

# SPECIAL REPORT

## FORUM: Taxation of intangible assets

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**FORUM:**

# Taxation of intangible assets

FW moderates a discussion on taxation of intangible assets between Emmanuel Llinares, Harlow Higinbotham and Yves Hervé at NERA Economic Consulting.

## THE PANELLISTS



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Emmanuel Llinares is the chair of NERA's global transfer pricing practice. He is an economist specialising in arm's length transaction pricing, asset and business valuations and IP analyses. For nearly 20 years, he has advised multinational companies and their legal advisers on defining and implementing their intra-group pricing policies, valuing assets, including, notably, the pricing of complex transactions. He has assisted them in the context of various restructuring, pricing design and negotiations with tax authorities.



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Harlow Higinbotham is a PhD economist and chartered financial analyst (CFA) with more than 30 years of consulting and research experience in the public, private and academic sectors. He applies his expertise to intercompany pricing controversies. Dr Higinbotham is recognised for developing innovative approaches to comparative functional analyses, the valuation of intangibles and the economic rationale for profit split proportions. He has also developed and implemented unique methodologies for the effective disposition of tax and regulatory review issues.



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Yves Hervé is a managing director in NERA's global transfer pricing practice. Prior to joining NERA, he was a transfer pricing partner at KPMG and German tax leader of the global value chain and digital transformation practice of PwC. Dr Hervé has covered major transfer pricing consulting issues for global clients, from integrated value chain structuring and transfer pricing planning to global transfer pricing compliance issues and documentation, economic solution design, IP valuation, cost contribution solutions, business restructurings, tax audit defence and dispute resolution.

**FW:** Could you explain how, for the purposes of taxation, the term ‘intangible assets’ should be interpreted following the OECD Base Erosion and Profit Shifting (BEPS) initiative?

**Llinares:** The work of the Organisation for Economic Co-operation and Development (OECD) on intangibles has led to a broadened definition of the concept of intangibles, based on the definition: “something which is not a physical or financial asset, and which is capable of being owned or controlled for use in commercial activities”. The OECD refers to the concept of intangibles and not intangible assets. This way, it is recognised that the definition is different and, in practice, broader than both the accounting and legal definition. Also, the definition itself is broad as it is worded as a negative – some have even referred to it as a non-definition. Such a broad definition is an essential part of the BEPS outcome, in that it should naturally better reflect the inherent link between intangibles and value creation. The relevance of the broad character has, paradoxically as it may seem, been confirmed more recently by the reform of US legislation regarding its taxation of foreign profits.

**Higinbotham:** Under the 2017 US Tax Cut and Jobs Act (TCJA), the US Treasury and the Internal Revenue Service (IRS) now explicitly recognises goodwill, going concern value and workforce in place as specific items included in the definition of ‘intangible property’ under the section 482 transfer pricing regulations. Thus, under both the OECD Guidelines and the IRS transfer pricing regulations, taxpayers must recognise substantially all intangible assets in determining arm’s length considerations for the transfer or exploitation of intangible property.

**Hervé:** The new definition of ‘intangibles’ goes far beyond the traditional legal view of ‘intangible assets’, which focuses on the legal ownership, separability and transferability of the assets, as well as the right of



legal owners to exclude other parties from using such assets in the conduct of their own business operations. In the traditional pre-BEPS world, it was assumed that legal ownership over high value ‘intangible assets’ was more or less sufficient to entitle the legal owners to all entrepreneurial profits generated from the existence of such assets. This put intangible asset planning at the heart of setting-up tax-effective intercompany business structures.

**FW:** What complications does the new view on intangibles present for tax-related purposes?

**Hervé:** Arm’s length pricing is the key international economic principle according to which multinationals should price their intra-group transactions. In the application of the arm’s length standard, group profit is allocated and subject to taxation across the globe. Through the BEPS initiative, a new standard on how to consider ‘intangibles’ in arm’s length pricing has emerged. Legal ownership of ‘intangibles’ is no longer the predominant criterion for allocating the arm’s length

return to intangible contributions. It has been replaced by ‘beneficial’, ‘functional’ or ‘economic’ ownership. Under this concept, the OECD member states have agreed that those entities functionally responsible for developing an intangible should be those earning the resulting entrepreneurial profits. It goes without saying that this creates significant uncertainty, since it will be subject to different interpretations and assessments by authorities across the globe, depending on the particularities of the individual cases at hand.

**Llinares:** The broad definition can be viewed as creating some uncertainty with a fear that tax authorities may over exploit the broadness of the definition. In practice, if the intangibles are well defined and characterised, in light, notably, of the value chain analysis, one should be able to mitigate those risks. Intangibles can be seen as the reflection of an enterprise’s sustainable sources of value creation. The challenge, for tax purposes, is to identify the parties within the enterprise driving the value of the intangibles. Meeting that

challenge is the outcome of a serious value chain analysis.

**Higinbotham:** In the US, the IRS is actively challenging historic valuations of transfers of pre-existing intangibles in connection with cost sharing arrangements (CSAs), such as the 2015 *Amazon* case and numerous other similar arrangements established by US taxpayers over the last two decades. As highlighted in the *Amazon* case and the earlier *Veritas* decision, much of the controversy concerns assumed limitations on what intangible assets were required to be included in the buy-in valuations for pre-existing property at the time that the CSAs were established. More generally, the broader definition of intangible assets requires taxpayers to evaluate their arm's length transfer pricing policies by considering substantially all sources of value creation in their business value chains.

**FW: What are the challenges of the new BEPS regulatory framework for the intangible planning structures of multinationals?**

**Hervé:** The new concept of functional ownership of 'intangibles' implies that situations will increasingly arise whereby tax authorities will claim that several

group companies have contributed to such intangibles. This means that the related entrepreneurial profit will have to be split across several jurisdictions. This will make international tax planning effectively more uncertain and international tax compliance more complex. International tax disputes will strongly rise in numbers, volume at stake and complexity.

**Llinares:** The practical challenge is to establish the link between value chain analysis and the role of intangibles in the context of a coherent and comprehensive analysis of the ways in which a company creates value. The introduction of the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions relating to the intangibles to determine the entitlement to an intangibles-related remuneration offers a framework which significantly limits the possibility of mispricing the intangibles, and provides guidelines under which established structures could now be regarded as abusive.

**Higinbotham:** In addition to the challenges posed for CSAs, country-by-country (CbC) reporting and related transfer documentation requirements are forcing companies to adopt more holistic and comprehensive frameworks that describe their value creation processes and

the relative contributions of their different business locations and value-adding functions. Intangibles valuation processes must be consistent and complete across geographies to satisfy potential audit challenges and mutual agreement procedure (MAP) requirements to avoid double taxation.

**FW: What are the implications for effective tax rate (ETR) planning?**

**Higinbotham:** Tax efficient structures need to be aligned with the DEMPE functions, as well as with funding and associated risk taking, if they are going to be defensible under the new OECD guidance and BEPS. This change reduces the appeal of 'tax havens' in favour of structures aligned with favourable tax regimes in countries or regions where business models and location are aligned.

**Llinares:** Intangibles will continue to be a core element for multinationals to manage their ETR. As such, strategies can no longer rely on the mispricing of intangibles; they are likely to be the main driver of a company's ETR, and will also be responsible for more tactical aspects, like the use of losses carried forward or the use of patent boxes.

**Hervé:** ETR planning will become significantly more complicated than in the past. First, certain legacy structures of multinationals are now dramatically exposed to risk. Risk provisions, or the unwinding of certain structures because they are no longer sustainable, will have a negative impact on the ETR, driving it up. Even if a certain structure remains sustainable in principle because it is backed up by economic substance in terms of value creating activities and decision making, it remains that black and white outcomes justifiable under past principles, such as legal ownership predominance, will have to translate into different shades of grey, whereby more often than not intangibles' related profits will have to be shared with other contributing entities. Also, it will become increasingly difficult

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NERA Economic Consulting

to embed business restructurings in a tax effective framework, since the extended ‘intangibles’ definition, for example including goodwill, as well as the functional ownership considerations, imply that tax exit costs when converting to new operating models are likely to increase dramatically.

**FW: What intangibles-related tax structures are under particular risk and how would you advise mitigating against those risks?**

**Llinares:** Any structure where intangibles play a key role in the value chain and where the remuneration of the intangibles stays with the legal owner of such intangibles is at risk unless one can ensure that the majority of the DEMPE functions are performed by the intangible owner in the sense of the new definition. Multinational enterprises should revisit those structures and consider a change in their organisation to better align legal ownership with the substance requirements grounded in a comprehensive value chain analysis and reflecting the DEMPE framework. When a company’s taxation is fundamentally linked to its value creation, a value chain analysis is as imperative to unveil a company’s sources of value creation, and identify which party or parties inside the business are effectively contributing to intangibles.

**Hervé:** Certain structures, acceptable in the past, which were based on the sole principle that a company has legal ownership over certain intangibles, are no longer sustainable. The defensive approach is to unwind certain structures and to amend the established transfer pricing system in such a way as to reduce the profit for the intangibles’ legal owner located in a favourable tax jurisdiction to a defensible range. An offensive approach is to amend the operating model of the multinational in such a way that the economic substance – functional value drivers and decision makers, internal functional processes that support the pre-eminence of a principal company

## “ INTANGIBLES VALUATION PROCESSES MUST BE CONSISTENT AND COMPLETE ACROSS GEOGRAPHIES TO SATISFY POTENTIAL AUDIT CHALLENGES AND MUTUAL AGREEMENT PROCEDURE (MAP) REQUIREMENTS TO AVOID DOUBLE TAXATION. ”

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– increases by so much that functionally the intangibles’ owner becomes a fully-fledged economic principal. Multinationals considering this approach should be aware that, coming from the principle that tax follows business, such a strategy should naturally fit with underlying business objectives. Establishing a new operating model to defend a certain tax outcome which runs against other business objectives is, in most cases, not sustainable.

**Higinbotham:** Existing structures, based on traditional valuation approaches, or unclear business purposes, are potentially at risk. Such risks may be mitigated, in some cases, by taking advantage of changes in tax regimes and restructuring options that offer cost-effective alternatives to conventional audit controversy.

**FW: In your view, how should multinationals plan their future business restructurings to consider increased tax risks related to intangibles planning?**

**Higinbotham:** Business structures should be aligned with value creation processes to provide defensible transfer pricing, in terms of the locations of functions and risks. In some cases, advance pricing agreements (APAs) and similar bilateral or multilateral MAP mechanisms may be

constructive in avoiding costly tax audits and controversies.

**Llinares:** The transfer pricing system, post-business restructuring, should be consistent with an up-to-date value chain analysis. In some business restructurings, there may be a component of the value chain analysis that has evolved. If the post-restructuring transfer pricing system reflects these changes and is performed in line with the DEMPE framework, it is more likely that the intangibles-related pricing will be arm’s length, post-change.

**Hervé:** Multinationals should also consider natural economic trends, which may help to establish certain structures in a tax-favourable manner. For example, digital transformation is a massive game changer across industries which generate new products such as digital solutions, new business models including customer-centric development and sales, and new operating models such as digitised global product and supply chain management. New digital activities have the potential to dramatically change the way and the level by which a multinational earns money. In other words, they create new intangibles. In most cases, there is no operating model precondition as to why such activities should be located in existing high-tax jurisdiction subsidiaries of a multinational. They can contribute as

much value to group success if they are established in favourable tax jurisdictions away from other group value chain activities. Planning and implementing this at an early stage of digital transformation runs counter to negative ETR impacts from BEPS. Conceptualised from the beginning, digital restructuring can be conducted without prohibitive tax exit costs, which would arise once you transfer an established business from one jurisdiction to another.

**FW: How should purchasers in M&A transactions identify the tax implications of any intangible assets? What might this mean for the overall cost of a transaction and future value projections?**

**Higinbotham:** Potential tax risks and tax audit implications are important factors to consider in valuing M&A targets. Conversely, synergies resulting from taking advantage of available tax benefits may be relevant to evaluating the overall cost of the transaction.

**Hervé:** Buyers should properly consider the increased tax risks from the BEPS's new consideration of intangibles and transfer pricing. Depending on the new 'intangibles' set-up of a target and its proper consideration in transfer pricing, this should be considered in

the price negotiation with the target's owners. Buyers should also consider that unwinding certain structures of the target to achieve post-merger integration synergies is also likely to generate higher tax costs than in the past.

**Llinares:** An important aspect is likely to be the role of the intangibles in correctly reflecting overall value creation inside the target company. Having a solid understanding of such a role will be key to assessing any tax implication of the envisaged transaction. Paper transfer of intangibles is likely to be ineffective unless the existing transfer pricing system relating to intangibles was not arm's length. ■

PAPER TRANSFER OF INTANGIBLES IS LIKELY TO BE INEFFECTIVE  
UNLESS THE EXISTING TRANSFER PRICING SYSTEM RELATING  
TO INTANGIBLES WAS NOT ARM'S LENGTH.

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