Intangible-Related Return Concept Requires Special Measures, Business Group Tells OECD

By: Kevin A. Bell

A group of U.S.- and foreign-based multinationals, while vigorously objecting to the proposed concept of “intangible related returns” set forth in the Organization for Economic Cooperation and Development’s 2013 revised intangibles discussion draft, have told the organization that adopting such a radical concept would require “special measures.”

In an Oct. 1 letter, the Transfer Pricing Discussion Group said adopting the concept of intangible-related returns would “shift” the OECD transfer pricing guidelines to emphasize functions and deemphasize contracts, funding and risks, thus requiring countries to adopt new legislation and to negotiate new provisions in their tax treaties.

Writing on behalf of the group of interested taxpayers, Steven P. Hannes of McDermott Will & Emery in Washington, D.C., said the OECD should drop the “pretense” that it is within the scope of the arm’s-length standard to incorporate the intangible-related returns concept into the OECD transfer pricing guidelines.

Pascal Saint-Amans, the OECD’s top tax official, said recently that he is “agnostic” concerning the arm’s-length standard. Hannes said countries should recognize that the proposed shift is dramatic, extremely controversial and highly debatable as a matter of sound tax and economic policy and inconsistent with existing income tax treaties that contain language in Article 9—the article governing associated enterprises—like that of the OECD Model Tax Treaty.

The Transfer Pricing Discussion Group consists of U.S.- and foreign-based multinationals in the automotive, chemicals, consumer durable goods, food and beverages, industrial equipment, information gathering and dissemination, news, pharmaceutical, and technical information industries.

Transfer pricing practitioners have universally bemoaned the concept of intangible-related returns, asserting that it would assign returns from intangibles on the basis of functions and disregard contracts, funding and risk bearing.

Legitimacy.

Hannes said that if the OECD proceeds with its approach to returns from intangibles, countries should adopt the concept by way of special measures in order to avoid contentious debates about semantics “or the legitimacy of the proposed solutions.”
An open acknowledgement of the OECD's proposed shift, Hannes said, would improve the quality of the ensuing public discussion on the merits of proposed solutions based on the concept of intangible-related returns.

“Ultimately, the legislative processes in countries will improve any resulting changes in pricing approaches considered and adopted by countries,” he said.

Adopting the OECD's approach to intangibles through domestic legislation, Hannes said, would allow countries to reconcile and coordinate the principles of the approach “with different legal standards used under the other provisions of their law that generally respect the structure of a taxpayer’s transactions if they are implemented consistent with their form.”

Hannes said it is hard to imagine a judge, at least in a common-law jurisdiction, interpreting the language of the current Article 9 of the OECD Model Treaty as allowing the new approach to contractual ownership, funding, and risks and entitlement to intangible-related returns that the 2013 discussion draft proposes for the OECD transfer pricing guidelines.

**U.S. Law.**

Hannes said that if the United States decided to adopt the OECD's approach to returns from intangibles, the U.S. Treasury “would have to address whether the IRS has the authority under the existing statute to do so or whether, instead, legislation is necessary.”

Increasing the compensation for functions by asserting that functions are entitled to intangible-related returns at the expense of rewarding contractual ownership, funding and risk-bearing, Hannes said, “is, with all due respect, not at all consistent with central tenets of transfer pricing statutes and judicial precedents, at least under U.S. tax law.”

Hannes said U.S. courts over many decades have interpreted Section 482 of the Internal Revenue Code to mean that the Internal Revenue Service cannot employ Section 482 to recharacterize or disrespect arrangements between taxpayers that are reflected in contracts and that are implemented consistent with the contracts.

Secondly, he said this case law also holds that marketplace benchmarks prevail under Section 482 over theoretical approaches, including profit split formulas, in determining a related party’s prices, including its markups.

Action 8 of the OECD's plan to combat base erosion and profit shifting has set a deadline of September 2014 for updating Chapter 6 of the transfer pricing guidelines, the chapter on intangibles.

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