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ABSTRACT: Cym H. Lowell and Christopher Hanna review The Transfer Pricing of Intangibles by Prof. Michelle Markham.

SUMMARY:

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Cym H. Lowell and Christopher Hanna review The Transfer Pricing of Intangibles by Prof. Michelle Markham.

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The Transfer Pricing of Intangibles, by Michelle Markham. Published by Kluwer Law International (2005). 335 pages. Price: $ 173.

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One of the most important current business and tax considerations for any multinational enterprise, whether its parent corporation is formed or based in the United States, Japan, Germany, or elsewhere, is the way it prices goods, services, and intangibles. The transfer pricing policies and practices used in connection with the transfer of assets from one affiliated corporation to another across borders has a greater impact on which government jurisdiction taxes the income generated from international transactions than any other aspect of the tax law. The importance of transfer pricing and its impact on the tax collections of the United States and other countries has brought this subject to the forefront of international tax debates. In fact, the transfer pricing of intangibles (such as the results of research and capital transferred to foreign affiliates) is one of the most important issues facing tax administrators in terms of revenue.

In effect, the governments of countries involved in expanding international trade are competing with each other to assign taxable profits of MNEs into their respective jurisdictions -- the quintessential tax base issue. If two governments assert claims to tax the profits earned by MNEs operating within their respective jurisdictions, MNEs must exercise due diligence to avoid double taxation and tax penalties, which might be imposed after past years' tax returns are examined. Also, MNEs face significant competition from financial markets and competitive pressures to maintain their effective tax rates at the lowest possible level. In many cases, tax expense is often the largest single expense of MNEs.

While MNEs are concerned about low effective tax rates and avoidance of potential double taxation, governments are concerned about the ability of MNEs to shift profits into a low- or no-tax jurisdiction, or more broadly, any jurisdiction other than their own. All tax administrators are particularly concerned about the transfer of intangible assets from domestic to foreign affiliates, thereby permitting the stripping of income from the home country to an affiliate located in a foreign country, which is typically a low- or no-tax jurisdiction.

In today's world, tax administrators appear to be worried that their respective tax bases are eroding as a result of transfer pricing practices that move profits from here to there. Accordingly, more than 50 countries have now adopted transfer pricing regimes that identify this as an issue of major importance, for both inbound and outbound investments./1/ In short, transfer pricing has become the central taxation issue for tax administrators and MNEs alike. A central focus of the intergovernmental OECD is to prescribe transfer pricing guidelines under its model income tax treaty./2/

The world of transfer pricing is a fascinating realm involving the intersection of law, economics, financial accounting, and common sense. It also often involves interaction with the world of intellectual property, as it is the profits earned from exploitation of intellectual property -- "intangibles" in transfer pricing parlance -- that generate transfer pricing disputes between MNEs and tax administrators. Transfer pricing relating to intangibles is one of the murkiest areas of transfer pricing, which is a complex world to begin with. This subject has long vexed transfer pricing practitioners, whether novices or seasoned experts.

Light has been shed on the treatment of intangibles in transfer pricing by a new book titled The Transfer Pricing of Intangibles, by Dr. Michelle Markham, who is an advocate of the Supreme Court of South Africa and a lecturer at Queensland University of Technology./3/ This excellent book of about 300 pages encapsulates the broad spectrum of the subject, including a simple definition of the term "intangibles" for transfer pricing purposes and the means for resolving major transfer pricing disputes between MNEs and tax administrators.

The subject is addressed from the standpoint of law and policy in the OECD, the United States, and Australia (where the author resided at the time of writing the manuscript). That provides an interesting comparison of the views of three different government entities on this vital subject.

The world of transfer pricing is both theoretical and practical, in that every international transaction among related parties has to be priced, with the pricing determining in which country items of income, gain, deduction, or loss will be

reported. To review this new work, we first focus on the structure of the analysis and then address how it handles the principal transfer pricing issues facing the international tax community today, with specific reference to intangible property matters.

Organization and Coverage

The Transfer Pricing of Intangibles is organized in the logical sequence of why transfer pricing for intangible property is an important issue,/4/ followed by a review of definitions./5/ In Chapter 2, Markham develops the problems that are encountered with transfer pricing for intangibles under the prevailing arm's-length standard, which is an area of criticism by academics in general and is reiterated throughout The Transfer Pricing of Intangibles./6/ As is done throughout the book, she does that by focusing on U.S. elements, followed by elements of the OECD and Australia. Markham also offers a recommendation for the problems identified, which, in this situation, is the adaptation of profit-split concepts to deal with difficult cases./7/ That is indeed how such matters are actually resolved in the mutual agreement proceedings between treaty partners, applying the OECD model income tax convention principles./8/

In Chapter 3 Markham addresses the difficult topic of achieving an arm's-length analysis of intangible assets involved in related- party transactions. The author correctly notes that this process is difficult because of the inevitable lack of comparable transactions, which is the bedrock of the arm's-length principle. She also notes that the valuation of intangible assets is emerging as a "key driver of corporate value" in the new millennium (that is, the so-called new economy of the 21st century)./9/ In the absence of comparable transactions to guide the determination of value, the OECD, the U.S., and Australian experience is to seek a means of making arm's-length determinations, or at least something akin to an arm's-length process. Markham's recommendation in this critical context is for some type of safe harbor to evolve, while also recognizing that tax authorities are skeptical of safe harbors, because they fear that the existence of bright-lines simply facilitates abuse by MNEs./10/

In this critical element of the intangibles issue, it is unfortunate that The Transfer Pricing of Intangibles does not include practical and theoretical illustrations of the alternative means of addressing intangible valuation. Such illustrations would allow the text to grapple with the problems of safe harbors, as well as other artificial (that is, non-market-driven) means of determining value. In fact, the transfer pricing world does have a means of addressing those issues in difficult competent authority (under treaties) or judicial (typically, in the absence of an applicable treaty) cases. The typical solution is the use of profit-split techniques, which are indeed addressed in The Transfer Pricing of Intangibles./11/ The use of illustrations, however, would provide much-needed guidance on how those principles can be applied to address the "key driver" question. Despite the lack of illustrations, the discussion is quite interesting and informative./12/

The same observations apply to the discussion of formulary apportionment as an alternative means of determining the value of intangible property. The Transfer Pricing of Intangibles correctly notes that the formulary method is often used for U.S. state tax purposes and has adherents in legislative and academic circles. However, the approach is formally rejected by the OECD and Australia./13/ Oddly enough, the transfer pricing world embraces the formulary method when all else fails. For example, in the case of so-called global trading, the expressly used method is simple formulary apportionment./14/ Also, the commonly used profit-split method for resolution of difficult cases could just as well be referred to as formulary apportionment in nature. In its recommendation on that topic, The Transfer Pricing of Intangibles suggests the use of formulary principles in difficult cases./15/ We agree with that approach, which is how difficult cases are actually resolved in the practical world, though under the rubric of the arm's-length standard via the profit-split method./16/

The balance of The Transfer Pricing of Intangibles provides a helpful summary of transfer pricing compliance;/17/ administrative means of resolving transfer pricing disputes,/18/ including competent authority processes/19/ and the evolving use of arbitration to address stalled cases;/20/ and advance pricing agreements./21/

Principal Tax Issues

The principal transfer pricing issues facing MNEs, whether U.S. or foreign-based, and tax administrators in 2007 can be summarized as follows:

a. Transfer pricing for intangibles and services. The aggregate of these two subjects has produced significant regulatory activity at the OECD and in the United States and Australia. There is significant controversy in these efforts, relating to how intangibles are to be addressed in conjunction with the provision of cross-border services, including the types of transactions that are perceived by tax administrators as eroding their respective tax bases. The controversy is especially stark regarding cost-sharing, which reflects the tax base protection anxiety of tax administrators with respect to transfer pricing matters./22/

b. Global transfer pricing methods. The advent of transfer pricing documentation-penalty APA regimes in an ever-expanding list of countries puts significant pressure on multinationals to have global transfer pricing methods for important units that can be defended on a global basis. Those efforts, not surprisingly, have their own unique considerations.

c. Transfer pricing enforcement. It seems that there is, in all countries, an invigorated effort to enforce and examine transfer pricing matters, including examination of contemporaneous documentation for purposes of compliance with transfer pricing penalties. That has plainly produced a significantly greater level of examination activity.

MNEs are seeing an even greater level of enforcement activity throughout the world, in developed and developing countries, as internationally accepted means of allocating income among jurisdictions (transfer pricing rules) are being enforced via penalty, examination, and APA regimes, now in about 50 countries. The expansion of those regimes has brought calls, and proposals, for formulating globally acceptable transfer pricing documentation packages./23/

d. Permanent establishment allocations. The most critical current area of substantive international taxation is, no doubt, the continuing work of the OECD to bring more precise definition to the allocation of income or loss once a PE is found to exist in the host country./24/ Those issues have become endemic in some countries for MNEs, with seemingly every examination ultimately adopting a PE theory, seeking (ultimately) to impose a profit-split method on the foreign-based MNE./25/

e. Facilitation of competent authority processes. As the level of transfer pricing controversy grows as a result of all of the evolutions noted above, it is apparent to tax administrators and MNEs that there must be evolution in the so-called competent authority (treaty dispute resolution) process. Innovations being addressed include the OECD monitoring initiative, establishment of benchmarks for transfer pricing method documentation, mediation, and arbitration./26/

f. Effective tax rate focus. The globalization of business has brought tax expense into the limelight as a critical expense issue, including the impact of that expense on market capitalization. Each of the evolutions noted above is pertinent to the effort of an MNE to evaluate its global exposures and devise appropriate means of eliminating unnecessary, duplicative, or inappropriate tax expense./27/

g. Uncertain tax positions. Plainly the most significant issue on the agenda of the tax departments of MNEs needing to issue financial statements under U.S. financial accounting standards is determining how to handle the sudden new demands of Financial Accounting Standards Board Interpretation Number 48, "Accounting for Income Taxes -- An Interpretation of FASB Statement No. 109";/28/ the Sarbanes-Oxley Act of 2002 section 404;/29/ Treasury Department Circular 230;/30/ and related considerations./31/

In the face of those developments, a critical international tax concern of all MNEs is how to satisfy the multiplicity of requirements in the countries in which it conducts business. The nightmare to be avoided is an intensive facts and circumstances examination of transfer pricing policies, risks, and functions of the MNE conducted repeatedly in several countries, with no means of facilitating acceptance of the findings of one tax authority by the tax authorities of other countries.

Each of those areas has an important relationship to transfer pricing for intangibles. While each is noted and discussed in The Transfer Pricing of Intangibles, the coverage could be significantly expanded in the next edition of the text. That, together with illustrations of the application of the principles discussed and recommendations made, would significantly expand the usability of this excellent new text.

Conclusion

In short, The Transfer Pricing of Intangibles is a significant addition to the literature of transfer pricing. The overall topic of transfer pricing is one that is poorly understood by those in the international community, whether working in business, accounting, finance, law, tax administration, or another field. That is especiallytrue regarding transfer pricing for intangibles. This remarkable new book will shed light on these prominent areas of the taxation world -- areas that are in great need of illumination.

* * * * *

Cym H. Lowell is a partner in the law firm of Gardere Wynne Sewell LLP, Dallas. He is the lead author (with Peter L. Briger and Mark R. Martin) of U.S. International Transfer Pricing (Warren Gorham Lamont/RIA 2007) and International Transfer Pricing: OECD Guidelines (Warren, Gorham & Lamont/RIA 2007) (with Richard Hammer and Marc Levey).

Christopher H. Hanna is the Altshuler Distinguished Teaching Professor and professor of law at Southern Methodist University Dedman School of Law in Dallas. He is the author of Comparative Income Tax Deferral: The United States and Japan (Kluwer Law International 2000).

Lowell and Hanna are also the coauthors (with Daniel E. Leightman, Michael J. Donohue, and Mark R. Martin) of a new treatise titled Financial Accounting for Uncertain Tax Positions, which will be published in mid-2007 by Warren, Gorham & Lamont/RIA.

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FOOTNOTES

/1/ See Cym H. Lowell, Richard Hammer, and Marc Levey, International Transfer Pricing: OECD Guidelines (Warren, Gorham & Lamont/RIA 2007), para. 10.05.

/2/ The OECD is an intergovernmental organization headquartered in Paris, which was set up in 1961 to promote policies to achieve sound economic growth and the expansion of world trade. The 30 member states include most of the world's industrialized countries. Id. at para. 16.02.

/3/ Michelle Markham, The Transfer Pricing of Intangibles (Kluwer Law International 2005). In the preface, Markham notes that the book is based on a doctoral thesis at Bond University, Gold Coast, Australia.

/4/ See id. at Chapter 1.

/5/ See id. at Chapter 2.

/6/ See id. at para. 2.4.

/7/ See id. at para. 2.5.

/8/ See infra notes 13-16.

/9/ See Markham, supra note 3, at para. 3.3.1.

/10/ See id. at para. 3.5.

/11/ See id. at para. 4.5.

/12/ Interestingly enough, the text does address the use of profit-split techniques to resolve difficult intangibles issues in the advance pricing agreement context. See id. at para. 8.9.

/13/ See id. at para. 5.3.

/14/ Cym H. Lowell, Peter L. Briger, and Mark R. Martin, U.S. International Transfer Pricing (Warren, Gorham & Lamont/RIA 2007), para. 4.13.

/15/ Markham, supra note 3 at para. 5.4.1.

/16/ See, e.g., Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1983), discussed in Lowell, supra note 14, at para. 4.09[7].

/17/ Markham, supra note 3, at Chapter 6.

/18/ See id. at Chapter 7.

/19/ See id. at para. 7.1.

/20/ See id. at para. 7.2.

/21/ See id. at Chapter 8.

/22/ See Lowell, supra note 1, at Chapter 6.

/23/ See id. at para. 10.05.

/24/ See OECD, "Report on the Attribution of Profits to Permanent Establishments, Parts I (General Considerations), II (Banks) and III (Global Trading)" (Dec. 2006), available at http://www.oecd.org/dataoecd/55/14/37861293.pdf (last visited Jan. 19, 2007).

/25/ See Lowell, supra note 1, at para. 12.02[10]

/26/ See id. at paras. 12.05[7] and 13.09.

/27/ See Lowell, supra note 14, at para. 6.05[3] [k].

/28/ Financial Accounting Standards Board Interpretation No. 48, "Accounting for Income Taxes -- An Interpretation of FASB Statement Number 109" (June 2006) (FIN 48), available at http://www.fasb.org/pdf/fin%2048.pdf (last visited Jan. 19, 2007). FIN 48, which is effective for fiscal years beginning after Dec. 15, 2006, generally provides a recognition threshold and measurement attribute based on a more likely than not standard for the financial statement recognition and measurement of a tax position taken (or expected to be taken) on a tax return.

/29/ Sarbanes-Oxley Act of 2002, section 404 (SOX 404). SOX 404 generally requires each annual report of a public company to include a report by management on its responsibility and assessment of the company's internal controls over financial reporting. SOX 404 also requires the company's auditor to attest to management's assessment of the effectiveness of the company's internal controls over financial reporting.

/30/ Treasury Department Circular 230 (Circular 230). Circular 230 contains regulations governing the practice of attorneys, CPAs, enrolled agents, enrolled actuaries, and appraisers before the IRS.

/31/ See Lowell, supra note 14, at para. 10.07.

END OF FOOTNOTES

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