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OECD WP6 Transfer pricing aspects of Intangibles

The notion of "economic rent"

Usefulness of the designations "routine" and "non-routine"

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Economic rent
An introduction to the economic concept

An economic rent is a profit in excess of the market return to the factors of production eg labour and capital

Under perfect competition economic rent should be zero.

Conditions of perfect competition are broken if, inter alia:

- there are barriers to market entry eg intangibles
- resources are scarce
- the future is uncertain

The basic concept

Revenues: volume x (market) price

- **Costs**: eg raw materials

- **Wages**: the market return to labour

- **Rent**: the market return to land, equipment etc

- **Interest**: the market return to risk capital (including debt and equity)

= "Economic rent" (a residual)

OR "Super profit"

OR (sometimes) "Economic profit"

The basic concept is widely understood ie it has escaped the realm of economics

Super profit, economic rent, economic profit

There are a range of terms that have long been used to describe similar concepts eg a level of profit that is above “normal”.

However, they have been used by different economists in different ways eg at the level of the economy, the industry or the enterprise. Karl Marx used “surplus profit”.

In wider usage the concept has also been applied to taxation…

- “Excess profits tax”: in the UK and USA, a wartime tax on profits in excess of pre-war levels – implicitly a tax on (unfair) “profiteering”
- “Super profit tax” – in Australia a proposed tax on mining profits in excess of “normal” (where “normal” was proposed to be the return on government bonds) *“Our resources belong to all Australians and Australians do deserve a fair share”* federal Treasurer Wayne Swan

Application of the concept to transfer pricing

Applying the concept of economic rent requires examination of:

- **the level of profit; and**
- **what generates that profit.**

Therefore it seems to fit with:

- the language in Chapters I-III (eg "unique contributions"); and
- terms lost in the last draft (eg "unique, high value intangible")

How would it work

At the level of an enterprise (rather than an industry or the economy as a whole) economic rent allows for:

- third party costs (eg materials, labour)
- a return on specific (valuable) assets
- a profit ie the return on risk capital.

Economic rent is what remains after these have been provided for.

Application to asset valuation as well as pricing

The same concept is used under national/international valuation methods.

Incremental cash flows are used where the "increment" is the additional cash flow over the next best possibility.

Therefore it seems to fit with the language in Chapters I-III eg:

• "options realistically available" (Para 1.34); or

• comparing "alternative…business opportunities" (Para 1.74)

Valuing a patent

In principle the value of a patent using the income approach would be derived by measuring:

• the cash flows from the patent; and

• those expected from the next best unpatented technology.

If unpatented technology cannot be used, then a valuer would look for the protected technology that represents the next best state of the art (ie industry) and make an adjustment.

High profits are not always economic rent

Economic rent is different to fluctuations in profit arising from individual business circumstances eg good decision making.

The future is uncertain and businesses have to make decisions with imperfect information.

Profit will naturally vary (high or low) and some businesses may be better at this than others.

This also fits with the provisions of Chapters I-III of the Guidelines.

Guidelines

"Of course, associated enterprises, like independent enterprises, can sustain genuine losses, whether due to heavy start-up costs, unfavourable economic conditions, inefficiencies, or other legitimate business reasons." Guidelines Para 1.70

And what is true for losses is equally true for profits

Using the concept for transfer pricing

Principles

A business may be able to earn an economic rent. *This can be measured.*

To evaluate the transfer pricing position it is necessary to know what gives rise to that economic rent. *Eg through functional analysis.*

Some things giving rise to economic rent are intangibles. *Intangibles that do not yield economic rent should not affect the transfer pricing.*

Some things giving rise to economic rent are not intangibles. *Factors that yield an economic rent should be reflected in transfer pricing regardless of whether or not they are intangibles.*

Usefulness of the concept

Definition of "intangible", "unique" or "high value" may be difficult.

The concept of economic rent does seem to sit well with much of what the OECD Guidelines already say and seek to achieve.

One option would be to define:

• "unique contribution" as something that gives rise to an economic rent; and

• "unique intangible" as a non-tangible asset giving economic rent.

Relevance

The implication of some of Chapters I-III of the Guidelines is that the OECD intends to encourage greater examination of what generates the profits of an enterprise eg:

• the term "unique contributions"

• Para 1.55 et seq. *"Economic circumstances that may be relevant… include…the extent of competition…the relative…positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand…consumer purchasing power; the nature and extent of government regulation…costs of production, including the costs of land, labour, and capital…"*

Difficulties with the concept

In common use, terms like economic rent, super profit, excess profit or surplus profit can imply unfairness.

In economics:

• the term economic rent is neutral (it describes a state of affairs);

• “rent seeking” as an activity is not neutral; but

• both cover things described in Para 1.55 of the Guidelines.

The OECD should be able to use the term without significant problems

Rent Seeking

“Trying to make more money without producing more for customers. Classic examples of rent seeking …include:

• …a cartel…agreeing to raise prices;

• …lobbying the government for tax, spending or regulatory policies that benefit the lobbyists at the expense of taxpayers or consumers…

Whether legal or illegal, as they do not create any value, rent-seeking activities can impose large costs on an economy.”

The Economist

Licences

Economic rent is not always earned by the supplier/seller.

This is often the case where intangibles are licensed ie owned by one enterprise and used by another

The economic rent is usually divided between:

• the licensee (whose investment and effort creates the opportunity); and

• the licensor (whose intangible contributes to the economic rent).

Market

In the market, a buyer and seller may negotiate over the economic rent. One or the other may be able to claim it.

For example:

• a supplier makes an investment (eg in an asset) that is highly specific to the customer;

• the supplier would face high costs trying to redeploy the asset to some other use;

• without a clear, long-term contract, the supplier is now vulnerable to the supplier;

• the economic rent that may arise from the specific nature of the investment can be expropriated (wholly or partly) by the customer.

Definition

If it adopts this concept, the OECD will need to:

- choose a term (eg economic rent, super profit or excess profit); and
- define it.

For the reasons given above, it will be necessary to be careful about the term it chooses and how it is defined.

But it should be possible to arrive at an adequate definition that works for TP purposes and fits well with the existing Guidelines.

*"Confusingly, rent has two different meanings for economists. The first is the commonplace definition: the income from hiring out land or other durable goods. The second, also known as **economic rent**, is a measure of market power…A soccer star may be paid $50,000 a week to play for his team when he would be willing to turn out for only $10,000, so his economic rent is $40,000 a week. In perfect competition, there are no economic rents, as new firms enter a market and compete until prices fall and all [economic] rent is eliminated."*
The Economist

nb this example refers to the player's economic rent (simply labour cost in TP terms and already reflected in the P&L account of the club).

The concept requires a comparison

Of all the terms, economic rent may be more suited to TP.

The term "super profit" requires a comparison with "normal" profit. The OECD has consistently rejected use of industry averages or general profit levels.

In TP, in the absence of a CUP we are looking to explain how profits are generated. The return to specific assets or risk capital may be specific to an industry/business.

Economic rent would take this into account.

"Normal" Profit

Economists distinguish between normal profit and excess profit. Normal profit is the opportunity cost of the [business], the amount of profit just sufficient to keep the firm in business. If profit is any lower than that, then enterprise would be better off engaged in some alternative economic activity. Excess profit, also known as super-normal profit…is usually evidence that the firm enjoys some market power that allows it to be more profitable than it would be in a market with perfect competition."

The Economist

The comparison is sometimes with "opportunity cost"

Economic rent is often defined by economists in comparison with opportunity cost.

The Guidelines consider marginal cost but advise caution (eg Para 1.72). Opportunity cost is not covered. The OECD may not need to be so specific because in TP we look:

• at the level of the enterprise; and

• evaluate 'normal' or 'routine' profit through comparable data not industry or national averages.

Guidelines

"Costs such as replacement costs and marginal costs also may need to be considered where these can be measured and they result in a more accurate estimate of the appropriate profit." Para 2.49

"In some cases, there may be a basis for using only variable or incremental (e.g. marginal) costs, because the transactions represent a disposal of marginal production. Such a claim could be justified if the goods could not be sold at a higher price in the relevant foreign market." Para 2.51

The Economist

“Routine”

Activities or assets that are “routine” could be defined to mean those that do not command an economic rent.

This is not the same as saying that every similar enterprise or competitor has those activities or assets.

In the language of Chapters I-III, a routine asset may be “unique” and may make a “contribution” but not make a “valuable and unique contribution” to profits.

Routine Intangibles

A business may possess intangibles that are routine eg where all its competitors possess intangibles that are similar or, if unique, substitutes. Such intangibles do not limit competition, permit higher prices or generate additional volumes.

All distributors in an industry in a country may have a customer list.

Many manufacturers may have a unique process and still compete with each other so that economic rent is nil. Some may not and may make lower profits. Comparability analysis takes this into account.

“Routine” v “Normal”

What is routine in an industry may or may not be “normal” for the economy.

What is routine in an industry or for a specific activity (eg contract manufacturing) may also be “normal”. But “normal” implies common or usual. The suggestion here is that:

- what is normal is routine; but
- what is routine may not be “normal”. Something may be unusual (or not “normal”) and still not command an economic rent.

“Normal” profits

The Australian proposal for a super profit tax suggested that “normal” profit be defined as the return on government bonds ie a (nearly) risk free return on capital at the level of the economy.

Residual profit split approach

The Guidelines note that the first stage of the residual approach (the “initial remuneration”) often uses TNMM. *“Thus, it would generally not account for the return that would be generated by any unique and valuable contribution by the participants.”* Guidelines 2.121

“Non-routine” v “Unique”

Adopting the approach set out above implies that something is non-routine if it does command an economic rent.

This is not the same as saying that it is “unique”. Something may command an economic rent without being absolutely unique.

If “unique” is used in a comparative sense, it means more than “not normal” but even then this does not mean that it must command an economic rent (see previous slide).

Unique

Strictly, “unique” means not the same as anything else. It is an absolute. It is also used in a comparative sense to mean very special. The Guidelines provide no definition.

OECD Guidelines

There are some difficulties with the Guidelines’ use of “unique” but there is a suggestion that it comes close to the meaning suggested here for “non-routine”.

“There are also many cases where a party to a transaction makes contributions that are not unique – e.g. uses non-unique intangibles such as non-unique business processes or non-unique market knowledge.” Guidelines 2.60

Conclusions

Economic rent is a concept that fits well with a number of different issues in the Guidelines. *Eg "unique contribution", "residual analysis"*

The concept offers the opportunity to define what is meant by eg "high value, unique intangible" independently of the definition of intangible. *And it provides an economic basis for the relevant TP analysis.*

The concept seems particularly suited to evaluating the effect of intangibles on transfer pricing (for goods and services, licences and asset transfers*). It can be applied consistently for each. If the intangible does not give rise to an economic rent then it is unlikely to affect the TP analysis.*

The terms "routine" and "non-routine" are useful as a means of applying the economic rent concept to intangibles whilst avoiding the term "normal" and explaining the term "unique".

Thank you…