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TAX IN A CHANGING WORLD: THE TRANSFER PRICING OF INTANGIBLE ASSETS¹

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'What seemed unthinkable 15 or 20 years ago is now a reality. In some respects, the world is becoming a single market with businesses from around the world competing for the same projects, no matter their geographic location...It is within this context that transfer pricing is constantly evolving.'²

'The lack of good information about intangibles leads to...opaqueness, volatility, and perceptions of unfairness in capital markets, and it makes designing a fair tax system more difficult'.³

INTRODUCTION

While transfer pricing has risen to the forefront of international tax issues in the last two decades, this has coincided with a concomitant increase in the importance of intangibles in the global economy. The so-called 'new economy' of the 21st century has seen business enterprises, particularly multinational business enterprises, divesting themselves of tangible assets while turning to intangible assets to enhance their standing in a world increasingly focused on technological innovation.

The spiralling cross-border trade in intangibles has compelled revenue authorities to scrutinize the tax treatment of these assets, along with the realisation that traditional

¹ This paper was presented at the Tax Research Network Conference, Edinburgh, September 2005.

² Brenda J. Humphreys and Saul Plener "Transfer Pricing for the Owner-Managed Business: Not Just a Big Company Problem!" published in the *Report of Proceedings of the Fiftieth Tax Conference* (Canadian Tax Foundation, 1999) p. 40: 2.

³ Margaret M. Blair and Steven M.H. Wallman *Unseen Wealth* Report of the Brookings Task Force on Intangibles, (Brookings Institution Press Washington, D.C. 2001) p. 3.

tax practices may be difficult or even impossible to apply to such inter-affiliate transactions. This is especially the case where unique or high-value intangibles are concerned. There is a need to investigate relevant, creative and flexible solutions to this issue.

This paper will look at the problems inherent in dealing with the transfer pricing of intangible assets in the context of the uncertainties and challenges surrounding the taxation of such assets in a changing world. Certain measures taken by the US and Australian revenue authorities, countries at the forefront of this rapidly evolving area of taxation law, along with views expressed in the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the OECD Guidelines) will be examined on a comparative basis.

REVENUE AUTHORITIES ARE NOW FOCUSING ON INTANGIBLE ASSETS

One of the factors linked to the more effective operation of transnational businesses, and hence to the growth of related-party trade in both volume and scope, is the increasing role of valuable intangibles in the economy.⁴ The OECD Guidelines cite one of the reasons for the rise of the multinational enterprise (MNE) in the global economy over the last twenty years to be technological progress.⁵ Studies reveal that international production is presently carried out by at least 61,000 MNEs with over 900,000 foreign affiliates, representing foreign direct investment of about US\$ 7 trillion.⁶

Transfer pricing in an international taxation context in essence refers to the division of intra-group profits (or losses) where members of a multinational group are jointly responsible for those profits (or losses). The scope for disagreement on this profit

⁴ Robert Turner, Ernst and Young, Toronto, *Study on Transfer Pricing Working Paper 96-10* Prepared for the Technical Committee on Business Taxation, December 1996, p.1.

⁵ OECD Guidelines Preface, para 1.

⁶ United Nations Conference on Trade and Development (UNCTAD) *World Investment Report 2004: The Shift Towards Services* Overview p. 4.

division is considerable, as taxpayers and tax authorities might foreseeably have different perspectives on the appropriate amount of profit to be allocated to a particular member of the group in a specific country, and hence to the amount of tax payable there. This represents a major problem for MNEs, as they are expected 'from the standpoint of the respective tax authorities, to warrant the highest tax base possible to each and every country where they operate.'⁷ In these situations the MNE often suffers double taxation, i.e. the same income is included in the tax base by more than one tax administration, as each argues that they are entitled to it. The climate for controversy is heightened where intangible assets are concerned, due to their often unique nature, which necessitates negotiation and evaluation on a case-by-case basis.⁸ According to the Australian Assistant Commissioner of Taxation - international strategies and operations, David Grecian, one of the big growth areas for transfer pricing is in intellectual property. 'Transfer pricing is easily the most complicated tax work. There is underpinning legislation, but you still have to make judgements on the commercial realities of what the taxpayers are actually doing.'⁹

The arm's length standard is internationally recognised as the benchmark for determining the appropriate transfer price to be allocated to a transaction between two related parties. For example, in the United States, the regulations to section 482 of the Internal Revenue Code, which embody the regulatory framework for dealing with transfer pricing provide that:

'In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.'¹⁰

⁷ ICC Policy Statement *Transfer Pricing Documentation: A case for international cooperation Document 180-46/1rev.9 FINAL* p. 1.

⁸ Paul Koenig 'Transfer pricing audits become more frequent' *PricewaterhouseCoopers International Tax Review Australia* April 2005, p. 1.

⁹ David Grecian quoted in Mark Abernethy 'The Tangled Transfer Pricing Web' (May 2005) 76 *Charter* Sydney p. 37.

¹⁰ US Treasury Regulations Section 1.482-1(b)(1).

Although the arm's length standard seeks to ensure objectivity by treating affiliated enterprises as if they were independent enterprises dealing in the open market, and by evaluating intercompany prices charged accordingly, this is a somewhat fluid concept as the interpretation of what constitutes an acceptable arm's length price may differ from country to country. Furthermore, applying the arm's length standard is especially complex where comparability of assets is reduced due to their different or unique nature, as is the case with intangible assets.

A recent global transfer pricing survey has drawn attention to a changing focus on the part of tax authorities worldwide.¹¹ Companies surveyed in 22 countries have revealed that although the type of transaction most commonly audited remains the sale of tangible goods, the percentage of such audits is decreasing.¹² At the same time, the percentage of audits of intangible property is increasing. Transfer pricing practitioners have expressed the view that 'in future years, transfer pricing and the issues associated with intangible and intellectual property (referred to as "intangibles") will be higher on the radar screen of tax authorities than ever before.'¹³

In the US, transfer pricing experts are predicting an increasing focus by the IRS on international intangible asset transactions, as evidenced by the publication in September 2003 of new draft US regulations on the pricing of services and intangibles.¹⁴ One of the reasons these new regulations were proposed was to prevent taxpayers slipping valuable intangibles out of the United States as part of an integrated services transaction, but practitioners have commented that: 'Although the benefit of hindsight may clarify what transactions involve a disguised intangible transfer, taxpayers, rather than the IRS, may be the ambushed party.'¹⁵

¹¹ Ernst and Young *Transfer Pricing 2003 Global Survey: Practices, Perceptions and Trends in 22 Countries Plus Tax Authority Approaches* in 44 countries 12.

¹² Ibid Figure 5 - Type of Transactions Audited (Parents).

¹³ Ernst and Young, International Tax Services *Transfer Pricing Brief* 'Tax authorities closely watching intangibles in the transfer pricing context' 8 June 2004, p.1.

¹⁴ 68 Frd. Reg. 53448.

¹⁵ Thomas M. Zollo, Christopher P. Bowers and Jeffrey P. Cowan Jr. 'Transfer Pricing for Services: The New Wave Hits' 82 *Taxes* Chicago Jan 2004 p.34.

The current GlaxoSmithKline legal challenge to transfer pricing adjustments made by the IRS - including USD 1.9 billion in adjusted royalty payments for licensed patents and other marketing intangibles - has further highlighted the significance of related-party intangible asset transactions. The main issue here is the contention by the IRS that the company undervalued the importance that marketing intangibles played in the promotion of drugs in the US, while at the same time overstating the importance of research and development (R&D) and marketing performed in the UK. The Australian Taxation Office (ATO) has also recently been reported as experiencing a renewed interest in intellectual property transactions, specifically in relation to marketing intangibles and to the arm's length nature of royalties paid and received.¹⁶

THE NEW ECONOMY

One of the reasons for an increased focus by revenue authorities on intangible asset transactions is the change that has occurred in the way that developed economies operate in the twenty-first century. Companies that once invested primarily in 'tangible' physical assets such as plant and machinery, farm land and mineral resources are now investing in intangible assets such as brand names, human capital, intellectual capital and R&D. Although intangibles are not a new phenomenon, economic forces have propelled intangible assets into becoming the key drivers and major determinants of economic growth and business success:

The competitive atmosphere of the global marketplace has compelled MNEs to focus on continuous innovation, achieved by means of massive investment in intangible assets. A further contributing factor to this surge in the importance of intangibles in global trade is the rise of information technologies, especially the Internet.¹⁷

As a result, many successful MNEs such as Coca-Cola and Ford are divesting themselves of their physical assets in order to concentrate on intangible assets.¹⁸ Pharmaceutical giants such as Merck and Co., and Pfizer, Inc. 'have prospered not

¹⁶ Koenig, above n 7, p.1.

¹⁷ Michelle Markham *The Transfer Pricing of Intangibles* (Kluwer Law International, The Hague, 2005) Chapter 1.

because they have built new factories for manufacturing and packaging pills, but because they have been technological leaders, spending substantial amounts on research and development to develop new pharmaceuticals.¹⁹ An extreme example of a successful 'New Economy'-type corporation is Microsoft Corp., which at the end of September 2000 had only USD 1.9 billion in property and equipment while its market capitalisation was around USD 328 billion.²⁰ Research has confirmed that 'brand development, e-commerce and the sale and consumption of products embodying intellectual property are overtaking the sale of commodities as a proportion of world trade.'²¹ Investment in intangibles has thus become a fundamental source of continuing profitability and increased market share for leading international corporations.

In Australia, the ATO's traditional approach of focusing on the use of intangible property by Australian subsidiaries of foreign MNEs, and thus on whether royalties paid were above what would be paid under an arm's length consideration, has changed with the realisation that Australia is increasingly exporting Intellectual Property (IP). This change in direction has been confirmed by research performed by the Australian Trade Commission (Austrade)²², which demonstrates that there has been strong growth in the number of Australian knowledge-based exporters, especially in businesses specialising in education, professional services and medium to high technology-based manufacturing.²³ It is anticipated that the ATO will now begin requiring Australian taxpayers to demonstrate that they are being adequately compensated for the local development and ownership of valuable intangible property where access to such property is granted to related foreign associates.

¹⁸ Ibid Chapter 3.3.1.

¹⁹ Blair and Wallman, above n 2, p. 1.

²⁰ Ibid.

²¹ Jill McKeough, Andrew Stewart and Philip Griffith *Intellectual Property in Australia* (Lexis Nexis Butterworths, Australia, 3rd edition, 2004) p. 605.

²² The Australian Trade Commission (Austrade) is the Australian Government agency that helps Australian companies win overseas business for their products and services by reducing the time, cost and risk involved in selecting, entering and developing international markets.

²³ Tim Harcourt, Chief Economist, Australian Trade Commission, Sydney 'Knowledge exports for a knowledge economy' Friday 15 November 2002, p.2.

PROBLEMS IN DEFINING AND VALUING INTANGIBLE ASSETS

There are inherent challenges for taxpayers and tax authorities alike in dealing with the transfer pricing of intangibles, due in part to the elusive qualities of these assets in an increasingly knowledge-based economy:

'By their nature, intangibles are harder to measure, to quantify, to manage - harder even to define - than tangibles... there is no common language for talking about intangible sources of value, and what language there is tends to be ad hoc and descriptive rather than quantitative and concrete, making comparisons from one institutional situation to the next impossible.'²⁴

In the United States, an attempt has been made in the final regulations of section 482 to define as intangible any asset falling into one of six broad categories which has substantial value independent of the services of any individual.²⁵ Although many types of intangible are directly listed, such as patents, inventions, designs, copyrights, trademarks, brand names, franchises and methods, and a catch-all category of 'any other similar item' that derives its value from its intellectual content rather than its physical attributes has been included, this list is not exhaustive, and clearly falls short of including some of the less traditionally recognisable forms of intangibles, such as human capital intangibles.

In looking at what constitutes intangible property, the OECD Guidelines concentrate on business rights, ie. on intangible property associated with commercial activities.²⁶ They classify such commercial intangibles into two main categories, namely trade and marketing intangibles.²⁷ Trade intangibles encompass patents, know-how, designs and models, while marketing intangibles are defined as a special type of commercial intangible including trademarks, trade names, customer lists and distribution channels as well as unique names, symbols or pictures with important promotional values.

²⁴ Ibid p. 2.

²⁵ US Treasury Regulations Section 1.482-4(b).

²⁶ OECD Guidelines para. 6.2.

Unfortunately, problems arise even within these broad definitions, as the OECD Guidelines acknowledge 'know-how' to be an imprecise concept, which may include secret processes or formulae or other secret information that is not covered by patent.²⁸ A further complication is that know-how and trade secrets can be either trade intangibles *or* marketing intangibles,²⁹ and it can also be difficult to distinguish income arising from trade intangibles from that arising from marketing intangibles.³⁰

In Australia, Division 13 of the *Income Tax Assessment Act 1936* ('ITAA') deals with transfer pricing in terms of international agreements and the determination of the source of certain income. Section 136AA(1), which deals with definitions pertaining to this Division, does not contain a specific reference to intangibles. The closest definition refers to 'property', which includes a chose in action, any estate, interest, right or power, whether at law or in equity, in or over property, and any right to receive income and services.

There is currently no global definition of intangibles, and thus in a multinational context problems can arise where intangibles are differently defined in different jurisdictions. This lack of clarity is exacerbated by the fact that as industries in the new economy have become more knowledge-intensive, there has been a wider recognition of less traditional forms of intangibles, including human capital intangibles, advertising slogans, business models or strategies as well as unique business cultures and philosophies. It is evident that national definitions have failed to keep pace with the continual changes and extensions to what formerly were defined as intangibles.

An Australian Government Consultative Committee on Knowledge Capital (AGCCKC) paper on knowledge capital and the management of intangibles postulates that intangibles can best be defined by separating them into two categories: so-called

²⁷ Ibid para.6.3.

²⁸ Ibid.

²⁹ Ibid para. 6.5.

³⁰ Ibid para. 6.12.

'hard' and 'soft' intangibles.³¹ According to this definition, hard intangibles encompass information protected by law, such as trademarks as well as non-accounting value evidenced by financial transactions such as goodwill. Soft intangibles on the other hand include knowledge assets, i.e. 'what people know', relationship assets, i.e. 'who people know', emotional assets, i.e. 'motivation levels' and time assets, i.e. 'effectiveness levels'. While this may be a simple and useful categorisation, organisations have not necessarily kept abreast of the changing forms that intangibles may take. 'Currently, people are aware of hard intangibles and often fail to understand soft intangibles exist. That is even more problematic when 90 per cent of intangibles are soft intangibles.'³²

Measuring or valuing intangibles is also an area fraught with difficulty. Accounting practice in relation to intangibles, especially in a new economy populated by intangible-rich companies, is generally acknowledged to be in need of reform on a worldwide basis. Peter Fritz, the chair of the AGCCKC, believes the central problem to be an entirely outdated methodology of intangible valuation that has no place in the 21st century. He has dismissed the impending rollout of the International Financial Reporting Standards (IFRS) in Australia by stating: 'Reporting intangible assets is an issue the accounting profession has walked away from'.³³

With the adoption of International Accounting Standards for Australia from 1st of January 2005, the new Standard 138 of the Australian Accounting Standards Board (AASB)³⁴ has changed the reporting and accounting for intangible assets in Australia in that self-developed brands, mastheads, publishing titles, customer lists and similar items will no longer be recognised as intangible assets. One of the many concerns raised by this change is that it will:

'result in a derecognition of many existing intangible assets. It essentially ignores how self-generated or homegrown brands, as opposed to acquired brands, can create shareholder value

³¹ AGCCKC paper on knowledge capital and the management of intangibles written by Chris Liell-Cock and Dr Ken Stanfield, referred to by Tamara Plakalo in 'Accounting for the uncountable' February 11 2005 <http://www.smh.com.au/technology/>

³² Ibid.

³³ Ibid.

³⁴ The Australian equivalent of International Accounting Standard 38 (IAS 38).

and prohibits the recognition of other internally generated intangibles, such as human capital intangibles, as assets.³⁵

The disconcerting effect of this new standard is that, in an era in which investors are clamouring for more detailed information on intangible assets, the reporting of certain internally generated intangibles will actually disappear from financial statements. Likewise, the US Financial Accounting Standards Board (FASB) does not require the valuation of internally generated intangibles. The problem is a worldwide one: while companies are investing heavily in intangible assets, there is a dearth of financial reporting of such assets.

Microsoft considers software development, its core competence, as an expense and writes it off in the year incurred. English football clubs do not include the value of their players in their accounts. Reuters, the leading electronic information provider, acknowledges that its balance sheet does not include the global databases of financial information or its software and other intellectual property.³⁶

One of the reasons why many accountants refuse to include certain intangible assets in published financial statements is that they are inherently different to tangible assets. Intangible assets are often heterogeneous, defying comparability. One hour of software programming does not necessarily equal another hour³⁷, while 'in the pharmaceutical industry only one in 4000 synthesised compounds ever makes it to market and only 30% of those recover their development costs.'³⁸ Human capital intangibles are especially difficult to measure. While the potential output contribution of a new computer may be quantified, the contribution of a new computer programmer is less easily measured.

Thus by comparison with tangible assets, intangible assets are highly unpredictable. Intangibles do not follow standard depreciation rules. Some depreciate rapidly, some

³⁵ Markham, above n 16, Chapter 3.3.3.

³⁶ Charles Goldfinger 'Foundations of the Knowledge Economy: Shift to the Intangible' (in German) Contribution to the *Practical Manual of Knowledge Management (Praxishandbuch Wissensmanagement)* Symposium Verlag in November 2002, p. 4.

³⁷ Ibid.

³⁸ Ibid p. 5.

appreciate with age ('like a good wine'³⁹) and others experience ebbs and flows in their lifecycles. While accounting rules are designed to record discrete and sequential transactions, the value created by investments in intangibles is often contextual and dependent on complementary investments in other intangibles, for example the value of a brand may depend on patent rights to some underlying technology or on a creative advertising program.⁴⁰ Moreover, a so-called "failure" in an R&D program might lead to insights that interact with the findings from another program and end up creating value in unexpected ways.⁴¹

Another complication is that intangibles may frequently be 'bundled' with, or 'embedded' in tangible assets, for example, where a new technological process is incorporated into a machine. These interactions can also pose challenges to the valuation of intangibles, as the disaggregation of the tangible and intangible components of an item may be required by revenue authorities

In a changing world where transfers of technology across national boundaries are on the increase, there is a need for a broad, flexible and globally harmonised definition of intangibles in order to promote the free flow of investment. As far as the valuation of intangibles is concerned, in the US Professor Baruch Lev has called for the standardisation of intangibles-related information by an appropriate policymaking body such as the Financial Accounting Standards Board (FASB).⁴² He has also proposed an information system known as the Value Chain Blueprint, which evaluates the fundamental economic processes of innovation from the discovery of new intangibles, their development and implementation and ultimately their commercialisation.⁴³

In Australia, the AGCCKC have stated that what is needed to deal with the widespread move towards investment in intangibles in the new economy is a set of global, comprehensive, tested and accepted standards for financially valuing,

³⁹ Ibid p. 4.

⁴⁰ Blair and Wallman, above n 2, p. 20.

⁴¹ Ibid.

⁴² Baruch Lev *Intangibles: Management, Measurement, and Reporting* (Brookings Institution Press, Washington D.C., 2001) p. 121.

reporting and strategically managing all forms of intangibles. They have also highlighted the need for international awareness and cooperation vis-a-vis knowledge capital, and an ultimate goal of the worldwide recognition and agreement on the measurement of knowledge capital.⁴⁴

OTHER PROBLEMS IN RELATION TO THE TRANSFER PRICING OF INTANGIBLE ASSETS

Ownership Issues

In addition to the problems of defining and valuing intangible assets for transfer pricing purposes, numerous other problems have recently arisen in relation to such assets. There are different concepts of ownership of intangibles, ranging from bare legal ownership to economic ownership. The determination of the ownership of intangible assets is of great importance in relation to their international tax treatment, as generally the owner of such assets in a group situation is entitled to the income stream flowing from such assets.

This is an area that lacks clarity across the US final transfer pricing regulations, the OECD Guidelines and Division 13 of the ITAA in Australia. Legal ownership is largely a matter of form, predicated on the legal registration of patents, trademarks, copyright and designs. Economic ownership, on the other hand, relates more to the substance of inter-affiliate relationships, in that the party bearing the greatest share of the costs of developing or enhancing the intangible (and likewise bearing the greatest risk should the item fail to deliver value) is deemed to be the owner. While economic ownership therefore relates to economic realities, applying legal ownership may lead to a haphazard treatment of intangibles, as proprietary rights strategies vary not only among different countries but also among different MNEs.⁴⁵

⁴³ Baruch Lev 'What then must we do?' in John Hand and Baruch Lev (eds) *Intangible Assets Values, Measures and Risks* (Oxford University Press 2003) p.514.

⁴⁴ Plakalo, above n 30, p. 3.

⁴⁵ Markham, above n 16, Chapter 3.2.1.

When the final transfer pricing regulations were issued in 1994, a radical change in the treatment of intangibles was introduced in that legal ownership was given precedence as far as legally protected intangibles such as patents were concerned (economic ownership is still applied where intangibles not legally protected, such as know how, are concerned). While this move has been criticised by practitioners, the IRS Proposed Section 482 regulations issued in September 2003 not only endorse the application of the legal ownership test, but also allow the IRS to impute legal ownership based on the perceived control of an intangible asset.⁴⁶ Unfortunately, 'the language of the proposed regulations in this case gives the IRS broad discretion to recharacterize related party transactions based on subjective judgements.'⁴⁷ These proposed changes to the determination of the income attributable to an intangible have produced further uncertainty, as 'the control standard indicated may not necessarily point to a single owner in all cases.'⁴⁸

The OECD Guidelines do not specify whether a legal or an economic ownership test should be applied to intangible assets for transfer pricing purposes, which has led to conflicting interpretations as to which ownership test they endorse. The Australian legislation is likewise silent on this point. While 'the economic ownership test appears to be the yardstick most closely aligned with economic realities'⁴⁹ it now seems unlikely that this test will be globally applied.

Transfer Pricing Methodology Issues

Revenue authorities in the United States and in Australia favour so-called traditional transaction methods for determining whether the transfer prices charged between related entities in a group situation comply with the arm's length standard. These methodologies, which have also been endorsed by the OECD Guidelines, focus on the comparability of the intangible transaction under review with intangible transactions conducted by independent, or non-related enterprises. However, given the unique

⁴⁶ Proposed US Treasury Regulations Section 1.482-4(f)(4)(i).

⁴⁷ Ken Wood and David Canale 'IRS proposes new rules for intra-group activities' (Mar 2004) *International Tax Review* London p.1.

⁴⁸ Markham, above n 16, Chapter 3.2.3.

nature of intangible property, problems arise when attempting to conduct a comparative analysis.

The OECD Guidelines acknowledge that intangible property may have a 'special character'⁵⁰ which complicates the search for comparables, and that even where business activities are deemed to be sufficiently similar to generate the same profit margin, a minor difference in the property transferred could materially affect the price, necessitating adjustments.⁵¹ In the United States, the use of transaction-based methodologies in relation to intangible asset transactions is restricted to the Comparable Uncontrolled Transaction, or CUT method. This method involves an evaluation of whether or not the amount charged for a controlled, or independent, transfer of intangible property was at arm's length by examining the amount charged in a comparable uncontrolled transaction.⁵² The US Treasury Regulations make it clear that for this methodology to be reliably applied, the intangible being transferred in the uncontrolled transaction should be 'the same' as the intangible under consideration, and be transferred under the same, or substantially the same circumstances.⁵³

The US CUT method corresponds to the OECD Comparable Uncontrolled Price, or CUP method, which is designated for use in evaluating intangible transactions in Australian transfer pricing rulings.⁵⁴ In the Australian context the term 'comparable' has been stated to mean 'the same as, similar to or analogous'.⁵⁵ The ATO has admitted that ascertaining an arm's length consideration is often 'extremely difficult' in practice, and that this difficulty is exacerbated where intangible property is concerned - or indeed where any property that is unique or highly differentiated is involved.⁵⁶

⁴⁹ Ibid Chapter 3.2.2.

⁵⁰ OECD Guidelines para. 6.13.

⁵¹ Ibid para. 2.8.

⁵² US Treasury Regulations Section 1.482-4(c).

⁵³ Ibid Section 1.482-4(c)(2)(ii).

⁵⁴ See for example TR 97/20 'Income tax: arm's length transfer pricing methodologies for international dealings.'

⁵⁵ TR 94/14 'Income tax: application of Division 13 of Part III (international profit shifting) - some basic concepts underlying the operation of Division 13 and some circumstances in which section 136 AD will be applied' para. 353.

⁵⁶ Ibid para. 355.

The unique nature of intangible property has meant that other, less traditional, transfer pricing methodologies have become more relevant in ascertaining the arm's length nature of transactions involving such assets. Profit-based methodologies are seen by revenue authorities as being less closely aligned to the arm's length principle than traditional methods. Profit-split methodologies in turn are viewed with special caution, as they are deemed to incorporate an element of apportionment. They also rely, at least in part, on internal data rather than on independent comparable transactions.⁵⁷ For example, the US residual profit split method attempts to allocate the combined operating profit or loss from a business activity by first allocating income to the routine contributions of the parties in the controlled group using comparables, and then allocating or apportioning the residual profit remaining on the assumption that this profit is attributable to nonroutine intangible property contributed to the activity by the controlled taxpayers.

The main criticism of the US residual profit split method is that this second step does not necessarily involve comparables, as the IRS acknowledges that external market benchmarks may not be available. Although this methodology has been seen as a 'last resort', there now seems to be some acceptance of the fact that where there are no comparable transactions, it may be more practical to focus on the profits actually earned, rather than on the hypothetical profits that ought to have been earned at arm's length in such a situation. The ATO has conceded that while profit split methodologies are a less direct way of applying the arm's length principle, they may be 'most appropriate for cases where a more direct comparability on price or profit margin is not possible or practicable.'⁵⁸ Other OECD countries such as Canada also seem to have become more open to the idea that profit split methodologies can provide the best means of achieving a result in keeping with the arm's length principle where non-routine intangibles are involved and hence good quality comparable transactions are not available.⁵⁹

⁵⁷ Markham, above n 16, Chapter 4.6.1.

⁵⁸ TR 94/14 above n 54, para. 349.

Transfer Pricing Penalties and Audits

Bearing in mind the problems described above with the definition, valuation, ownership and transfer pricing methodologies to be applied to inter-affiliate intangible asset transactions, it is foreseeable that difficulties can arise when MNEs seek to provide revenue authorities with the required contemporaneous (ie accurate, up-to-date and detailed) documentation regarding such transactions. This is especially the case as the trend among these taxing authorities worldwide in recent years has been to introduce more onerous documentation requirements coupled with increasing penalties for any inadequacies in the information provided. Australia and the US were the first two countries to introduce transfer pricing documentation rules in the mid-1990s,⁶⁰ and since then, many more countries have followed suit, seeking to ensure that they secure or increase what they regard as their 'fair' share of an MNE's taxable income.

Where MNEs engage in cross-border transactions involving intangibles, they have to deal with the problem that: 'Tax compliance practices are developed according to each country's own domestic legislation and administrative procedures, therefore each country enforces its own specific documentation rules and regulations, as well as its own particular penalties for non-compliance.'⁶¹ The OECD Guidelines do not provide guidance with regard to specific transfer pricing documentation requirements, and countries have enacted diverse administrative procedures which may differ substantially from country to country.

In Australia, for example, transfer pricing penalties range from 50% of the tax avoided where the arrangement was deemed to be entered into for the sole or dominant purpose of reducing or eliminating tax, to 25% of such tax where the

⁵⁹ See Canada Revenue Agency APA Program Report 2003-2004 Table 5, which demonstrates the profit split method to be the predominant transfer pricing methodology used in Canadian Advance Pricing Agreements.

⁶⁰ Ernst and Young *Transfer Pricing 2003 Global Survey*, above n 10, p. 8.

taxpayer had a reasonably arguable position. In other cases, 25% of the tax avoided must be paid as a penalty, or 10% where the taxpayer has a reasonably arguable position. Unfortunately, no definition of what may or not be 'reasonably arguable' is provided, nor does the ATO specify the extent of the documentation they require, or even a checklist of documentation that is desirable. Instead, it states that it 'does not expect taxpayers to prepare or obtain documents beyond the minimum needed to make a reasonable assessment of whether they have complied with the arm's length principle in setting prices or consideration.'⁶² This 'minimum' will of course vary from taxpayer to taxpayer, as each business will need to be evaluated according to its own individual facts and circumstances, including whether or not it participates in intercompany transfers of intangible property. The ATO recommends that taxpayers should use their commercial judgment according to what a prudent business person would do in such circumstances.⁶³ The onus is thus on the taxpayer to supply all the necessary documentation on intrafirm transactions, and ensure compliance with the arm's length principle. If the documentation supplied by the MNE is incomplete, it will find it difficult to avoid the imposition of penalties.

In the absence of any real guidelines as to the extent and depth of documentation required, it is perhaps no surprise to discover that most companies do not meet revenue documentation requirements. A clarification of the ATO's documentation requirements would greatly assist taxpayers to avoid penalties imposed due to deficient documentation.⁶⁴

In the United States, on the other hand, transfer pricing penalties range from 20% to 40% of the amount of tax that has been underpaid.⁶⁵ The transactional penalty applies to valuation misstatements falling outside a certain 'safe harbour' range, which also result in an underpayment of tax. Here, penalties may be avoided even if a transaction falls outside this range, if the taxpayer can show reasonable cause and good faith.⁶⁶

⁶¹ Markham, above n 16, Chapter 6.1.

⁶² ATO document Schedule 25A instructions 2003, Item 4 *Adequacy of documentation* p. 7.

⁶³ *Ibid.*

⁶⁴ Markham, above n 16, Chapter 6.3.

⁶⁵ See US Internal Revenue Code Sec. 6662.

⁶⁶ See US Treasury Regulations Section 1.6664-4 Reasonable cause and good faith exception to section 6662 penalties. Section 1.6664(c)(1) states 'no penalty shall be imposed under this part with respect to

Once again, what may constitute reasonable cause and good faith is not defined, and requires a case-by-case determination.⁶⁷ The net adjustment penalty applies if the net section 482 transfer price adjustments for the year exceed certain thresholds. Having reasonable cause for the transfer price is not enough here, and there is no good faith exception to the imposition of the net adjustment penalty, increasing the likelihood of its imposition.

In addition to the increasing compliance burden, the risk of a transfer pricing audit is high in both Australia and in the United States. The ATO will, as a matter of principle, review transfer pricing as part of a taxpayer's tax audit or risk review.⁶⁸ Intangibles (both Australian and foreign owned) have been recently reported as receiving particular attention.⁶⁹ Each year transfer pricing audits result in hundreds of millions of dollars' worth of tax and penalties being levied.⁷⁰ Likewise, the IRS is known for extensively regulating transfer pricing⁷¹, and, as mentioned above, on increasingly focusing on intangible asset transactions.

With transfer pricing remaining the 'most significant international tax issue facing international business today, and in the foreseeable future'⁷², and with intangible assets becoming vitally important to a multitude of businesses in the global marketplace, controversy management is emerging as a key priority for MNEs.

any underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.'

⁶⁷ See Internal Revenue Manual, IRM 120.1 A. Reasonable cause: '1.Reasonable cause is based on all the facts and circumstances in each situation and allows the Service to provide relief from a penalty that would otherwise be assessed. Reasonable cause relief is generally granted when the taxpayer exercises ordinary business care and prudence in determining their tax obligations but is unable to comply with those obligations.'

⁶⁸ Ernst and Young *Transfer Pricing Global Reference Guide* May 2005 p.7. In addition, the Ernst and Young *Transfer Pricing 2003 Global Survey* revealed that while 33% of parent corporations surveyed globally perceived intangibles to be particularly susceptible to transfer pricing disputes with revenue authorities, for Australia this figure rose to 48%. See: Ernst and Young 'Transfer Pricing 2003 Global Survey' *Transfer Pricing Brief* 7 November 2003 p. 2.

⁶⁹ Ibid.

⁷⁰ In the 2003-04 financial year, transfer pricing audits by the ATO raised AUD 868.5 million in tax and penalties, while AUD 157.3 million in losses were disallowed. See: Peter Murphy, Transfer Pricing Practice, International Strategy and Operations, ATO, 'Transfer Pricing And The ATO's Compliance Program 2004-5' presented at KPMG Transfer Pricing Seminars, Sydney and Melbourne, October 2004.

⁷¹ A recent study by the US Treasury Department has confirmed that following an internal directive issued in January 2003 requiring auditors to request transfer pricing documentation in all audits with international transactions, requests for such documentation in audits rose from 35% to 55% in the audits studied. See: Sean Foley, KPMG, 'US Outbound: IRS targets transfer pricing compliance' (December/January 2005) *International Tax Review* International Updates p. 1.

CONTROVERSY MANAGEMENT: THE MUTUAL AGREEMENT PROCEDURE

The Mutual Agreement Procedure (MAP), as enshrined in Article 25 has been a part of the OECD Model Income Tax Convention since it was first issued in 1963. It is a controversy management procedure whereby revenue authorities which disagree on the amount of tax to be levied on an MNE in a particular jurisdiction can consult in order to resolve their dispute, if they are linked by a double taxation agreement (DTA) which provides for such a conference.

The rationale for the MAP is the avoidance of double taxation, a situation where the same income is taxed twice by different revenue authorities. Here the corresponding adjustment mechanism seeks to even out the increases in the amount of tax levied by one jurisdiction according to the arm's length principle (the primary adjustment) by a corresponding downward adjustment to the tax liability of the MNE in another jurisdiction. It is immediately evident that tax administrations may be reluctant to forfeit what they regard as their fair share of taxation in order that another tax administration may obtain a larger portion of such tax.

While the avoidance of double taxation is a worthwhile aim, the procedure is notoriously lengthy. According to a transfer pricing expert:

The company that has operations in Australia and the US just wants to get on with business. But if, say, the Australian Taxation Office (ATO) says it wants more of the profits booked in Australia, a company can get caught between two governments and that's not a good place to be. These disputes can drag on for 10 years.⁷³

At present tax administrations are under no compulsion to seek a resolution to their dispute under the MAP. This is because Article 25 simply instructs competent

⁷² Ernst and Young *Transfer Pricing 2003 Global Survey* above n 10, p. 4.

⁷³ Stephen Breckenridge, Baker and McKenzie, quoted in Abernethy, above n 8, p. 36.

authorities (the treaty country representatives) to 'endeavour to resolve' such disputes - they are under no compulsion to do so. Taxpayers have further criticised the lack of transparency and lack of taxpayer involvement in the procedure.

Related-party intangible asset transactions are particularly susceptible to disputes between the taxing jurisdictions involved. This is evidenced by the GlaxoSmithKline case referred to above, where the issues are so complex that two historically cooperative tax authorities, the UK Inland Revenue and the IRS, were unable to reach an agreement under the mutual agreement procedure and a tax court petition has now been filed by the US subsidiary of GlaxoSmithKline PLC.

The IRS has acknowledged the complex nature of intangible asset transactions in an agreement they signed in June 2005 with the Canada Revenue Agency (CRA). This agreement sets out principles and guidelines to improve the performance and efficiency of the MAP under the Canada - US DTA. It lists seven examples of transfer pricing issues that these two competent authorities have failed to resolve to date, including the determination of an arm's-length value for non-routine intangible assets and the characterisation of a transaction as a service agreement or a licensing of intangible assets.

In Australia, the ATO's Assistant Commissioner David Grecian has summed up the situation as follows: 'There are no vanilla cases; you're dealing with intangibles and you're dealing with other taxation authorities. We meet with the competent authorities on a set program called a mutual agreement procedure, but this is still a fine science. Everything is always changing.'⁷⁴

The OECD released a draft progress report entitled 'Improving the Process for Resolving International Tax Disputes' on July 27 2004, which offers some useful suggestions for reducing the number of cross-border tax disputes. A major recommendation has been the introduction of Supplementary Dispute Resolution (SDR) techniques such as mediation and arbitration on either an optional or

⁷⁴ David Grecian quoted in Abernethy, above n 8, p. 38.

mandatory basis. Greater transparency and more efficient timeframes have also been advocated as necessary reforms. While this is a step in the right direction, no final decision as to the implementation of such reforms has yet been reached.

The need to reform the MAP process has also been highlighted by the Pacific Association of Tax Administrators (PATA) issuing guidance to facilitate and support the resolution of MAP cases among PATA members (Australia, Japan, Canada and the United States) on June 25 2004.⁷⁵ While this guidance seeks to ensure the consistent and timely treatment of such cases,⁷⁶ and sets a two-year target for completion of PATA MAP cases, it does not modify the rules and procedures under the domestic law, policies, or procedures of the PATA members in relation to the MAP process. It creates no legal rights and obligations between the members. Whether this guidance will have a beneficial effect on MAP proceedings between PATA members remains to be seen, but the effect of a lack of compulsion to reach a mandatory resolution has already been noted.

CONTROVERSY MANAGEMENT: ADVANCE PRICING AGREEMENTS

An Advance Pricing Agreement (APA) is a formal agreement between the taxpayer and one or more revenue authorities on three basic issues:

(1) the factual nature of the intercompany transactions to which the APA applies; (2) an appropriate transfer pricing methodology (TPM) to apply to those transactions; and (3) the expected arm's length range of results from the application of the TPM to the transactions.⁷⁷

The main advantage of an APA is that potential transfer pricing problems, such as the imposition of double taxation, can be addressed on a prospective basis. Australia signed the world's first APA with the United States in 1991, and both the IRS and the

⁷⁵ MAP Operational Guidance for Member Countries of the Pacific Association of Tax Administrators. (PATA).

⁷⁶ Ibid Section 1 Purpose of Guidance.

⁷⁷ Ernst and Young *Transfer Pricing 2003 Global Survey* above n 10, p. 22.

ATO have promoted APAs as a cooperative venture⁷⁸ which provides taxpayers with certainty as to the tax treatment of their international transfer pricing transactions, including inter-affiliate transfers of technology, for the period of the APA (usually three to five years in Australia, while the US favours five-year agreements). Australian companies are currently leading the global market on the use of APAs, and 83 percent of those who had used an APA would consider doing so again.⁷⁹ The Ernst & Young 2003 global transfer pricing survey revealed that while only 21 percent of US parent companies reported the use of an APA as a controversy management tool in 2003, 80 percent of US subsidiary companies that had used an APA intended to renew their APA.⁸⁰

Practitioners have expressed different viewpoints as to the suitability of using an APA for intangible asset transactions. Some feel that APAs may be too rigid for any industry undergoing constant change. The market for intangibles is of necessity a dynamic one, and it may be difficult to predict an expected arm's length range of results over a three-to-five year period.

What may have appeared to be an appropriate APA to use at the beginning of this period may change at some later point. There may be a need to update comparables, particularly in a field of enterprise (such as computer technology) where advances are constantly being made.⁸¹

Along these lines, a US practitioner has advised that while the APA process may be useful where straightforward issues such as routine intangibles are involved, there may be problems where controversial issues such as the allocation of income with respect to high-value intangibles need to be resolved.⁸²

However, another US transfer pricing analyst has commented that APAs may be especially beneficial where transactions involve unique or technologically

⁷⁸ See the US Rev. Proc. 2004-40, Section 2: Principles Of The APA Program, section 2.01, and the ATO's publication *Advance Pricing Arrangements* NAT 2748-04.2005, p. 2.

⁷⁹ Ernst and Young 'Transfer Pricing 2003 Global Survey', above n 67, p. 2.

⁸⁰ *Transfer Pricing 2003 Global Survey* above n 10, p. 72.

⁸¹ Markham, above n 16, Chapter 8.6.8.

⁸² See the comments of Joel Williamson in R.E. Ackerman et al 'The Real World of Transfer Pricing Today' (Mar 1999) *Taxes: The tax magazine* p. 177.

sophisticated products or transfers of difficult-to-value intellectual property.⁸³ The ATO likewise adopts the view that transactions involving transfers of intangible property are particularly suited to the APA process.⁸⁴

This view is borne out by the fact that APAs have addressed situations involving high-value intangibles.⁸⁵ In the US in the 2004 calendar year, ten APAs dealing with the use of intangible property by a non-US entity were executed, along with six APAs dealing with the use of intangible property by a US entity. In Australia in the 2003-04 tax year, 4 out of a total of 23 APAs completed involved intangibles.⁸⁶ Like the IRS, the ATO encounters a range of APAs involving the inbound or outbound licensing of intangibles every year.⁸⁷

Perhaps one of the main advantages of using an APA where intangibles are transferred in cross-border inter-affiliate transactions and the risk of scrutiny by revenue, and hence the scope for controversy, is high is that a resolution can be reached relatively swiftly.

'A taxpayer can avoid a time-consuming and expensive tax controversy with the IRS by entering into an APA. Because tax controversies have several phases (audit, appeals office consideration, litigation and, in some cases, competent authority consideration), many of the litigated transfer pricing cases have lasted 10 to 15 years from the audit phase through completion. Competent authority consideration alone may take five to seven years'.⁸⁸

⁸³ GERALYN M. FALLON 'Advance Pricing Agreements: Policy and Practice' (September 1995) *Taxes* Chicago p. 493.

⁸⁴ TR 95/23 'Income tax: transfer pricing - procedures for bilateral and unilateral advance pricing arrangements' para.52

⁸⁵ See: Michael Durst, quoted in Robert E. Ackerman et al, 'The Real World of Transfer Pricing Today' (Mar 1999) *Taxes: The tax magazine* p. 177.

⁸⁶ ATO publication *Advance Pricing Arrangement Program - Report on developments in 2003-04* October 2004 NAT 12082-10.2004 Figure 6: APAs completed by subject.

⁸⁷ *Ibid* p.7.

⁸⁸ GERALYN M. FALLON 'Advance Pricing Agreements' (June 1997) *75 Taxes* Chicago p. 307.

CONCLUSION

The reality is that the transfer pricing of intangibles is an inherently complex issue, regardless of the type of controversy management employed in seeking a satisfactory outcome for both taxpayers and tax administrations. Successfully dealing with intercompany transactions involving intangibles is a difficult task for all parties to an APA, especially as at present there is no global definition of intangibles, and even national definitions have failed to keep pace with the continual changes and extensions to what were formerly defined as intangibles.

The situation is further exacerbated by the fact that in many cases, intangibles are not reflected on the balance sheet of the taxpayer, and may even be disappearing from financial statements, making it more difficult to determine the value they have added to a transaction. In some cases, the bundling of tangible and intangible property can cause problems where these elements require disaggregation for tax purposes. The ATO has recognised these problems, stating:

'we try to spend time ensuring that the intangibles are clearly identified before they are rewarded. We have found it necessary to clearly establish the existence and nature of the intangibles before attempting to attribute to them any value or take them into account in applying an arm's length methodology.'⁸⁹

Ownership issues also need to be resolved, especially the tension between 'legal' and 'economic' ownership. In light of the changing stance towards ownership, especially in the US, MNEs need to carefully document and structure their related party transactions in order to avoid a group member being imputed with ownership in situations where this does not reflect the reality of the situation.

Applying a traditional transactional methodology in order to determine the arm's length nature of an intangible asset transaction presents certain challenges, due to comparability issues in relation to their specialised nature. A solution here may be not only for revenue authorities to adapt to the proliferation of intragroup intangibles in

⁸⁹ ATO publication *Advance Pricing Arrangement Program - Report on developments in 2003-04*, above n 85, p. 7.

the global economy by adopting a more flexible stance to the choice of transfer pricing methodology, but also to be innovative in devising new ways of dealing with dynamic enterprises subject to continual change. APAs may be an ideal vehicle for such innovation, as they have the ability to be tailor-made to suit individual fact scenarios. For example, the flexible profit split matrix developed in Australia a few years ago for an APA in the electronics industry was a world first.⁹⁰

There remains a necessity for both taxpayers and tax authorities to realise that significant changes are taking place in the global economic landscape, and that relevant, creative and flexible solutions are required to deal with the fact that 'the present and the future is no longer shaped by physical flows of material goods and products but by ethereal streams of data, images and symbols'.⁹¹

If consensus can be reached between the key players involved in the international tax treatment of intangibles in the transfer pricing context that a new, cooperative and coherent approach is needed to meet the demands of a worldwide shift towards investment in technology, this has 'the potential to release more of the natural dynamism in the business sector to stimulate innovation and encourage global trade in intangible assets. This in turn can only benefit national governments. It is a path worth pursuing'.⁹²

⁹⁰ Jim Killaly 'Transfer Pricing - Compliance Issues And Insights In the Context Of Global Profit Allocation' (Paper presented at the Transnational Crime Conference convened by the Australian Institute of Criminology in association with the Australian Federal Police and Australian Customs Service and held in Canberra, 9-10 March 2000) p. 7.

⁹¹ Goldfinger, above n 35, p. 1.

⁹² Markham, above n 16, Chapter 9.8.