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BEPS Action 8: Transfer Pricing Aspects of Intangibles

On 16 September 2014, ahead of the G20 Finance Ministers' meeting on 20-21 September, the OECD published seven papers as a first tranche of deliverables under the Base Erosion and Profit Shifting ('BEPS') Project. The OECD will be continuing its work on the remainder of the 15 Actions on BEPS throughout 2015. It is clear that the G20 and OECD governments intend that recommendations under each of the BEPS Actions will form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the model tax treaty and transfer pricing guidelines. As a result, the proposed solutions in the first seven papers, while agreed, are not yet finalised and may be affected by decisions and future work on BEPS in 2015.

Deloitte Comments

The OECD has undertaken the difficult task of providing additional guidance on the valuation of intangibles for transfer pricing purposes. The important section on rights to returns for the development and exploitation of intangibles is 'greyed out' pending further work on other BEPS areas in 2015. Although it is not final, the direction is clear; the mere legal title to intangibles is unlikely to result in a party receiving significant intangible returns. Businesses should consider reviewing their supply chains to ensure that intangibles have been correctly identified, including existing contracts and arrangements for the development, enhancement, maintenance, protection and exploitation of intangibles in light of the proposed guidance. Functional and economic analyses remain the foundation of the application of the arm's length principle for all transactions.

It is important to understand the value and use of intangibles across a multinational enterprise and in many cases the use of a 'one-sided' analysis (looking only at one party to the transaction, such as a distributor) will not give an arm's length result, particularly when the intangible is unique and valuable. There will be more use of the transactional profit split methodology for pricing intangibles transactions, in the absence of reliable comparables (CUPs) but the guidance is clear that the most appropriate pricing method should be used. The guidance respects legal arrangements if they are consistent with the actions of third parties and value-creating activities. Situations where contractual arrangements are inconsistent with third party behaviour will require further analysis and adjustment to pricing.

Some of the difficulties inherent in determining the arm's length price of intangibles will remain. Demonstrating the capacity for an entity to exert control over another will be an important part of allocating profits, as will determining options realistically available to both parties and the returns that should be anticipated from intangibles.

The finalised guidelines (when the OECD republishes its *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* for all the BEPS transfer pricing areas, most likely in 2016) will need to be adopted into UK law. In practice, it is likely that some tax authorities will begin to follow the revised guidance before it is finalised as it provides the most detailed analysis available.

Guidance on Transfer Pricing Aspects of Intangibles

The guidance is in the form of a proposed new Chapter VI of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.*

Definition of an intangible

The guidance defines an intangible for transfer pricing purposes as something that i) is not a physical nor a financial asset; ii) is capable of being owned or controlled for use in commercial activities; and iii) whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. The broad definition is not dependent on accounting or legal definitions. A transfer pricing analysis should consider whether an intangible exists and whether it has been used or transferred. For example, not all research and development expenditure produces or enhances an intangible and not all marketing activities result in the creation or enhancement of an intangible.

The availability and extent of legal, contractual or other protection is not a necessary condition for an item to be an intangible, although it may affect the value of an item and the returns that should be attributed to it. Similarly, separate transferability is not a pre-requisite.

Specifically, intangibles for transfer pricing purposes include: patents, know-how and trade secrets, trademarks, trade names and brands, rights under contracts and government licences, licences and similar, goodwill and going concern value. Group synergies, market specific characteristics (e.g., local consumer purchasing power and location savings) and an assembled workforce are not intangibles as they are not owned and controlled by a single enterprise.

The functional analysis should identify the relevant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, and the manner in which they interact with other intangibles, with tangible assets and with business operations to create value.

Rights to returns for the development and exploitation of intangibles

This section is not in final form and some aspects may be revised following consideration of risk, hard to value intangibles and special measures, which will take place in the 2015 BEPS work.

It addresses the difficult question of how to allocate profits attributable to an intangible when ownership of the intangible is separated from activity that relates to its development, enhancement, maintenance, protection or exploitation. This is an important and controversial section because it has the potential to require significant changes to practice under the current guidelines. The guidance confirms that payment for use of an intangible should be made to the party with legal ownership of that intangible. When another group entity has participated in activity leading to the development, enhancement, maintenance, protection or exploitation of an intangible a separate transaction dealing with that activity must also be considered and priced at arm's length. The results should be driven by a functional analysis of the functions performed, assets owned and risks assumed by all group members under general transfer pricing principles. The legal owner of the intangible might not earn any functional profit from simply owning it, after compensating other members of the group for those activities. If the actual assumption or control of risk and the actual functions leading to the development, enhancement, maintenance, protection or exploitation of intangibles differs from the contractual agreement between the parties then it is the actual position that is to be priced.

The legal owner does not need to carry out all of the functions related to the development, enhancement, maintenance and protection of intangibles itself, on the basis that independent parties sometimes engage others to do so. If such outsourced activity is to be considered a 'service' under the arm's length principle and priced accordingly, control needs to be exercised over its performance. A party would be considered to exercise control if it has the ability to understand the function being performed, to determine if it is being performed adequately and to be the final decision-maker on important matters. If the legal owner does not adequately control the outsourced activities, then the party that controls the outsourced activity, whether that is the party performing the outsourced activity or another, should be appropriately compensated.

In determining the prices to be paid for functions performed some 'important functions' will have, in appropriate circumstances, 'special significance' because they make a significant contribution to intangible value. Important functions include design and control of research and marketing programmes; direction and establishment of priorities for creative undertakings including determining the course of 'blue-sky' research; control over strategic decisions regarding intangible development programmes; management and control of budgets; important decisions regarding defence and protection of intangibles; and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.

The reliability of one-sided transfer pricing methods will be substantially reduced if parties performing a significant portion of the important functions are treated as tested parties. Failure to perform or control the important functions is likely to leave the legal owner with only a small return on the other functions it performs. If the important functions would not have been outsourced by unrelated parties the transfer pricing consequence might be that comparables cannot be found which is likely to lead to the application of the profit split method.

Compensation needs to be determined on the basis of anticipated or 'ex ante' information at the time of the transaction.

Realistically available options

A comparability analysis must consider the 'options realistically available' to each of the parties. One of the examples given is that a transferor of intangibles would not accept a price that is less advantageous than its other realistically available options merely because it lacks the resources to exploit effectively the transferred rights.

Transfer pricing methods and comparability analysis

The selection of the most appropriate transfer pricing method should be based on a functional analysis and take into account all of the relevant factors materially contributing to the creation of value. Depending on the facts, any of the five OECD transfer pricing methods may constitute the most appropriate transfer pricing method for the transfer of intangibles. The OECD cautions that one-sided methods, including the resale price method and the transactional net margin method, are generally not reliable methods for intangibles transactions, in part because they can assume that all of the residual profit is allocated to the owner of the intangible. The transfer pricing methods most likely to be appropriate for intangibles are the CUP method and the transactional profit split method. Supplemental guidance requires the evaluation of the unique features of an intangible in conducting a comparability analysis for transfer pricing purposes. In practice, the difficulties with finding suitably comparable third party transactions will make the CUP method difficult to apply except in cases when there is a recent acquisition from an unrelated party or a suitable internal CUP.

It may be possible to use valuation techniques, including income-based methods such as discounted cash flow, to estimate the arm's length price of intangibles. New guidance on the application of the discounted cash flow method is provided and of key importance is the accuracy of financial projections and assumptions regarding growth rates.

The intangibles guidance has new sections on the impact of unanticipated 'ex post' returns, and the importance of determining whether returns were actually unanticipated. If they are unanticipated then they will be earned by the entity that has the control and management of, and actually bears, the relevant risks.

Other transactions, including location specific advantages

The OECD has also published new guidance to be included in Chapter I of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, which considers items that are not intangibles because they are not owned or controlled but nonetheless may add value and should be considered in relation to comparability analyses. This covers:

- location savings and other local market features, including when such savings exist and the amount and allocation of those savings;
- assembled workforce – where a business assembles a uniquely qualified or experienced group of employees which result in benefits; and
- group synergies – including illustrative examples demonstrating that the benefits from corporate synergies are allocated to the entities that contributed to those benefits.

Timetable and Next Steps

BEPS Action 9 requires the OECD to develop rules to prevent base erosion and profit shifting by the contractual transferring of risks among, or allocating excessive capital to, group members. The guidance notes the interaction between this work and risk in relation to the pricing of intangibles. The OECD notes that there may be incentives for taxpayers to 'overstate anticipated risk' and because of asymmetries of information between tax authorities and taxpayers.

Tax authorities have expressed concern that some intangibles are hard to value using traditional methods, either because the intangible is unique in nature, the transaction would not happen between unrelated parties or because the income stream that it might generate is highly speculative at the time of the transaction. The discussion will consider circumstances where it is necessary to look at alternatives to the arm's length principle. The guidance on intangibles may also be affected by the output from BEPS Action 10 on the transfer pricing of high-risk transactions and consideration of the need for 'special measures,' such as the controversial issue of recharacterisation (which has the potential to increase the number of disputes between tax authorities requiring resolution via mutual agreement procedures).

Deloitte EMEA Dbriefs Webcast

Deloitte's Dbriefs webcast programme for Europe, the Middle East and Africa will include a discussion of these proposals on 21 October 2014. Registration for the webcast will be available shortly at **www.emeadbriefs.com**.

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