

12TH ANNUAL NABE

TRANSFER PRICING SYMPOSIUM

JULY 19-21, 2022

FOUR SEASONS HOTEL | WASHINGTON, DC



The Legacy of the White Paper: The Good, The Bad, and The Unknown

White Paper Panel: Moderator and Panelists



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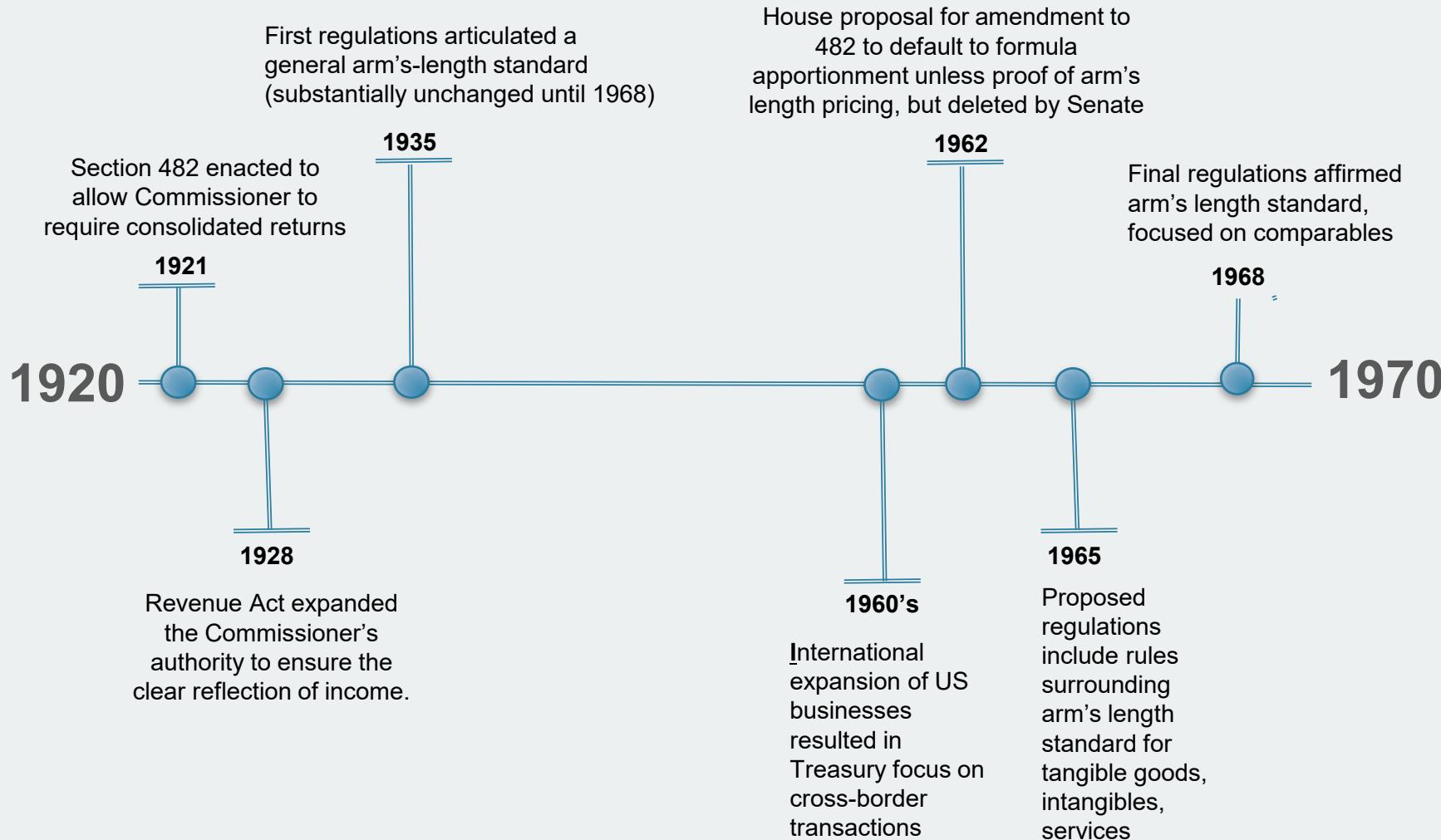


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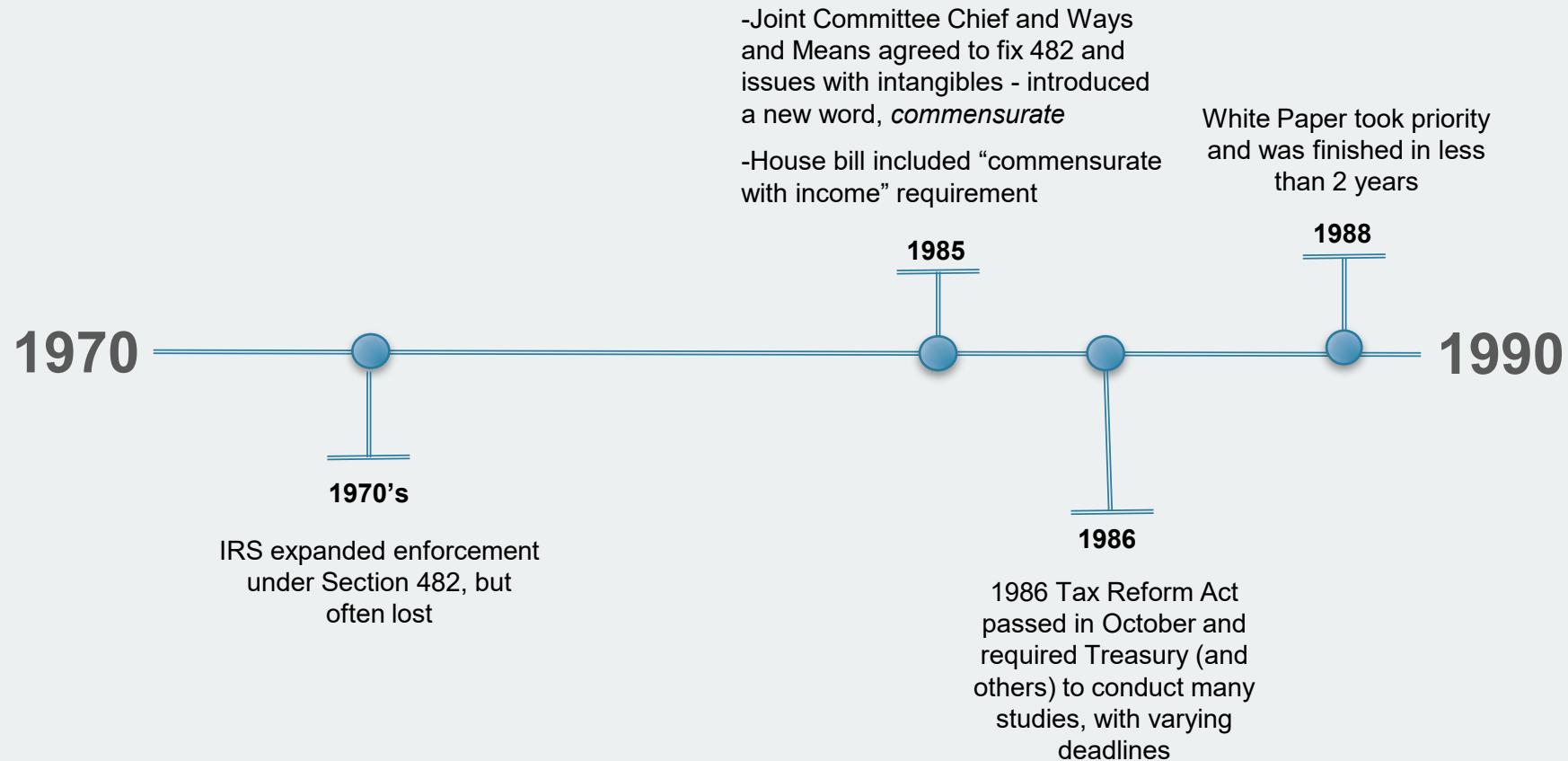
Before There Was a White Paper



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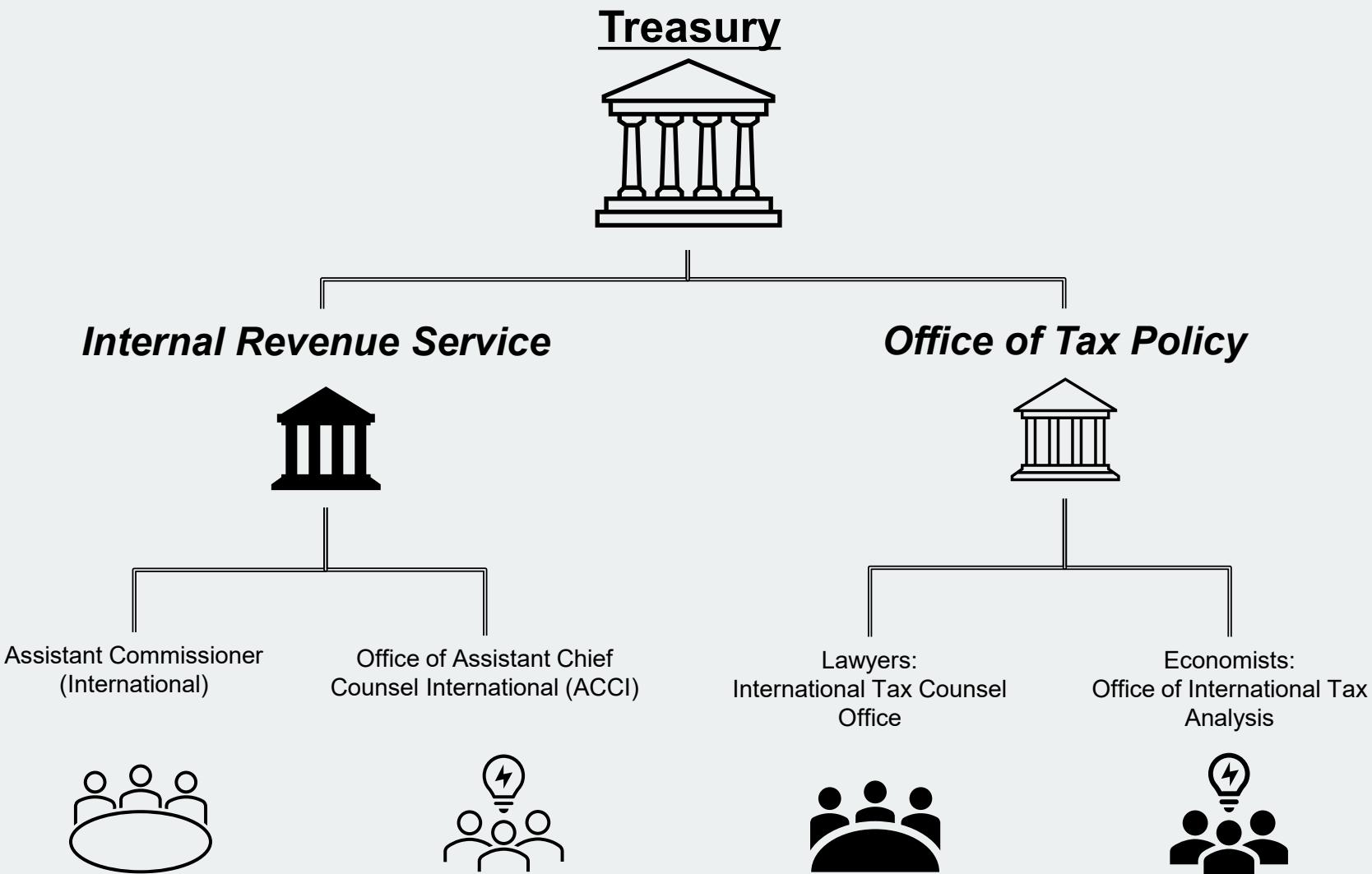
Before There Was a White Paper



White Paper Drafting Process



White Paper Drafting Process: A Collaborative Effort



White Paper Recommendations and Outcomes



Recommendations: Administration of Transfer Pricing

- Recommended contemporaneous TP documentation and assertion of penalties in abusive cases
 - Resulted in modification of IRC §6662 to add 20%/40% penalties for substantial/gross understatement of income
 - Adoption of similar documentation and penalty requirements in many countries
- Recommended eliminating the priority of TP methods (other than CUP) in favor of selecting the best method
 - Resulted in adoption of the Best Method rule in Treas. Reg. 1.482-1 (c) and the Most Appropriate Method rule in the OECD TP Guidelines
- Elaborated on the criteria for evaluating comparability of potential comparable transactions (internal and external standards of comparability)
 - Resulted in expanded comparability factors used to evaluate potential comparables in the 1994 final TP regulations and OECD Guidelines
- Recommended adoption of a multi-functional approach to IRS examination of TP issues
 - Resulted in expansion of IRS use of economists, other experts and counsel in TP examinations
- Highlighted the role of functional analysis in evaluating potential comparable transactions
 - Recognition of the importance of functional analysis in the final 1994 TP regulations and the OECD Guidelines
- Recognition that returns to intangibles and for assuming risk should be based on assets employed, economic functions undertaken, and economic risks assumed.
 - These concepts became embedded in the 1994 final TP regs and the OECD TP Guidelines
- Re-affirmed the arm's length standard as the accepted international norm for evaluating controlled transactions and rejected formulary apportionment
 - The arm's length standard is still recognized universally as the norm, although the OECD Pillar 1 and 2 proposals are reducing the scope of the ALS.
- Elucidated approaches for implementing the commensurate with income standard (CWI)
 - CWI is reflected in the 1994 revisions for Treas. Reg. 1.482-4

Other Recommendations

Transfer Pricing Methods

- Recommended adoption of profit-based transfer pricing methods as alternatives to traditional transaction-based TP methods: Basic Arm's Length Return Method (BALRM) and Basic Arm's Length Return Method with profit split (BALRM/Split)
 - BALRM became the CPM and BALRM/Split became the residual profit method
 - OECD recognized the profit- based methods beginning with the 1995 revision to the OECD TP Guidelines

Cost Sharing

- Recommendations for revised cost sharing rules including rules for scope of cost sharing, RAB shares, buy-in/buy-out transaction, characterization of cost sharing payments, use of cost shared IP for manufacturing (active trade or business) and administrative requirements
 - Most of the recommendations were adopted in the 1997 adoption of Treas. Reg. 1.482-7 and later cost sharing reg revisions.

APAs

- An Appendix described selected non-US TP rules, including the Japanese pre-confirmation ruling process
 - The Japanese procedure led to internal IRS discussions that opened the door for the initial APA test cases and publication in 1991 of Rev. Proc. 91-22 formally adopting the APA program.
 - APA procedures later adopted by many countries

Dissatisfaction with the White Paper



Dissatisfaction with the White Paper

- Transfer pricing has arguably become more contentious, not less, since the White Paper (WP).
 - For example, the IRS has brought more and larger cases to court.
 - The OECD has become more and more concerned with transfer pricing.
- What did the WP get wrong?
 - Intangibles
 - Income in market countries

Dissatisfaction with the White Paper: Intangibles

- The WP made some progress applying arm's length to intangibles.
 - Before the WP, even for extremely valuable intangibles, one would use an industry average of royalty rates, or a rule of thumb that the licensee keeps 50% (or more) of profits.
 - That pretty much has gone away.
- But there was a fatal flaw: Cost Sharing Arrangements (CSAs)
 - The legislative history forced the WP to allow CSAs.
 - However, the WP did not require that a CSA had to be arm's length. No requirement that a taxpayer show that arm's length parties would have entered into the CSA.

Dissatisfaction with the White Paper: Intangibles (Cont'd)

- Lack of restrictions on CSAs put enormous pressure on “buy-ins”.
 - In theory, even if a company would never enter into a CSA with unrelated parties, there is some price that would induce it to do so.
 - So, the theory was that, as long as taxpayers are required to pay arm's length buy-ins, everything will be all right.
 - That was a ridiculously pollyannaish view, in hindsight.
 - In fact, the vast majority of buy-ins have failed to come anywhere close to equaling the value of what the parent gives up and the CSA participant gains.
- Since CSAs are permanent (and look back has been rarely enforced), the consequence has been that income gets shifted to participants in low-tax locations forever.

Dissatisfaction with the White Paper: Income in Market Countries

- Latest issue: Unhappiness of OECD countries in which multinationals sell their products.
 - China and India have always claimed that their large markets are reasons why multinationals should earn more there than otherwise.
 - But the OECD has traditionally been sympathetic to the BALRM view of the world that income should be reported where functions are performed.
 - That has changed. France, Australia, UK, etc., now demand that profitable, large US multinationals report more income in market countries. Thus BEPS II.
- Would the OECD countries be more comfortable if these multinationals didn't earn so much of their income in low-tax places?
 - The OECD countries don't seem to care about how much low-intangible, low-profit companies, even large ones, earn in the market countries.
 - Thus, would solving the intangibles problem alleviate the new concerns?

Intangibles: Hypotheses for Discussion



Intangibles: Hypotheses for Discussion: Is the Problem “High-Value” Intangibles?

- Hypothesis #1A: The problem is not the types of intangibles that are routinely licensed between unrelated parties—e.g., the license of the *Calvin Klein* label to put on a bottle of perfume; the license of *Snoopy* or *Disney* figures by a shoe manufacturer; the license of foreign jurisdictional rights to a pharma or biotech drug prior to Phase III trials.
- Hypothesis #1B: The “intangibles” problem relates to so-called “high-value” intangibles, such iPhone technology and brand rights, which are problematic because they are “mother-ship” intangibles that the taxpayer would never in a million years license to a third party and, therefore, comparable licenses to unrelated parties do not “exist in nature.”

Intangibles: Hypotheses for Discussion: Should the IRS Prohibit Licenses of High-Value Intangibles?

- Hypothesis #2A: Dan says that the White Paper effectively adopted Pollyanna-ish view that somehow or another an arm's length buy-in could be determined for high-value intangibles and that allowing taxpayers to license high-value intangibles to enter into cost sharing arrangements were the fatal flaw of the White Paper. The hypothesis that follows from that would seem to be that licenses of high-value intangibles should have been prohibited in the absence of truly comparable market transactions.
- Hypothesis #2B: The IRS was constrained as a technical/legal matter, for two reasons:
 1. Section 482 does not preclude transactions that do not exist in nature but, instead, asks the question, "If the taxpayer were crazy and licensed their core IP to a third party, what would the terms of that hypothetical, non-existent transaction be?"
 2. The legislative history indicates that Congress assumed that cost sharing arrangements, and therefore, licenses of shared intangibles, would be permitted.

Intangibles: Hypotheses for Discussion: Could/Should Subpart F Solve the Problem?

- Hypothesis #3A: Subpart F was enacted in large measure because Congress did not trust the transfer pricing rules to address abuse—*i.e.*, preventing taxpayers from shoving inappropriate amounts of income in base companies. Subpart F has been waiting in the wings as the obvious solution the problem of high-value intangibles and avoiding the fight over hypothetical valuations, but it was ignored.
- Hypothesis #3B: The scope of the problem could be reduced if licenses of U.S. rights are effectively precluded by including sales and other income from licenses of U.S. rights in subpart F income, notwithstanding the resulting competitive disparity between U.S. multinationals and foreign multinationals.
- Hypothesis #3C: It is appropriate for a U.S. multinational to establish a CFC to compete in foreign markets with some U.S. tax preference in order to compete with tax-advantaged foreign competitors.
 - For example: Oil companies were allowed to establish CFCs once foreign extraction activities demonstrated that the activity would be profitable—but only on the condition that the U.S. tax system gets back the tax benefit of all previously expended IDC (dry hole losses) in the relevant country. This approach does not give the U.S. tax system any benefit for partially bearing that “dry hole” risk.
- Hypothesis #3D: With high-value intangibles, identifying the U.S.-deductible costs that added to the value of high-profit intangibles would be a difficult, if not fruitless, exercise, and, furthermore, the U.S. tax system should be compensated for sharing the risk that the development costs would result in a “dry hole.” *Instead, income earned by CFCs from the license of foreign rights and CSAs that qualifies for the lower GILTI rate (or deferral under prior rules) could be (could have been) limited in some fashion, however arbitrary—e.g., 50/50 profit split a la section 936(h)—with the remainder taxed as subpart F income at the full U.S. corporate rate.*

Intangibles: Hypotheses for Discussion

Who Has the Right to Tax High-Value Intangibles?

- Hypothesis #4A (the BEPs issue): Transfer pricing should not be distorted to address jurisdictional “taxing authority” issues. Whatever the value of such high-value intangibles, the market country in which the products are sold have no rationale for sharing in intangible profit from such intangibles.
 - Why? Because the market country affiliates and the market country taxing authority bore no risk as to the development of the intangibles. If the iPhone were to become the next Blackberry, the market country affiliates and the market country would be insulated from the loss of whatever development costs became worthless.
- Hypothesis #4B: If Apple had never gone to Ireland but sold iPhones from the US to Orange (the equivalent in France of Verizon and other U.S. cellular providers combined), France would have no claim to intangible income earned by Apple US.
- Hypothesis #4C: Similarly, if Apple had never gone to Ireland but sold iPhones from the US to a French marketing affiliate, France would have no claim to intangible income earned by Apple US.
- Back to Hypothesis #4A: The fight over Apple’s intangible profit should be a fight between the US, on the one side, and the taxpayer and Ireland on the other side. France and other market countries don’t have a “dog in that fight.”

Open Discussion



Open Discussion

- Questions and Comments