Funding the Future

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Intangible assets are a major problem in international taxation. They are the basis of much of the base erosion and profit shifting (BEPS) that is the focus of concern at the G8 and G20 which has given rise to the discussion I am taking part in at the OECD.

It's my argument, and that of the BEPS Monitoring Group of major NGOs that I am representing here, that intangibles are real. No one can pretend that logos are not real, the copyright in a book is artificial and that patents can protect innovators to ensure that they can earn a return on their investment in R&D can be protected for a reasonable period before it becomes public property. All these things are intangible assets (or IP - for intellectual property).

However, intangible as they are they rarely, if ever, create value by themselves. Take a simple example: this blog has a large traffic for a web site of its type but there is no cash flow that I can attribute to it. None of my funders ask me to write it. No one will penalise me if I do not. No one pays to read what is posted here. I choose not to carry advertising. The intangible asset that this blog represents is very real but has no obvious value attributed to it.

And that is also the problem when it comes to intangibles when it comes to tax. Clearly there is a legal issue of significance when it comes to intangible assets. They have to be created and protected. There is a cost to creation that may have a monetary cost on which a risk adjusted interest reward may be due. That seems fair. But what is also fair is that it be recognised that the creation and protection of intangible property is not what creates the value within it but that is all IP owning companies usually do.

What does instead create the value within IP is the activity of the user of the IP. That is, the marketing, selling and straightforward use of the IP that shows how it might develop in use it what creates the   value in IP. 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.

This is when the problem with IP arrives. How, when the ownership of IP is separated from the activity that creates the current value of the IP which gives rise to taxable income, can profit be apportioned between companies and states and what is the profit that should be apportioned?

The second question may in some ways be the easier to answer. The capital cost of creating the IP may appropriately be paid a return - effectively a form of interest on the cost of creation of the asset - as a first allocation of profit. But the reality is that if the IP has real value the group that owns it will create value overall and it will be almost impossible to attribute that to the ownership of any one asset, whether it's tangible or intangible. Arguing that the return to an intangible can be determined is about as meaningless as arguing that the profit due to the company's investment in IT can be determined - which will not be the case. It's an almost absurd question to ask.

So what should instead be done is to ask how this excess profit over the risk adjusted interest return for the period can be allocated for the period when it arises - which is what taxation is about. The answer to this question is, in my opinion, to go back to what drives profit. Ownership definitely does not. But the process of selling does. And the people who work within an entity do create value (hopefully). And they need real, tangible assets to support their work - which indicate whee they are. Purchases also indicate value creation - because there is value in what is bought in, of course, but given that this value is taxable in the hands of the suppliers of those goods this is not a great indicator of where taxable profit should be allocated within a company. In that case the allocation formula to indicate where value (after risk based returns) is generated in a period is, I think, fairly based on a formula based on where these real activities undertaking by human beings take place, but what is very clear is that the formula cannot take IP into account.

There is good reason for that suggestion that IP is not in any formula. Ip cannot generate profit. It is undoubtedly true that it can protect or defend such a stream but it cannot create one. In that case the ownership of IP is not a profit driver, wherever it is located and so profit cannot be allocated to it beyond an adjusted rate of return on capital , which once the IP is in use will be relatively modest as the risk related component of that return will usually by then be relatively small.

To put it another way, for profit allocation purposes IP can effectively be ignored. Doing so would undermine tax abuse models used by many multinational corporations. As importantly, the whole transfer pricing area will be simplified, considerably. You can see why the former is why many large companies are reluctant to see change in this area and the latter is a reason why tax authorities may want change. I am neither such body; I simply want fair taxation and to allocate profit to an intangible asset makes no sense in that context. To use an idea not wholly unrelated in tax, such an asset can have no incidence relationship with tax generation. In that case it's time to ignore such assets for tax purposes.