MNEs face multiple IP tax challenges in Asia

Multinational companies (MNEs) are struggling with the challenge of complying with a growing number of different intellectual property (IP) tax policies as governments compete with each other for tax revenue.

Different national interests are producing differing tax policies on intangibles. The threat of disputes continues to grow.

“You have the Chinese government tweaking its rules to protect marketing expenditure,” one in-house tax consultant at a US biotech company told *TP Week*. “They are looking to defend marketing intangibles because Chinese industry feels that there is a lot of value in building a customer base and spending money on advertising and so forth.”

In comparison, “Japan is really big into technical intangibles, especially the products of research and development [R&D], because you have crazy engineers building new products all the time,” the consultant said.

“By contrast, the Indian authorities are much more interested in service transactions because services are much more important to their economy,” he added.

The view from California is also very different to the Shanghai skyline or Cyber City in Gurgaon, India, and so are the challenges facing businesses looking to plan long-term.

Companies have to be aware of these variants, which are becoming more diverse as countries try to maintain a competitive edge for investment.

China

The US regularly claims China is out of line with international standards on IP rights, but a more pressing difficulty for taxpayers is the importance the Chinese authorities put on some kinds of intangibles over others.

“MNEs operating in China should keep an eye on their local marketing and sales expenditures,” said Shanwu Yuan, head of TP at Baker McKenzie.

“If the expenditures go above the level found in comparables, it is advisable to take another look at the transfer pricing method used for their Chinese operation,” Shanwu told *TP Week*.

There are always ways to manage and contain such risks. One well-trodden road is the APA pathway, including bilateral agreements covering present arrangements. As part of this, taxpayers have to consider how they approach marketing expenditure and factor this into their existing arrangements.

"It would be good practice to track non-routine marketing activities and expenses separately," said Jinghua Liu, head of tax disputes at Baker McKenzie.

"Other jurisdictions may have different views if there are local marketing intangibles, in which case double taxation would occur," she said.

The Chinese subsidiaries that are limited risk distributors or sales and marketing service providers will face a higher risk of challenge on their limited cost-plus profit because of local marketing intangibles if they house a large sales team to manage customers and conduct substantial marketing activities in China.

"A lot of the Chinese subsidiaries of MNEs are single function limited risk entities," Jinghua said. "There are also many MNEs setting up full-function entrepreneurial subsidiaries to operate in the Chinese market more independently."

Marketing intangibles are very important to these types of entities and they can use the fact that they develop and hold local marketing intangibles to defend their entrepreneurial status.

However, China is losing manufacturing activities due to increasing costs. The Chinese tax authorities have reduced their audits on manufacturing companies, hoping to slow the trend. Yet the focus on TP audits has just shifted and most disputes now centre on local marketing intangibles.

India

The story is quite different in India, where business process outsourcing (BPO) has become one of the fastest growing areas of the Indian economy. If the BPO industry is just the beginning, knowledge process outsourcing (KPO) is the next step – where R&D can play a key role and IP is developed.

Several household names from the US have moved back-office operations to India, including American Express and General Electric. Gurgaon, a northern city near New Delhi, has become a BPO hub since the 1980s when American Express set up operations there.

“The Indian revenue authorities are scrutinising service transactions in great depth, especially in the case of IT back offices set up here,” said Maulik Doshi, partner at SKP Group in Mumbai.

“The tax authorities justify this with the fact that comparable companies performing similar functions in India are also earning around the same levels of profit,” he told *TP Week*.

The Indian authorities expect to see 15-25% operating profits on services given their importance to the local economy, but this is still a big target for back offices. At the same time there are other factors to take into consideration.

The tax authorities argue that the risk-free return in India is much higher – approximately 7-8% – compared to investing in the US, for example, where it is around 1-2%. The authorities believe that a mark-up of 5-10% is very low and therefore Indian service providers are not being adequately compensated.

“These disputes are not only with respect to the mark-up rate,” Doshi stressed. “The authorities are increasingly challenging the functional characterisation of the Indian captive service providers.”

“They would look at the activities of Indian companies to see if they really provide any value-added work and, accordingly, classify those companies as either BPO or KPO,” he explained. “Then they can determine the mark-up.”

Jimmy Spencer, CFO at Chemtex Group, stressed the importance of consistency when it comes to preventing a clash with the tax authorities.

“Your historical record allows you to establish that you are consistent in your practices,” Spencer said. “You can tweak what you have been doing for the sake of changing standards, but it’s always better to stick to your original position when you’re not facing litigation right now.”

“If you change something in Indian tax assessments which is not consistent with a fundamental change required, the taxman will find it suspect and you will face questions about your operations,” the CFO told *TP Week*.

“So even changing your position comes with a risk,” he added. “Whenever there is no litigation and no disallowance, it’s best to continue on the path you’ve been on all along.”

Japan

The situation is quite different in Japan where the economy is more advanced, but also less dynamic and slower to grow despite the fast pace of innovation. Historically, Japanese companies have had a strong preference for technical intangibles and tend to keep their IP onshore.

"Japanese companies and foreign tax authorities, including the US, but also emerging economies, take different approaches to value creation," said Hiroshi Makuuchi, tax policy manager at the Japanese business association Keidanren.

"If we look at the digital tax debate, there seems to be a growing trend towards greater allocation of income to market jurisdictions," he stressed. "This may not be a good development for Japanese manufacturers."

When it comes to the risk of disputes, Makuuchi warned against "oversimplifying" the issue. He stressed that Japanese manufacturers allocate a modest amount of income to other jurisdictions in TP arrangements.

"Japanese manufacturers tend to perform important R&D activities in Japan with their IP controlled and managed centrally by the parent company," Makuuchi said. "Many of them believe their key value driver is R&D rather than 'low risk' activities such as contract manufacturing and marketing in other jurisdictions."

At the same time, there are changes underway in Japan. Not only has the government initiated ambitious tax reforms, the country may be moving away from traditional TP methods when it comes to intangible assets.

The Tokyo District Court set a crucial precedent in November 2017 when it ruled in favour of the tax authority against a taxpayer. The company favoured the comparable uncontrolled price (CUP) method, while the Japanese authorities were insisting on the use of the residual profit split method (RPSM).

The arm's-length price is calculated under the RPSM by taking into account the routine return on transactions between uncontrolled parties and foreign-related parties. What was left over (the residual profit) was distributed to each party according to its functions.

Facing the prospects of a much higher tax bill, the company has appealed the decision and taken the case to the Tokyo High Court. Nevertheless, this is a part of an international shift and the profit split method is on the rise around the world.

Taxpayers can manage the different kinds of risks with intellectual property, while the tax authorities are increasingly belligerent. The threat of disputes for IP-rich companies may continue to rise, but there are still plenty of ways to manage these risks.

The full results of the effective IP management survey are available here.