

The International Taxation of Goodwill and Other Intangibles

Willard B. Taylor

What are intangibles and why is their taxation important?

Intangible assets are often divided between those, such as patents or trademarks, that are owned or controlled and can be separately transferred by the owner or controlling person, on the one hand; and, on the other hand, “residual” assets, such as good will or going concern value, that ordinarily can be transferred only as part of an entire business. There are also intangible liabilities or responsibilities that can be separately transferred or assumed – for example, the market risk that sales will fall below a target, or the financial risk that a customer will default in payment or that a product that is covered by a warranty is defective. Intangible liabilities are important in so-called “business restructurings”¹ and pose the question of whether the ability to assign intangible liabilities separately undercuts the notion that “residual” intangible assets are not separately transferable and thus are different from non-“residual” intangibles.

The international taxation of intangibles is important because of the huge growth both in multinational trade and in the percentage of business assets represented by intangibles. This is essentially the reason for the OECD tax committee project on intangibles that was announced in December 2010.² Additionally, the taxation of intangibles is important because the rules and definitions are in flux – this is reflected, for example, in the OECD intangibles project, the ongoing revisions to the U.S. transfer pricing regulations, legislative proposals and court decisions. One of the uncertainties, mentioned above and discussed below, is how to treat so-called “business restructurings”. And finally, the taxation of intangibles is important because of the increasing extent to which multinational enterprises purposefully locate intangible assets and

¹ See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (22 July 2011), Chapter IX, “Transfer Pricing Aspects of Business Restructurings”; and Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing (JCX-37-10), July 20, 2010, at 11-17, “I. Business Restructuring”.

² As a project for 2011. Submissions in response to a request for comments are available on the OECD website. A “scoping” paper, also available on that site, was released in January of 2011 after meetings with those who commented.

liabilities in no- or low-tax countries, *i.e.*, countries in which the rate is far lower than in the home country or the country of use or exploitation.

I.

Separately transferrable intangibles. The focus of international tax has historically been on the first group of intangible assets – that is, those which are owned or controlled and can be separately licensed or transferred. Traditional analysis formulates the tax issues as, first, identifying the country that has the jurisdiction to tax the income; then, in the case of a license, whether royalties derived from the country of use or exploitation will be deductible by the payor and exempt from withholding tax in the user’s country; and, finally, if the parties to the transaction are related, what rules apply to determine whether each party’s income or deductions are appropriate.

In tax treaties entered into by the U.S. and other OECD countries, it has long been established that the income from the license of an intangible is taxed in the country in which the owner of the intangible resides; that royalties paid for its use or exploitation by a resident of another country are ordinarily deductible by the user; that there is no withholding tax on the payment of royalties; and that the “arm’s length” standard is used to determine whether the amount of the royalty is appropriate. More specifically, under the present rules in the U.S. and other OECD countries, the income from intangible property is taxed to the owner or person who controls the intangible property – it is “portfolio” not “business” income for purposes of the taxes imposed by the country of use or exploitation. Jurisdiction to tax is given to the owner’s country of residence by Article 12 of the OECD Model Treaty,³ which provides that income for the use of intangible property is exempt from source country withholding tax (which in the case of the U.S. would otherwise be 30%) if the owner is a resident of the other country.⁴ While the OECD Model Treaty does not expressly provide that royalties for a license are deductible in the

³ For the Article 12 exemption to apply, the recipient of the income must be the “beneficial” owner, and in U.S. treaties this is supplemented by limitation on benefit articles, by “conduit” financing rules, and by rules with respect to payments made to hybrid entities.

⁴ Income that falls outside of Article 12 would be dealt with in the OECD Model Treaty by the permanent establishment articles (Articles 5 and 7), the capital gains article (Article 13), or in the case of athletes and entertainers, by the separate treaty article that applies to their compensation (Article 17).

source country, it does provide (in Article 24(4), relating to non-discrimination) that they are deductible if a deduction would have been allowed for a payment to a resident of the source state.

Whether these basic rules – assigning exclusive taxing jurisdiction to the owner’s country and the notion that transactions between related parties can ever truly be at arm’s length – are out of date is a central question.⁵ Some see the ability of multinational enterprises to locate ownership or control of intangibles in no- or low-tax countries as evidence that the rules are misguided. Even if a license is at arm’s length, for example, doesn’t the assignment of exclusive taxing jurisdiction to the country of the owner of the intangible permit the “stripping” or “shifting” of income, potentially to a no- or low-tax country?

A. Articles 9 and 12 of the OECD Model Treaty Article 12 does not apply to all payments for the use of intangible assets – just those made for the use of specified intangibles,⁶ and so it would not cover payments for distribution rights, for the development of designs that do not yet exist, or for services. There are a number of on-going issues under Article 12 – for example, the treatment of endorsement and like fees paid to athletes and entertainers – are the payments for services or the use of property? What about software? Additionally, Article 12 is not in all U.S. or other OECD member country treaties – e.g., the U.S.-India treaty allows 15-20% withholding tax on royalties and “fees for included services”, and the U.S.-Canadian treaty allows a 10% withholding tax and excludes altogether payments for motion pictures and for reproductions used in television

If the owner and the user of a transferable intangible asset are related (or “associated”) and resident in different countries, there is a transfer pricing issue. Is the owner’s compensation too little? Or too much? The OECD transfer pricing guidelines⁷ and the U.S. transfer pricing

⁵ See, e.g., Graetz, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies, 54 Tax Law Rev. 261 (2001) at 315 (“III. Outdated Concepts”).

⁶ Payments for the “...use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph[ic] films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial commercial or scientific experience”

⁷ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (22 July 2011).

regulations⁸ have consistently used the arm's length standard to determine the way income is divided – specifically, the standard of “a taxpayer dealing at arm's length with an uncontrolled taxpayer;” and thus they have consistently rejected formulary apportionment. This is also embedded in U.S. and OECD treaties.⁹ But the absence of comparables is a serious problem in applying the arm's length standard, particularly in light of the asymmetry between the taxpayer's and the tax administration's knowledge of the facts; and the increasing emphasis on “profit split” methods may signal a gradual move towards something like formulary apportionment. In a profit split method, the allocation of combined profit or loss is based on the relative value the parties' contributions to that profit or loss after, in the case of the “residual” profit split method, deducting (and allocating) market returns for “routine” contributions.¹⁰

Suppose the tax authorities of one state adjust the royalty or other compensation paid for an intangible? Article 9 of the OECD Model Treaty and the corresponding provisions of U.S. treaties allow the tax authorities to adjust profits – to “re-write the accounts of the enterprises” – where transactions are not at arm's length. Thus the U.S. transfer pricing regulations, as well as what is contemplated by the OECD transfer pricing guidelines, are consistent with treaty obligations. If there is an adjustment by one state, and it results in double taxation, the other state is to make an appropriate adjustment, but it need do so only if agrees with the adjustment. If not, the only resort is to the mutual agreement or competent authority provision of the treaty.¹¹

B. U.S. transfer pricing regulations The U.S. transfer pricing regulations include a broad definition of intangible assets – in addition to patents, copyrights, trademarks and the like, intangible assets includes methods, programs, systems, procedures, studies, and “other similar

⁸ Under Section 482 of the Internal Revenue Code.

⁹ E.g., Article 9 of the OECD Model Treaty which authorizes adjustments where “conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprise”, and specifies that the adjustments are to reflect the “profits which would, but for those conditions, have accrued....” And Article 12(4) limits the exemption from source country tax to the arm's length amount.

¹⁰ Regs. §§1.482-6 and -6T.

¹¹ Article 25 in the case of the OECD Model Treaty, which provides for arbitration if the competent authorities do not resolve the dispute. More recent U.S. treaties also commonly include arbitration clauses

items”, but only if the item has substantial value independent of the services of individual persons.¹² It is unclear whether intangibles in the transfer pricing context include residual intangibles such as goodwill, going concern value or workforce-in-place,¹³ or transferable intangibles such as a “business opportunity”.¹⁴ The owner of an intangible is ordinarily the person who is the legal owner under local or contract law or, failing that, the person with “control”.¹⁵ Absent “sufficiently comparable” transactions, the regulations use the “best” method to determine what is comparable – the “most reliable measure” of an arm’s length result.¹⁶ The Regulations contemplate cost-sharing arrangements in which related parties agree in advance to share costs of developing, and the benefits of, intangibles.¹⁷ Apart from regulations, the U.S. has an advance pricing agreement program which seeks to resolve the choice of a method in advance. The results, however, are not public (and thus do provide even anecdotal precedent).

The U.S. Internal Revenue Code contemplates that royalties can be adjusted so that they are “commensurate with” the income derived from the intangibles¹⁸ – arguably, a look-back rule. But the regulations under the “commensurate with income” provision narrow its possible scope

¹² Regs. §1.482-4(b), which largely parallels the definition in Section 936(h)(3). Services are dealt with separately by “controlled” service regulations, which have their own “methods” for determining what is at arm’s length generally, except for routine services, they reject the cost-plus method.

¹³ The regulations under Section 936 do include these as being “similar” to the enumerated items.

¹⁴ See, e.g., Hospital Corporation of America v. Comm’r, 81 T.C. 520 (1983) (which arguably excludes business opportunities from the definition of intangibles). See also, United Parcel Service of America v. Comm’r, 254 F.3rd 1014 (11th Cir. 2001).

¹⁵ Regs. §1.482-4T(f)(3).

¹⁶ The methods are the comparable uncontrolled transaction, comparable profits, profit split methods, and an “unspecified” method – a method that is not listed but which provides the most reliable measure.

¹⁷ Regs. §1.482-7T.

¹⁸ Section 482, which provides that “[i]n the case of any transfer (or license) of intangible property...the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.”

by using the look-back to evaluate the initial transfer pricing (and not to compare the current year's reported result with what is "commensurate with income") and by including safe harbors and other limitations that largely eviscerate its possible effect.¹⁹

C. OECD transfer pricing guidelines OECD has transfer pricing "guidelines" – not rules, as such – with respect to intangibles. These were revised and reissued in July 2010, but with an announcement shortly thereafter that there would likely be a project on intangibles to further update that part of the guidelines.

The U.S. transfer pricing regulations and the OECD transfer pricing guidelines converge in many ways – *e.g.*, in the use of the arm's length standard, in the emphasis on finding comparable transactions, in the permitted methods. The U.S. would say it is in this regard the leader. But there are important differences – *e.g.*, in the rules for cost sharing (or, in the OECD guidelines, cost contribution) arrangements, in the greater deference given by the OECD guidelines to the terms of contracts between related parties, and in the separate OECD rules on "business restructurings".

In the case of intangibles, the existing OECD guidelines have a narrower definition of intangibles than the U.S. regulations, limiting the rules to "commercial" intangibles (which are further divided into "marketing" and "trade" intangibles).²⁰ Whether this will be changed by the OECD intangibles project announced in 2010 is, of course, an issue, but comments from the business community in response to the announcement of that project generally take the view that the definition should not be changed to include residual intangibles.

D. Transfer pricing and the rules for taxing "outward" and "inward" investment. Any country's transfer pricing rules need to be evaluated in the context of the rules that it applies to "outward" and "inward" investment. An exemption, or territorial, system, may, for example,

¹⁹ Regs. §1.482-(f)(2), which among other things has a safe harbor if the profits or cost savings were not less than 80% or more than 120% of what was reasonably foreseeable at the time the contract was entered into, with a further exception if failure to meet the safe harbor was attributable to "extraordinary events" and with complete pass on the commensurate with income rule if the safe harbor is met for 5 years. *See* pages 18-20, "II. Past and Present Law – Commensurate with income principle" in Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing (JCX-37-10), July 20, 2010.

²⁰ OECD Transfer Pricing Guidelines, Chapter VI, "Special Considerations for Intangible Property".

put more pressure on transfer pricing than a system in which worldwide income is currently taxed, whether derived directly or by a foreign subsidiary, and a resident corporation is therefore less interested in reducing foreign taxes.

While on the one hand the U.S. does not have an exemption (or territorial) system, it does not on the other hand have a worldwide system since it does not tax the undistributed foreign income of a foreign subsidiary (a “controlled foreign corporation”) unless the income is so-called “subpart F” income. The subpart F rules tax passive income of a foreign subsidiary (a “controlled foreign corporation”) currently and, as in the case of a dividend, allow a foreign tax credit for foreign income taxes associated with the income. While subpart F income includes royalties, there are significant exceptions – *e.g.*, for active business royalties, and for royalties and certain other payments made by one controlled foreign corporation to another.²¹ Additionally, the check the box regulations (in one instance of the pervasive phenomenon of tax arbitrage) can be used to create fictitious payments of royalties and interest,²² and the U.S. foreign tax credit rules may operate to eliminate U.S. tax on untaxed foreign income – in particular, royalties. And domestic expenses and losses can, with limits, be used against foreign income. A dividend, which includes “investments” in “United States property”, such as loans to the U.S. parent, would be income to the U.S. parent, with a foreign tax credit for foreign income taxes on the repatriated earnings. But there have been “indirect” repatriations – *e.g.*, the use of cash to buy U.S. parent stock for use in an acquisition – which have avoided the repatriation rules.

Thus, the subpart F and other U.S. rules for taxing foreign income rules do not “back up” transfer pricing rules, leading some to say that the present U.S. system is more biased towards multinational corporations than an exemption, or territorial, system in which active foreign business income, including dividends from foreign subsidiaries paid out of such income would be exempt, but no deduction would be allowed for foreign losses or for expenses related to exempt foreign income, and foreign royalties and other passive income would be currently

²¹ Sections 954(c)(2)(A) and 954(c)(3) of the Internal Revenue Code.

²² *E.g.*, a royalty paid by an entity that is disregarded in the U.S., but not where it is organized, to its controlled foreign corporation parent could create a deduction in the country of source without corresponding income in the controlled foreign corporation.

taxed.²³ At least in the U.S., therefore, there is a seeming consensus that the transfer pricing, subpart F and foreign tax credit rules are, from the tax administration’s point of view, “broken”. If so, intangibles are a major reason – because of their mobility, the difficulty under the arm’s length approach of finding comparables, the asymmetry of the taxpayer’s and the tax administration’s knowledge of the facts, and the lack of clear definitions and rules. Together with the “stripping” or “shifting” of income through deductible payments of interest and royalties or for services performed offshore, this has led to the accumulation of a huge amount of untaxed cash in low- or no-tax foreign subsidiaries of U.S. corporations – more than \$1 trillion. The result is the so-called “lock out” effect, in which cash of U.S. corporations is kept in foreign subsidiaries solely because its repatriation would be too expensive.

In the case of “inward” investment, the U.S., like most OECD countries, imposes regular tax on business income of a foreign investor (as well as a branch profits tax, at the rate applicable to dividends, if the investor is a foreign corporation) and withholding tax on U.S. source portfolio income, such as royalties and dividends.²⁴ There is, oddly, much less focus on the effect of transfer pricing on “inward” investment by foreign corporations, notwithstanding that in such a case there are no subpart F or other rules to “back up” the transfer pricing rules; and there is evidence that foreign multinationals use transfer pricing, income stripping or shifting, and other strategies to eliminate U.S. tax in the same way that U.S. multinationals seek to reduce foreign tax. The U.S. does have rules to limit the deduction for interest paid to, or on a loan guaranteed by, a related foreign person,²⁵ and there may in the future be rules on reinsurance premiums paid to related foreign reinsurers, but whether the limitations on the deductibility of related party interest are effective is an open question.²⁶

²³ See, e.g., Fleming, Peroni and Shay, Worse Than Exemption, 59 Emory Law Journal 80 (2009); and, more recently, Kleinbard, Stateless Income, USC Legal Studies Research Paper No. 11-6 (2011); and Kleinbard, The Lessons of Stateless Income, USC Legal Studies Research Paper No. 11-7 (2011).

²⁴ Interest, other than interest paid to a related foreign person, is generally exempt from withholding tax (as “portfolio” interest); and, in the case of interest paid to a related foreign person will ordinary be exempt if a tax treaty applies.

²⁵ The earnings stripping rules in Section 163(j).

²⁶ See, Department of Treasury, Report to The Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties (November 28, 2007).

II

Goodwill and other “residual” intangible assets What about the second group of intangibles – “residual” assets, such as good will, workforce in place and going concern value that ordinarily can be transferred only as part of an entire business? Article 12 of the OECD Model Treaty seems to have no bearing on goodwill, going concern value, workforce-in-place and the like – that is, intangibles that are generally not transferable except as part of an entire business. The definition of intangibles in the OECD transfer pricing guidelines seems to exclude them when it defines intangibles for that purpose as “commercial” intangibles.

In the U.S., gain is recognized gain when ownership of a business of a U.S. corporation is transferred to a foreign corporation in a tax-free “reorganization” or otherwise except to the extent that, in an otherwise tax-free transaction, the assets, including residual intangibles such as good will and going concern value, are used in the active conduct of a business outside of the U.S.²⁷ If the transfer is to an unrelated person, gain is recognized in respect of other (or non-residual) intangibles, such as patents, trademarks and copyrights; if the transfer is to a related person, those intangibles are deemed to be licensed for a royalty “commensurate” with the income from the intangible. Likewise, transfers of intangibles by foreign corporations that are “successors” in certain expatriation transactions result in the recognition of gain or income -- that is, transactions in which the former shareholders of the U.S. corporation own 60% or more by value of the expatriated foreign corporation.²⁸

How do income tax treaties fit into these rules? U.S. treaties, like the OECD Model, generally do not constrain subpart F and like rules that currently tax income of foreign

²⁷ Regs. §§1.367(a)-1T(b), -1T(d)(5), -2T.

²⁸ Section 7874(a)(1) of the Internal Revenue Code, relating to inversion gain. If the former shareholders owned 80% or more by value, the transaction would be disregarded altogether, *i.e.*, the foreign corporation would be treated as a U.S. corporation.

corporations to their shareholders, or the rules that require the recognition of gain or income on cross-border transfers of intangible property.²⁹

Business restructurings. What about so-called “business restructurings”? Do they involve a transfer or residual intangibles, such as goodwill?

In these transactions, the financial and other “intangible” liabilities or responsibilities of an enterprise are assumed by a related foreign person³⁰ and the payments to the enterprise for what it does are correspondingly reduced. For example, a stand-alone manufacturing enterprise may be stripped of responsibilities and its income correspondingly reduced (so that it becomes a “contract” manufacturer or distributor). Should there be a transfer pricing adjustment, or a taxable disposition of goodwill, so long as each transaction is at arm’s length -- *i.e.*, so long as the liabilities assumed offsets in value the reduction in profitability of the U.S. manufacturing subsidiary? If all of the responsibilities and functions of an entity – inventory, financial, and so on – are moved, what in fact has happened to the good will or going concern value that was there before the restructuring?

The OCED transfer pricing guidelines, when reissued in 2010, included a chapter on business restructurings and, to a surprising degree, seemed to accept the view that a business restructuring should be treated just like any other transfer pricing transaction and each leg analyzed on this basis.³¹ The U.S. has no specific rules on business restructurings, but there is an increasing focus on, and concern about, these transactions.³²

²⁹ Article 13 of the OECD Model Treaty.

³⁰ *E.g.*, exchange rate, inventory, warranty or distribution risks; and functions such as reviewing sales performance, setting pricing and other policies, and establishing sales strategies.. See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (22 July 2011), Chapter IX, “Transfer Pricing Aspects of Business Restructurings”.

³¹ Stating, *e.g.*, that “an independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction in its profit potential or expected profits.”

³² See, Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing (JCX-37-10), July 20, 2010, at 11-17, “I. Business Restructuring”.

III

What is the solution? What might happen? Given the huge number of tax treaties that incorporate basic concepts, such as the arm's length standard for determining the correct transfer price or the assignment to the owner's country of residence of jurisdiction to tax intangible income, it is not plausible to think these rules will be fundamentally changed. Nor is it realistic to expect a wholesale revision of the OECD transfer pricing guidelines or the U.S. transfer pricing regulations. If there is change in the rules for taxing intangibles, it is much more likely that it will be in the domestic rules of each country with respect to the taxation of outward and inward investment.

At least in the U.S., those who think the transfer pricing system is "broken" would urge fundamental reform of the U.S. system of taxing foreign income – for example, that the U.S. adopt an exemption (or territorial) system, but not allow deductions attributable to foreign income against domestic income; and currently tax, with a foreign tax credit, passive foreign income, including royalties; or that it adopt a true worldwide system, *i.e.*, not exclude from current tax any income of a foreign subsidiary.³³ More modest solutions would be to tighten significantly the current subpart F and foreign tax credit rules and amend the transfer pricing rules (including moving towards profit split methods).³⁴

Proposals of the current U.S. Administration The U.S. Administration's fiscal 2012 revenue proposals would preserve the present U.S. system of taxation but significantly constrain the ability of U.S. corporations to locate intangibles abroad and to avoid current U.S. tax.³⁵

³³ *E.g.*, Kleinbard, The Lessons of Stateless Income, USC Legal Studies Research Paper No. 11-7 (2011).

³⁴ *E.g.*, Durst, The Two Worlds of Transfer Pricing Policymaking, Tax Notes Today, January 25, 2011.

³⁵ *See* Department of the Treasury, February 2011, General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals, pages 39-49; and Staff of the Joint Committee on Taxation, Description of Revenue Provisions contained in the President's Fiscal Year 2012 Budget Proposal (JCS-3-11) June 2011, Part V.C., Other Revenue Changes and Loophole Closers - Reform of the U.S. International Tax System, pages 161-273.

Specifically, the proposals would currently tax, under subpart F, “excess income” of a low-taxed controlled foreign corporation from intangibles transferred directly or indirectly by a related U.S. person. “Excess income” would be income in excess of net income plus a percentage markup. Transfers would include transfers in cost-sharing agreements, as well as licenses. The proposals would also “clarify” that intangibles for all purposes includes workforce in place, goodwill and going concern value. Value may be based on the prices or profits that would be realized in a realistic alternative to the controlled transaction. The most significant proposals, in terms of additional tax revenue, however, relate to the taxation of foreign income generally – that is, a proposal to defer the deduction for domestically-incurred interest expenses attributable to untaxed foreign income and to determine the foreign tax credit on a pooling basis.

In the case of inward investment, the Administration’s proposals would further limit the deductibility of related party interest expense, but only in the case of expatriated entities, *i.e.*, corporations that were formerly U.S. incorporated. They would also disallow a deduction for certain untaxed reinsurance premiums paid to foreign affiliates of the company writing the insurance or reinsurance.