Funding the Future

Are accountants or tax lawyers right? Do we ignore intr...

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Following my comment on the taxation of intangibles yesterday Andrew Jackson, a chartered tax adviser wrote a comment and blog post in response.

The first thing to say is that Andrew very clearly did not follow the argument very well. I know I was writing whilst listening to a session at the OECD, but he seems to think a headline is the same as an argument and that's not the case. I did not say there was no such thing as IP. Nor did I say that IP should not be taxed if charged for by third parties. What I did say, in summary, was:

When that IP is transferred to an asset owning enterprise ownership and use of the IP is separated, and when the asset owning company is located in a low tax state, which is now commonplace within many multinational corporations, the tax treatment of the IP owner and the company within a group that actually exploits that IP and makes the value that results from that use are also separated.

I thought it pretty obvious that the argument I made did, therefore relate to multinational corporations, but some seem to have missed that point, as Andrew did, at least in part. Instead he posed this question:

To take an example of a UK company that creates a successful brand identity (which I think you accept is IP), and then sets up a French subsidiary to use that brand in France, would you argue that for tax purposes the UK should not recognise any form of income relating to the French use of the IP? That is, all profits made by the French company should be taxed only in France, with any royalties paid to the UK for the use of the IP being ignored in both France (hence not deductible) and the UK (not taxable)?

That would seem to be ignoring a significant commercial issue. You may consider your own blog to be worthless (if you excuse the phrasing!), but many people consider other forms of IP to be worth paying considerable sums for, to third parties as well as related ones.

The upshot would be, for example, that subsidiaries using group branding would be *taxed more harshly than third-party franchisees using the same branding. And in the example above, the UK parent would have expended considerable tax-deductible costs to generate non-taxable royalty income, which again would seem odd.*

I'd agree that it is hard to get IP valuations right, and there's a lot of subjectivity there, but simply washing one's hands of a tricky question seems to me to cause more problems than it hopes to solve.

I have responded on the original post, but think it worth sharing that observation more widely, as follows, because the points made are important in this debate:

Your claim is based on a number of assumptions that you have probably never chosen to question because few do. They are nonetheless just assumptions; they are not facts.

The first of these assumptions is that the entities in France and the UK are separate entities but this is quite untrue: whilst under common control they actually form parts of a single entity. There is no reason why they are separate: a branch could also be used. It is choice but not necessity that a separate legal entity is used but to suggest that because this legal form is adopted the two entities are distinct and separate. You explicitly state that one controls the other. They are therefore not just under common control, they are an integrated whole.

That then is how they should be taxed, as a single entity. Any other approach is taxation on the basis of a fiction that does not really exist. In this case the tax base for the two companies is their combined profit. That is what they make and can return to their owners; a legal fact that the availability of group consolidated accounts recognises. The duplicity of tax and accounting approaches here is absurd: accounting seeks to reflect the reality of the integrated whole, the tax part of what is in effect the same profession seeks to deny that reality when the group profit does, in practice, provide the appropriate tax base (subject to adjustments) for the entity as a whole.

In that case the question to be asked is how the group profit is allocated between the states in which the combined company operates. That has, again, to reflect economic reality. And if a payment was made from France to the UK for the use of intellectual property that was the supposed property of the UK group that would, of course, be eliminated from consideration in the group accounts as being irrelevant to the overall profit made. All it represents is an allocation of profit — which is of course subject to challenge by both tax authorities on the basis of its artificiality under transfer pricing rules.

So what I am suggesting is that arbitrary payment that is open to challenge be ignored for tax and instead the combined profit be allocated on the basis of facts to the two states in which the combined operation trades. The basis suggested is a formula based on rational, ascertainable and pretty much indisputable data.

The question then is why would you prefer to be taxed on the basis of a fiction — which is what happens in the separate entity, arm’s length pricing approach instead of on the basis of economic and accounting reality with profits apportioned on the basis of fact and by ignored wholly artificial assets that have no real intra-group significance, like intellectual property? The only answer I can come up with is that the artificial approach — fairy tale taxation as I think of it — helps the tax profession abuse profit allocation for its own advantage (there are lots of fees to be earned in this process which is little understood by the businesses concerned, who are therefore stuck over a barrel when the demand for payment from the profession is presented) and which allows it to claim its own intellectual property when candidly not many of the tax profession can otherwise claim a unique competitive advantage of equivalent value.

So what I propose offers certainty, simplicity, economic reality and reduced documentation, all with the result that reduced accountancy fees are paid.

No wonder tax advisers do not like my suggestion. But that does not mean it’s wrong. Indeed, it may well mean it is right.

To reiterate: my comments relate to groups of companies. They do consider the nature of IP and the concept of value inherent within them. But mostly they relate to base erosion and profits shifting and the role of intellectual property in that process. That erosion does not take place without the active connivance of the accounting and tax professions. Intellectual property lets them play games to achieve that aim. It's time they were brought to an end by following the accounting and not the tax approach to this issue.