Pergamon

The International Journal of Accounting
36 (2001) 349–374

The International Journal of Accounting

Transfer pricing of intangible property Harmony and discord across five countries

Susan C. Borkowski*

Department of Accounting, Box 340, La Salle University, 1900 West Olney Avenue, Philadelphia, PA 19141-9985, USA

Abstract

Transnational corporations (TNCs) regard transfer pricing as the most important tax issue confronting them in the immediate future. Coupled with the increase in the number and type of cross-border transfers of intangible property, concerns arise about the adequacy of current transfer pricing regulations, and the harmony, or lack thereof, of such regulations when a TNC must address both host- and home-country tax authorities. This study of TNCs domiciled in Canada, Germany, Japan, the United Kingdom, and the United States (US) reveals a similarity in corporation approaches to valuing intangible property that transcends national borders. This is in stark contrast to current practices regarding the transfer of tangible goods, which vary by country, rather than by industry or nature of the transferred good. However, in many cases, this agreement is reached because TNCs are using transfer pricing methods for intangible transfers that do not follow the Organization for Economic Cooperation and Development (OECD) and/or US Internal Revenue Service (IRS) guidelines. © 2001 University of Illinois. All rights reserved.

Keywords: Transfer pricing; Intangible assets

1. Introduction

> Transfer pricing remains a key international issue for multinational organisations and will be *the key issue* facing them over the next two years. (Ernst & Young, 1999, p. 4)
>
> The transfer of intangible assets is viewed in some analyses as providing more positive impacts on a host's economy than capital transfers. (Government of Canada, 1996)

* Tel.: +1-215-951-1025; fax: +1-215-951-1488.
E-mail address: borkowsk@lasalle.edu (S.C. Borkowski).

PII: S0020-7063(01)00108-X

> The taxation of income from intangibles is perhaps the most important large case issue in the intercompany transfer pricing world today ... In the case where a series of products are highly profitable, there is almost always some key intangible property involved. (Mentz & Carlisle, 1997, p. 50)

Given these declarations, the transfer pricing of intangible assets is a critical concern of transnational corporations (TNCs). Transfer pricing is both a business strategy and a tax issue because "decisions regarding products, location and supply-chain matters affect tax planning and tax compliance in both home and subsidiary countries" (Ernst & Young, 1997, p. 4). As more TNCs expand their foreign direct investment (FDI), conflicts among TNCs and the host and home countries' transfer pricing legislation and the philosophies of their tax authorities increase. These differences may also encourage some TNCs to shift income from higher to lower tax jurisdictions to minimize their total tax burden and maximize profits. Consequences may include increased audits, litigation, double taxation, and penalty assessment, dampening a TNC's enthusiasm for FDI, especially in developing countries and economies in transition. The need for increasing FDI in these lesser-developed countries and economies is so important that the United Nations (UN) is currently developing a multilateral framework on investment for such countries. Among the key issues included in this framework are the transfer pricing of tangible goods and intangible property (UNCTAD, 1999) and the transfer of technology, including intellectual property rights (not yet released).

The "gross income tax gap" in the United States (US) attributable to transfer pricing was in excess of US$2.8 billion per year for the 1996–1998 period. How much of this is due to intangible property transfers is not clear. However, it was the perception of the US Congress about significant abuse involving the transfer pricing of US developed intangibles, which led to the major 1986 revision by the US Internal Revenue Service (IRS) of Section 482 vis-à-vis the transfer pricing of intangible property (Cole, 1999, Section 1.02). Continuing concerns with abuses and the magnitude of tax revenues associated with intangible property transfers led the Organization for Economic Cooperation and Development (OECD) to revise its transfer pricing guidelines in 1996 to include a chapter wholly devoted to intangible property issues (OECD, 1996).

Past and recent activity of the US Tax Court is one indicator of both the importance and the prevalence of the transfer pricing of intangible property in TNCs. Since the Section 482 revision in 1986, many Tax Court cases have involved very significant adjustments and penalties attributable to the improper transfer pricing and valuation of intangible property.[1] One estimate is that "nearly half of all adjustments proposed by the US IRS under Section 482 have involved the use or transfer of intangibles" (Cole, 1999, Section 8.01). In one recent and ongoing case, DHL Corp. v. Commissioner,[2] the TNC is appealing the assessment by the US IRS of US$424.6 million in deficiencies and US$992.2 million in allocations from trademark sales and royalties.

Another indicator is the number of advance pricing agreements (APAs) involving the negotiation of transfer prices for intangible property. The APA program allows TNCs to negotiate acceptable pricing methods for complex transactions for an extended time period to radically reduce the risks of audit and penalty assessment. Since the US IRS began its APA