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OECD Tax Evasion Rules Could Spur IP Operations Shifts

By **Eric Kroh**

Law360, New York (October 7, 2015, 6:33 PM ET) -- The Organization for Economic Cooperation and Development's new transfer pricing guidelines released Monday contain stricter rules for attributing profits from intellectual property, which may require multinational companies to shift employees and operations to satisfy the requirements.

The changes to the guidelines were put forth as part of the OECD's project to tamp down tax base erosion and profit shifting. In a report on transfer pricing, the organization laid out the expectation that profits attributed to intangibles must be associated with risk and development of the intangible and mere ownership of IP is not enough to assign returns to an entity.

To avoid running afoul of the guidelines, companies will have to shift operations to jurisdictions in which they do not already have an adequate presence if they want to continue to benefit from holding intangibles there, according to Alston & Bird LLP partner Henry J. Birnkrant.

"Naked ownership isn't going to work," Birnkrant said. "Multinationals will need to move quickly to match the people and functions with the profits attributable to the IP."

The OECD developed the new guidelines in order to prevent the skirting of tax rules from the moving of intangibles among members of a multinational group of companies. The organization said the growing reliance on intangible property by businesses and the risk of tax evasion through transfers of intangibles made it essential to clarify the rules regarding transfer pricing, or the way that companies in a related group are compensated by other members of the group for goods and services.

Under the guidance released Monday, the OECD said members of a multinational group are to be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles.

The guidance says if a contract between two related companies relating to the use of intangible property does not adhere to the arm's-length standard — that is, if the conditions of the contract are different than they would be if the contract were made between two unrelated parties — then tax administrations can attribute profits to an entity and tax them as if it does follow the standard.

OECD official Marlies de Ruiter, in a Monday presentation explaining the guidance, said members of a multinational group that perform functions such as the development, enhancement, maintenance, protection and exploitation of intangibles must be compensated for those costs even if another member of the group is the legal owner of the intangible.

“The anticipated returns will go to the important functions,” de Ruiter said.

The guidance sets out a framework involving six steps that should be performed to analyze transactions involving intangibles between associated enterprises: identifying the intangibles transferred in the transaction, identifying the contractual arrangement between the parties, identifying the parties performing the critical functions related to exploiting the intangible using assets and managing risks, confirming consistency between the terms of the contract and the conduct of the parties, outlining the actual controlled transactions related to the critical functions, and determining the arm's-length pricing of the transactions, where possible.

De Ruiter said funding is an important factor to consider when determining which members of a related group are performing critical functions related to exploiting an intangible, but that funding must be linked with control over financial risks for an entity to be compensated under the guidelines.

The guidance says a so-called cash box entity, or a member of a group that is rich in capital but does not control the risks or perform other functions associated with the activity it funds, under an arm’s-length transaction generally would not receive returns equal to those received by an investor that does perform important functions and controls risks.

“In that case it will get no more than a risk-free financial return and as we know that is very low at the moment in many countries,” de Ruiter said. “Can it be lower than a risk-free financial return? Yes it can. If it is an artificial structure, nonrecognition will kick in and that may mean that you won’t get anything at all.”

Birnkrant said the concept that an entity that has no ability to control its risks should just get a risk-free return strikes him as an overreach on the part of the OECD.

“To say that it’s a risk-free return is in essence saying there’s no substance to the transaction,” Birnkrant said.

Mayer Brown LLP’s Warren Payne said the transfer pricing guidelines give countries too much latitude to undermine the arm’s-length standard and will set up divisions between the U.S. and the rest of the world.

The transfer pricing guidance provides “a clear opportunity for foreign tax jurisdictions to move away from the arm’s-length standard in a way that could effectively create conflicts between U.S. and foreign tax jurisdictions over which country can claim, and tax, that income," Payne said.

The guidance on transfer pricing and intangibles will work hand-in-hand with new requirements for companies to submit country-by-country reports of income, taxes paid and other economic activity, de Ruiter said. The information in those reports will be shared among countries via an automatic exchange.

Among the data to be included in the reports is the number of employees, retained earnings and tangible assets in each tax jurisdiction as well as an identification of each entity of the group doing business in the jurisdiction and an indication of the business activities they engage in. The information is intended to provide tax administrations information to assess transfer pricing practices and identify whether companies have artificially shifted income into low-tax jurisdictions.

Birnkrant said companies should put themselves in the shoes of tax administrations and consider how the information in the country-by-country reports will appear through their eyes and think about moving employees and operations if it appears problematic.

“Think about what your country-by-country reporting will look like” Birnkrant said. “If it’s going to look as if it’s inconsistent with the guidance on intangibles, look at shifting some functions.”

Officials from the U.S. Department of the Treasury and the Internal Revenue Service have already said the government will put out guidance beginning this year on country-by-country reporting for U.S.-based multinationals that is consistent with the OECD’s recommendations.

--Editing by Jeremy Barker and Kelly Duncan.
