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The new transfer pricing landscape
A practical guide to the BEPS changes

Global Transfer Pricing
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Intangibles

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The revisions to Chapter VI of the Transfer Pricing Guidelines contain some of the most significant changes adopted by the OECD/G20 under its BEPS mandate to ensure that transfer pricing outcomes are consistent with value creation. The revisions contain new guidance on risk consistent with changes to Chapter I—the returns to capital—and place significant emphasis on the returns to the important functions related to the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles. The new guidance will likely drive significant changes to current practices. The release does not contain any new guidance on the transactional profit split method, which has been deferred until 2016 or 2017.

Definition of intangibles

In most respects, the new guidance is unchanged from the previous draft. It adopts a broad definition of intangibles to preclude arguments that valuable items fall outside the scope. This expansive approach is similar to that of recent domestic rule-making in many countries.

The new guidance defines an intangible as something (1) that is not a physical asset nor a financial asset; (2) that is capable of being owned or controlled for use in commercial activities; and (3) whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. In commercial terms, this would include (but not be limited to) "intellectual property."

In identifying intangibles for transfer pricing purposes, the new guidance focuses on what would be agreed upon between unrelated parties in a comparable transaction. The broad definition is not dependent on accounting or legal definitions or characterizations, and is not dependent on or intended to be used for any other tax purposes. The new guidance notes that a transfer pricing analysis should carefully consider whether an intangible exists and whether an intangible has been used or transferred. For example, not all research and development expenditures produce or enhance 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 forms of protection is not required, although it will usually affect value. Likewise, separate transferability is not a necessary condition for an item to be characterized as an intangible for transfer pricing purposes, a point included in the new guidance following the debate on the nature of "goodwill." The new guidance discusses several items that are characterized as intangibles for transfer pricing purposes, and some that are not:

Intangibles for tax purposes	**Not intangibles for tax purposes** (not owned or controlled by a single associated enterprise)
• Patents • Know-how and trade secrets • Trademarks, trade names, and brands • Rights under contracts and government licenses, including contractual commitment to make a workforce available • Licenses and similar limited rights in intangibles • Goodwill and ongoing concern value	• Group synergies • Market specific characteristics (e.g., local consumer purchasing power and location savings) • Assembled workforce

The new guidance provides that, in conducting a transfer pricing analysis, it is important to identify the relevant intangibles with specificity, and that vaguely specified or undifferentiated intangibles are insufficient for that purpose. 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

Section B of the new guidance addresses the difficult question of how to allocate the overall profit created by an intangible among the functions involved, assets used, and risks associated with the DEMPE functions related to the intangible. Section B incorporates the new guidance on contractual terms, risk, and control of risk in the revisions to Chapter I. The strong point in this section is its directive to apply the arm's length principle in accordance with Chapters I-III of the Transfer Pricing Guidelines. As such, the analysis in section B is based on expected returns, not actual returns. A separate discussion in Chapter VI on hard-to-value intangibles examines when it is appropriate to look at actual returns.

The new guidance in Section B recognizes that payment for use of an intangible should be made to the party having the legal rights to such intangible. However, when another party has participated in the DEMPE activities, provides funding, or assumes various risks, a separate transaction dealing with that activity must also be considered. There is therefore no intention under the new guidance to divert the income stream arising from use of the intangible away from the legal owner, but instead to recognize that the legal owner has a transfer pricing obligation to pay for those activities that it does not perform. The new guidance is clear that the legal owner of the intellectual property might not earn any profit from simply owning the intangible, after compensating other members of the group for their respective contributions.

The new guidance states that contracts may be used to describe the roles, responsibilities, and rights of associated enterprises, and may serve as a reference point for identifying and analyzing controlled transactions. Thus, associated enterprises are encouraged to express their intent in contracts. However, the new guidance is clear that if the actual assumption or control of risk and performance of the DEMPE functions differs from those stipulated in the contractual agreement, then the transfer pricing analysis must be based on the actual activity.

The guidelines contain a clear statement that the legal owner need not be the one to carry out all the DEMPE functions itself, but recognize that independent parties do sometimes engage others to perform such functions. Accordingly, under the arm's length principle, it is acceptable for related parties to act in a similar manner. According to the new guidance, for an outsourced activity to be priced as an "outsourced service," someone other than the service provider should exercise control over its performance. In this situation, an entity would be deemed to exercise control if it has the ability to understand the function being performed, to determine if the function is being performed adequately, and to be the final decision-maker regarding important aspects of the function. The new guidance is clear that when the legal owner does not adequately control the outsourced activities, the party that in practice controls the outsourced activity, whether the party performing the outsourced activity or another, should be appropriately compensated.

The new guidance states that, in determining the prices to be paid for functions performed, some "important functions" will have, in appropriate circumstances, "special significance" because they usually make a significant contribution to intangible value. The list provided is not all-inclusive but is intended to be merely illustrative. In some situations, any of the listed items might not have special significance; in others, something not listed might. The list includes:

- Design and control of research and marketing programs
- Direction of and establishing priorities for creative undertakings, including determining the course of "blue-sky" research
- Control over strategic decisions regarding intangible development programs
- Management and control of budgets
- Important decisions regarding defense and protection of intangibles
- Ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible

In practice, as between unrelated parties, any of these activities might be performed by another party whose specialized knowledge makes it sensible, from a business point of view, to rely on the other parties' judgement. Transfer pricing practitioners need to investigate and identify the activities of "significant importance" and show the arm's length nature of the actual arrangements. The new guidance cautions that 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 significant functions is likely to leave the legal owner with only a small return on the other functions it performs. If these significant functions would not have been outsourced by unrelated parties the transfer pricing consequence might be that comparables cannot be found, which leads either to the application of profit split methods or, in appropriate cases, to the recharacterization of the transaction.

One new aspect of the new guidance is the way in which it now recognizes and rewards a party that funds the performance of the DEMPE functions. The new guidance distinguishes between financial risk associated with funding a project and operational risk associated with operational activities with which the funding is used, such as development risk when the funding is used to develop a new intangible. The new guidance states that when the party that provides funding exercises control over financial risk without assuming and controlling operational risk, the funder would generally expect only a risk-adjusted return, such as the cost of capital or a realistic alternative investment. The new guidance states that to exercise control over financial risk, the party providing the funding must make the decisions with respect to the risk-bearing opportunity and respond to risks associated with the opportunity, such as determining how the development project will impact the expectation of returns and the requirements for additional funding. In addition the funder must perform day-to-day risk-mitigation activities regarding the management of financial risk or, if those activities are outsourced, exercise appropriate control over the outsourced activities. A funder that does not exercise control over the financial risk will be entitled only to a risk-free return.

The new guidance lists a number of risks that may be important to transactions involving intangibles:

- Risk related to the development of intangibles, including the risk that the development may not be successful
- Risk that competitors' technical advances or other factors may make the product obsolete
- Infringement risk
- Product liability risk
- Exploitation risk associated with the returns to be generated by the intangible

The party actually controlling and assuming the relevant risks consistent with the requirements of Chapter I will be entitled, by way of a secondary transaction rewarding such activity, to gains and losses associated with those risks. Conversely, a party that is not controlling and assuming the relevant risks nor performing the important functions will not be entitled to any of the gains, nor be responsible for the losses that might be associated with any difference between anticipated and actual returns. For situations in which a party is allocated a specific risk under a contract, which it has the financial capacity to assume, the Chapter I guidance allows that such party will be allocated the risk even though other parties may also exercise control over the specific risk.

Valuation of intangibles

The new guidance makes it increasingly likely that, when taxpayers select a transfer pricing method to value intangibles, the "most appropriate method" will be the transactional profit split, and the use of discounted cash flow techniques by requiring consideration of both parties' realistic alternatives. The new guidance specifies the difficulties, in many circumstances, of finding suitable comparables for the use of the comparable uncontrolled price (CUP) method.

Realistically available options

The new guidance strongly emphasizes that the comparability analysis regarding intangibles transactions must consider the options realistically available to each of the parties to the transaction, and that a one-sided comparability analysis is insufficient. The new guidance further provides that the specific business circumstances of one of the parties should not be used to support an outcome contrary to the realistically available options of the other party. The new guidance includes an example that states 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 effectively exploit the transferred rights. A second example states that a transferee should not be expected to accept a price that would make it impossible to anticipate earning a profit using the acquired rights in the intangible in its business.

The new guidance takes the position that an intercompany price for a transaction in intangibles can be identified that is consistent with the realistically available options of each of the parties, and is consistent with the assumption that taxpayers seek to optimize their allocation of resources. The new guidance cautions that in situations when there is no overlap in the prices acceptable to both parties, given their realistically available options, it may be necessary to consider whether the actual transaction should be disregarded based on the new guidance in Chapter I.

Comparability analysis

The supplemental new guidance states that it is essential to evaluate the unique features of the intangibles in conducting a comparability analysis. This is particularly important when the CUP method is applied, but it is also relevant in applying other methods that rely on comparables. Important factors in determining comparability include the actual and potential profitability of potential comparables in comparison to the transferred intangible, and whether the transferred intangible can be used as a platform to shorten the development time of future generations of the product. The new guidance questions whether comparable information drawn from public or private databases is sufficiently detailed to satisfy the new guidance's comparability standards.

The new guidance provides that if amounts attributable to comparability adjustments represent a large percentage of the total value, the computation of the adjustment may not be reliable, and the intangibles being compared may in fact not be sufficiently comparable to support a valid transfer pricing analysis. The new guidance effectively sets a high comparability bar in applying the CUP method to value intangibles transfers, and the OECD explicitly notes that the identification of reliable comparables involving intangibles may be difficult or impossible in many cases.

Transfer pricing methods

The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE's global business processes and how the transferred intangibles interact with other functions, assets, and risks that comprise the global business. The functional analysis should identify all factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies, among others. The transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should take into account all relevant factors materially contributing to the creation of value, not only intangibles and routine functions.

The new guidance states that, depending on the specific facts, any of the five OECD transfer pricing methods may constitute the most appropriate transfer pricing method for the transfer of intangibles. Nevertheless, the new guidance goes on to caution that one-sided methods, including the resale price method and the transactional net margin method (TNMM), 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 new guidance further notes that transfer pricing methods that seek to estimate the value of intangibles based on the cost of intangible development are generally discouraged, because there rarely is any correlation between the cost of developing intangibles and their value or transfer price once developed. Consequently, the new guidance concludes that the transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method, and that valuation techniques can be useful tools.

As described above, the new guidance sets a high bar on comparability, which in practice will likely make the CUP method difficult to apply (except in cases when there is a recent acquisition from an unrelated party, a suitable internal CUP, or when there are multiple intangible options that achieve the same result).

The new guidance suggests that a profit split may be a reliable method for valuing developed intangibles in the absence of CUPs. However, as mentioned, the guidance on the application of the profit split method has been deferred until 2016 or 2017.

The new guidance further provides that it may be possible to use valuation techniques, including income-based methods such as the discounted cash flow method, to estimate the arm's length price of intangibles. New guidance on the application of the discounted cash flow method is provided. In applying a valuation technique, it is essential to consider the assumptions that underlie the analysis. In particular, the new guidance notes that the following issues should be considered:

- Accuracy of financial projections
- Assumptions regarding growth rates
- Discount rates
- Useful life of intangibles and terminal values
- Assumptions regarding taxes
- Forms of payment

The final report provides little guidance on how to allocate intangible returns among the multiple parties that together may be contributing to the creation of a valuable intangible.

Implications

In many cases, the new guidance will require companies to identify and obtain a much deeper understanding of how value is created with respect to the development and exploitation of a company's significant marketing and technology intangibles. In the future, companies will need to pay particular attention to identifying specific risk associated with intangible transactions, as well as identifying who within the organization exercises control over those risks. It may no longer be possible for one party to simply contract with a related party to undertake the development of the IP and have all of the residual return inure to the payor without that party demonstrating substantive functions capable of exercising oversight and control of the development process. This may mean being able to demonstrate the performance of such functions and capabilities in either its own qualified personnel or in others that they control. For companies with complex structures where important functions are distributed among many group companies, these rules could prove particularly onerous and difficult to comply with. In other cases, movement of qualified personnel may be required and additional qualified personnel may need to be assigned to specific control functions.

The new guidelines and examples assume that a single set of defined transactions and a single set of intangibles are the main drivers of the intangible returns. In many cases, companies have multiple intangibles, some of which derive their value from synergies with other types of intangibles. Determining intended returns from development activity for some but not all of the intangibles in these cases is likely to be a challenge.

As a practical matter, it may be necessary to document contemporaneously the important risks and functions and identify the parties assuming and controlling those risk and functions. The new guidance requires that the analysis be done up front at the time development activity begins or a structure is put in place. In many instances, it may be very difficult to assess what may have been the upfront expectations of the parties, and identify the exact parties that were controlling and assuming risks, several years later when a tax authority inquiry begins. This may create a challenging administrative burden for companies who, in many cases, may not possess information necessary to track significant intangible-creating activity in real time.

The final report provides little guidance on how to allocate intangible returns among the multiple parties that together may be contributing to the creation of a valuable intangible. The examples in the new guidance are simplistic. For instance, the examples assume that one party takes on and controls the significant risks and activities, and the other party is simply left with either a service or financing return. Perhaps the guidance on transactional profit splits will provide some additional guidance. However, even then, it is possible that companies will face significant challenges and potential controversy determining which entity contributes the most to value creation.

Conclusion

The changes to Chapter VI of the Transfer Pricing Guidelines on intangibles, along with the changes to Chapter I, go a long way to articulating the OECD/G20's stated goal of trying to align transfer pricing outcomes with value creation. It is likely that that the OECD/G20 will have achieved its goal of preventing a cash-rich minimally functioning entity (a cash box) from earning the residual returns associated with development, enhancement, maintenance, protection, and exploitation of intangibles.

The new guidance will likely require companies to devote significantly more resources to documenting their intellectual property transfer pricing. However, even with due diligence, it is likely that the new guidance will increase the incidence of protracted controversies concerning the proper allocation of intangible returns. Many companies may find that they will need to invoke potentially time-consuming mutual assistance procedures to eliminate double taxation to resolve their intangible-related disputes.

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