontracted R&D costs may be deducted in the same way.

Anti-avoidance legislation is another matter to be considered. Such legislation is especially relevant to the question of whether costs are tax deductible. This needs to be looked at carefully because there is a general provision under which costs which are not associated with the business activities are not deductible. This rule is very often used – and sometimes misused – by the Hungarian tax administration as a basis for carrying out reassessments.

In light of the above, Hungary might initially appear to be an "idyllic location" for establishing an IPHC. However, Tamás Fehér's view is that Hungary's rapidly changing tax laws present a major problem. To a certain extent it is true to say that such changes are commonplace in many other countries, but in Hungary it is possible for very fundamental changes to occur over very short periods of time. This, combined with an uncertain political climate and the potential for other unforeseen changes, reduces Hungary's attractiveness as an IPHC location.

One effective way to mitigate some of these risks could be to apply for a binding ruling or APA (as the case may be) both of which are available in Hungary. Although these options are somewhat costly, when used correctly they offer a reasonable level of certainty with regard to future taxes (in the case of a binding ruling), or arm's length prices (in the case of an APA). This of course is subject to any changes in the law. In conclusion, when choosing a location for an IPHC many criteria need to be scrutinized, and it is of the utmost importance to be aware of all the consequences of the choice. This is clearly illustrated by the following case.

c) The Polish case

It is always crucial to be aware of the law in force in the jurisdiction in which you are planning to acquire or sell a business. This factor can dictate the success or failure of a transaction. To illustrate this statement, Agnieszka Wierzbicka presented a Polish example that took place a few years ago.

The case concerned a client which was selling a business in Poland. The business involved was in fact a branch consisting mainly of intangible rights (a product brand). The seller and buyer entered into negotiations and agreed that the branch would be sold without its debts. The price proposed was EUR 50 million. It seemed possible to regard the branch as the organized part of an enterprise, since it had its own customers, employees, suppliers, contracts, assets, IP rights etc. Nevertheless, as the debts were not to be transferred the parties decided to ask the tax authorities whether the subject-matter of the transfer was to be considered as part of an enterprise. Surprisingly, the tax administration determined that only assets that were being transferred, and not a part of an enterprise.

This issue is of crucial importance in Poland, since transaction tax does not apply where VAT is payable, but does apply to a transfer of part of an enterprise which is not subject to VAT. Accordingly, the tax authority's ruling fundamentally changed the transaction, and the price increased from EUR 50 million to EUR 50 million plus EUR 11 million in VAT (instead of EUR 1 million in transaction tax), because the transaction was viewed as a sale of assets.

Finally, special consideration should be given to the timing of the application for a ruling. In fact, in Poland this leads to different types of protection. On the one hand, if the application is made before the transaction, and therefore before any tax consequences have occurred, the applicant is fully exempt from paying any tax which would otherwise arise from the factual situation covered by the ruling. This is the fullest protection which can be achieved. On the other hand, if the ruling is obtained after the transaction, the applicant is only protected from fiscal penalties, and the tax itself will remain payable.

In conclusion, there are significant and complex issues surrounding the value and impact of intangibles on any given business, and this has made them a priority for multinationals as well as tax authorities worldwide. The aim of this article, and above all the conference to which it relates, was to present concrete and practical examples of the different problems that may arise in relation to intangibles. For the time being, a major conclusion that might be drawn is that in order to achieve effective tax and asset management, dealing appropriately with intangibles, a multi-jurisdictional, technical and cultural approach is key. This crucial subject remains delicate, and until clear guidance is given both taxpayers and tax advisors should be sure to give it particular attention.

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