Transfer pricing aspects of intangibles: the OECD project

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The new guidelines should be clear, more comprehensive, and consistent with the realities of business

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In many multinational enterprises ("MNEs"), a significant part of the value creation is attributable to the ownership and exploitation of intangibles. Significant tax planning opportunities therefore arise for MNEs from the possible location or cross-border relocation of intangibles, which cause concern to governments due to the risk of tax base erosion that they imply. From a transfer pricing perspective, the transactions concerned may consist in the use of intangibles in the production of goods or the delivery of services (for example, the use of trademarks, patents or know-how), and/or in the transfer between associated enterprises of rights in intangibles. Such transfers may concern the full ownership rights in the intangibles or partial rights only, for instance in the case of a licence agreement for the exploitation of the intangible. The transferee is sometimes an associated enterprise that will exploit the intangible transferred to it; sometimes an Intangible Property ("IP") holding company, possibly located in a country where it enjoys a favourable tax regime, which will operate as an investment company.

In January 2011, the OECD Committee on Fiscal Affairs approved a scoping document for a new project looking at the transfer pricing aspects of intangibles.[1] This project is the logical continuation of the work that led to the approval by the OECD Council, in July 2010, of a major update to the Transfer Pricing Guidelines ("TPG").[2] The goal now is to update Chapter VI ("Special Considerations for Intangible Property") of the TPG, as well as possibly Chapter VIII ("Cost Contribution Arrangements").

Chapters VI and VIII of the TPG date back from 1995-1997. While their content remains valid, it is no longer sufficient to address the diversity of problems arising today regarding the definition, the identification of the use or transfer, the allocation between associated enterprises and the valuation of intangibles for transfer pricing purposes. Many of the issues addressed in the 2010 revision of the TPG are relevant to intangible transactions, especially the new guidance on the selection and application of transfer pricing methods and the new guidance on business restructurings. A number of issues specific to intangible transactions were however left aside in the 2010 revision of the TPG. The complexity of the subject leads to many monetarily-significant transfer pricing disputes throughout the world, with risks of double or less-than-single taxation. The OECD believes that the development of clearer and consensus-based international guidance on the transfer pricing aspects of intangibles will help limit this uncertainty for taxpayers and for governments alike.

I. Process

In July 2010, the OECD launched a public consultation on issues to be considered under this new project.

Fifty written contributions were received, constituting a rich and detailed body of information on the issues encountered in practice and reflection on how to address them. Most of these contributions are available on the OECD website. A meeting with commentators was held in November 2010. The scoping document approved in January 2011 is the result of this intensive consultation process.

The project is carried out by Working Party No. 6 of the Committee on Fiscal Affairs on the Taxation of Multinational Enterprises, through a Special Session on the Transfer Pricing Aspects of Intangibles ("WP6 TPI") set up for this purpose. The WP6 TPI has already met twice since the scoping paper was approved earlier this year. The WP6 TPI is open to all interested member countries and Observers.[3] Early and substantial involvement from the business community is intended, by involving private sector representatives in part of the WP6 TPI meetings. Thus, during the March 2011 WP6 TPI meeting, two full days were devoted to a thorough discussion with international private sector experts of issues concerning the valuation of intangibles. The agenda for this meeting, the list of participants and the presentations made are available on the OECD website.[4] Another two day meeting with private sector representatives is scheduled to take place in November. Other meetings of this type will be organised with the private sector throughout the process to examine other aspects of the project (*e.g.* definition, ownership, intangibles transfer, as well as issues specific to cost contribution arrangements, if necessary).

The OECD aims to publish a discussion draft for public comment if possible by the end of 2013. This timeline, illustrated in Figure 1, is considered to be both ambitious and realistic, given the extent and the complexity of the issues involved, and the will to reach a broad international consensus. Further consultation meetings may be organised after 2013 depending on the nature and extent of the comments that will be received.

II. General comments on the scope of the project

The intention with this new project is not to re-open issues that were resolved in the 2010 revision of the TPG, particularly in Chapter IX on business restructurings. Rather, it is to develop guidance on issues that are specific to intangibles and in need of further elaboration or update.

The scope of the project is confined to the examination of the transfer pricing aspects of transactions involving intangibles between associated enterprises, *i.e.* in the context of Article 9 of the OECD Model Tax Convention. It does not include a discussion of intangible dealings or of the attribution of the economic ownership of intangibles to a permanent establishment in an Article 7 context, as these are addressed in the July 2008 and July 2010 Reports on the Attribution of Profits to Permanent Establishments.[5] Furthermore, the scoping document states that the guidance that will be provided under Article 9 will be developed independently from the Authorised OECD Approach that was developed for Article 7, which is particularly important with regards to the extent to which contractual terms between associated enterprises will be respected and to the role that "people functions" may play in the attribution of the "economic ownership" of intangibles.

The scoping document also states that the OECD is aware of and will keep in mind in the development of its new guidance the need for the compliance burdens

Figure 1: Timeline

Indicative timeline for the OECD project on the transfer pricing aspects of intangibles (As of June 2011)	
July 2010	Approval of the 2010 revision of the Transfer Pricing Guidelines, including a new Chapter IX on business restructuring Invitation to comment on the scoping of future work to be undertaken on the transfer pricing aspects of intangibles
September 2010	50 contributions received from the public
November 2010	Meeting with commentators
January 2011	Scoping paper approved by the Committee on Fiscal Affairs ("CFA")
2011-2013	Working Party No. 6's Special Session on the TP Aspects of Intangibles meeting 3 times/year; involvement of business representatives
March 2011	Meeting with private sector representatives on valuation issues
November 2011	Meeting with private sector representatives on definitional issues, economic ownership, brands, etc.
.../...	
End of 2013 (target date)	Release of a discussion draft for public comment

imposed on taxpayers to be reasonable and proportionate to the significance and complexity of the transaction.

III. Specific areas identified for further work

A. Framework for analysis of intangible-related transfer pricing issues

The OECD will give consideration to the possibility of describing in the TPG an overall framework or process for analysing transactions involving the use or transfer of valuable intangibles. Such a framework may be similar to the multi-step framework for conducting a comparability analysis developed at paragraph 3.4 of the TPG, *i.e.* a typical, non-compulsory process the use of which would be regarded as an accepted good practice.

B. Definitional aspects

The TPG currently do not contain a definition of "intangibles" for transfer pricing purposes. Paragraph 6.2 of the TPG contains an illustrative list of some typical intangibles. Consultations with the private sector have demonstrated that it would not be desirable or realistic to provide an exhaustive list of all possible intangibles. It seems preferable to identify general principles that allow the identification of valuable intangibles, and more importantly that help determining whether intangibles are used or transferred, in isolation or in conjunction with other tangible or intangible assets, whether such use or transfer would be remunerated between independent parties, and if so, how. The presence of an intangible by itself does not necessarily mean that a transaction should be remunerated at arm's length.

This poses the question of the relevance and usefulness, for transfer pricing purposes, of definitions drawn from accounting, financial valuation, intellectual property law, and other similar sources. Some private sector commentators have suggested that only intangibles in an accounting sense or protected intellectual property rights should be taken into account in a transfer pricing analysis. While this position is understandably attractive from the point of view of the legal certainty it could provide, it is not certain that it would make it possible to capture all the valuable intangibles that are remunerated between independent parties. There are for instance intangibles that do not enjoy any specific protection in terms of intellectual property but may nevertheless be valuable. One obvious example is know-how, although it may enjoy protection under unfair competition rules in the absence of intellectual property protection. Other examples include economic or accounting concepts such as goodwill. Economists and transfer pricing practitioners also discuss a wide range of business attributes or value drivers, for which there is at this point in time no consensus as to whether or not they should be regarded as transferable intangibles or as comparability factors (*e.g.* as part of the economic conditions).

Furthermore, several commentators have raised the question of the practical usefulness and analytic relevance of the various efforts to categorise intangibles, for example between "marketing intangibles" and "trade intangibles", "routine" or "non-routine" intangibles, etc. This is being reviewed by the OECD, with the understanding that such categories would only make sense if different rules apply to intangibles according to the category to which they belong, which remains to be determined.

C. Specific categories of intangibles

1. Research and development activities ("R&D")

Examples of contract research activities are currently found at paragraphs 2.55, 7.41 and 9.26 of the TPG. In these examples, questions arise about the selection and application of the most appropriate transfer pricing method or about whether the allocation of risks between the contract researcher and the principal is arm's length. These are important questions for countries such as India, where many MNEs have set up R&D centres. The WP6 TPI will review these examples to determine whether any further guidance on R&D activities is needed.

2. Services, employee assignments, transfers of know-how

Multiple comments were received with regards to the opportunity and possibility of differentiating between services involving the use of intangibles and services involving a transfer of intangibles. A typical example would be a transfer of employees to an affiliate that would ultimately involve the transfer of know-how to that affiliate. There is often an observed tendency in practice to use a cost plus method for services while a profit split would be considered for intangibles transfers. The OECD however notes that there are services which are unique and carry high value added, for which a cost plus may not be appropriate. There are also intangibles transfers which are not unique or not highly valuable, for which a profit split would not be appropriate.

While a full revision of Chapter VII on intra-group services is not in the scope of this project, the OECD intends to undertake a consistency check of Chapter VII to ensure that it is consistent with the terminology and concepts that will be found in the revised Chapters VI and VIII.

The scoping paper also mentions that the opportunity will be seized to clarify what the similarities and differences are between the concept of intangibles for transfer pricing purposes and the definition of royalties for Article 12 of the Model Tax Convention. In this respect, many interesting decisions have been rendered by Indian courts concerning the boundaries between services and intangibles transfers under Article 12 of Indian treaties. The arguments developed by the courts in that context may stimulate the debate on the transfer pricing front.

3. Marketing intangibles

Marketing intangibles pose challenging questions in relation to their definition, identification, allocation between associated enterprises and valuation.[6]

One particular area of concern raised by commentators relates to the perceived broadening of the notion of "marketing intangibles" in current transfer pricing disputes between taxpayers and tax administrations. A typical issue concerns whether "marketing" intangibles exist and are held by a distributor which exploits a trademark belonging to an associated enterprise. In what circumstances should an enterprise, under arm's length conditions, share the profits generated by the exploitation of a trademark belonging to another enterprise, because, for example, of the importance of the functions it carries out that contribute to enhancing the value of such trademark, and of the contractual and economic conditions under which it carries out such functions? Points to consider therefore include the definition of intangibles (does the distributor hold a "secondary" or "local" intangible, linked to but separate from the trademark?) and the "economic ownership" of the trademark (see below). The existing guidance in paragraphs 6.36-6.39 of the TPG will be examined and possibly updated to the extent needed.

4. Other intangibles and business attributes

Business commentators have listed a wide range of business attributes or notions for which they find that there is legal uncertainty as to whether they should be regarded as compensable intangibles for transfer pricing purposes. The list includes workforce in place, a commitment to undertake research and contribute to the development of future intangibles, goodwill, going concern, profit potential, business opportunities, value drivers, first mover advantage, location savings, market premium, and many others. The OECD intends to examine the relevance and treatment for transfer pricing purposes of such notions, a list of which remains to be determined.

D. Rights of an enterprise to share in the return from an intangible that it does not own

The scoping paper notes that for transactions between associated enterprises, it is generally possible to identify which of the associated enterprises is the legal owner of a legally protected asset (*e.g.* a patent or a trademark). However, it may be that an enterprise that is not the legal owner of an intangible should nevertheless be entitled, at arm's length, to share in any additional return attributable to the development or exploitation of that intangible, *e.g.* because it has incurred significant risk and expenses related to the development of an intangible. An example is found at paragraphs 6.36-6.39 of the TPG dealing with marketing activities undertaken by enterprises not owning trademarks or trade names. The question can arise of how to allocate the profits between the distributors and an IP holding company that owns the group's trademarks but does not exploit them directly, *i.e.* operates as an investor who provides the capital and bears the investment risk but does not undertake any operational activities in relation to the investment.

The OECD notes that in such cases, Article 9 of the MTC and the TPG do not generally suggest disregarding the legal ownership of the intangible,[7] but rather ensuring that each associated enterprise obtains an arm's length share in the benefits derived from the intangible, based on what independent parties would have agreed to in comparable circumstances. The question of the attribution of the economic benefits derived from the development or exploitation of an intangible, by contrast to its legal ownership, is sometimes referred to as "economic ownership". In an Article 9 context, this is a slightly different notion from the one of "economic ownership" developed under Article 7 and used for the attribution of profits to a permanent establishment, the latter involving the attribution of ownership of an intangible held by the legal entity to the permanent establishment or to the head office. This can lead to some confusion between the two notions. In addition, other phrases such as "beneficial ownership", "equitable ownership" and "functional ownership" are sometimes used by practitioners. Several commentators noted the need for clarification of this notion and consistent use of the terminology in the context of the TPG.

E. Determining an arm's length price (or range of prices) for a transfer of intangible

Chapter VI of the TPG confirms to a large extent that all five OECD recognised methods may in theory apply to transactions involving intangibles, depending on the facts and circumstances of the case. At the same time, it also repeatedly points to the difficulties that arise in their application, due in particular to comparability issues where valuable unique intangibles are involved. Some of these difficulties are addressed in the 2010 revision of Chapters I-III.

The guidance in Chapter VI emphasises the need to consider, when determining an arm's length price, "the expected benefits from the intangible property (*possibly determined through a net present value calculation[emphasis added]*)" (paragraph 6.20 of the TPG). Given the limitations inherent in the application of recognised transfer pricing methods for intangibles transfers, practitioners and tax administrations often consider the use of financial valuation approaches relying on profit projections or future cash flows, weighted average returns, replacement costs, etc. There is currently no international consensus on the circumstances where financial valuation approaches and in particular the Discounted Cash Flow ("DCF") may be appropriate for applying the arm's length principle, on how these approaches relate to the currently recognised transfer pricing methods, on how they should be applied in order to satisfy the arm's length principle and on how tax administrations may audit them retrospectively. The OECD therefore intends to consider the extent to which these methods should be given recognition in the TPG, including the similarities and differences of approach that may exist between valuations for financial, accounting or transfer pricing purposes. Furthermore, the OECD wishes to develop guidance, for taxpayers and tax administrations, on how to assess the reasonableness of the parameters used and assumptions made in the application of such valuation methods.

One of the main difficulties regarding the application of these methods is that they are based on inherently uncertain projections. To what extent can a tax administration rely on projections that were drawn by a taxpayer for internal purposes two or three years before the audit? What if the actual results significantly differ from the projections? What are the circumstances were independent enterprises would have put in place price adjustment mechanisms such as earn out or renegotiation clauses? The TPG already include guidance on intangibles transferred at a point in time when valuation is highly uncertain (see paragraphs 6.28-6.35 and Annex to Chapter VI). Working Party No. 6 is currently conducting, as part of its monitoring procedures, a review of the use of post-transaction and post-filing information by taxpayers and tax administrations, and of the extent to which it constitutes hindsight.

Other technical questions may arise in the course of the project, for instance with regards to situations where intangibles have to be valued separately or aggregated, with practical implications for the possible inclusion of goodwill; the question how to take into account the perspectives of both parties and whether a valuation gap may exist between the two (paragraph 6.14 of the TPG); and the question of whether or not valuation should be based on the "highest and most productive use" of the transferred intangible (paragraph 6.15 of the TPG).

F. Recharacterisation issues

Paragraphs 1.64 to 1.69 of the TPG provide that for transfer pricing purposes, a tax administration's examination of a controlled transaction should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them. However, there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first circumstance arises where the economic substance of a transaction differs from its form. The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

These paragraphs gave rise to difficult debates in the context of the work that led to the drafting of Chapter IX of the TPG on business restructurings. A particularly sensitive issue for enterprises and governments was the determination of the exceptional circumstances where a tax administration could disregard a restructuring transaction, involving for example the transfer of valuable intangibles to an IP holding company located in a low tax country, on the grounds that such a transaction would not have taken place between independent enterprises under comparable conditions. The outcome of these discussions is found in paragraphs 9.161-9.194 of the TPG. Note that the question addressed in the TPG deals with the recharacterisation of such transactions under transfer pricing rules, independently from the possible application of domestic anti-abuse rules.

The scoping document on the new project on the transfer pricing aspects of intangibles states that it will not reopen the discussion of paragraphs 1.64-1.69 of the TPG. However, the application of that guidance to intangible transactions may possibly be illustrated in the context of the revision of Chapters VI and VIII, as has been the case in the context of the new Chapter IX.

Some business commentators have suggested that the new guidance should apply differently depending on whether a transaction takes place with an associated enterprise in a high tax or low tax country. The view of the OECD is that the arm's length principle does not apply differently depending on the tax rate of the associated enterprise. Certainly, the tax rate of the associated enterprise (as well as the existence or non-existence of a bilateral Tax Treaty with the State of the associated enterprise) could be considered as part of the risk assessment made by tax administrations when deciding for example which cases to audit. In addition, domestic anti-abuse rules could apply in the case of a transaction involving a tax haven. This is not a matter of a different application of the arm's length principle, but rather of applying distinct legal rules.

G. Cost contribution arrangements

Current OECD guidance on Cost Contribution Arrangements ("CCAs") is found in Chapter VIII of the TPG. CCAs are similar to although different from Cost Sharing Agreements ("CSAs") defined for instance in the United States Regulations. They are sometimes used by MNEs to organise the development and ownership of valuable intangibles. Important controversies have arisen on issues related to the characterisation of intangibles transfers made at the inception of a CCA or CSA and issues related to the valuation of the contributions made by the participants in a CCA or CSA. The OECD intends to proceed with a review of the existing guidance in Chapter VIII of the TPG, to the extent it relates to the sharing of the costs and risks of developing, producing or obtaining intangibles (rather than services). The extent of the work needed to bring Chapter VIII up-to-date remains to be determined.

IV. Conclusion

The OECD's new project on the transfer pricing aspects of intangibles is extremely important and complex. Success will be measured by the OECD's ability to produce guidelines that are clear, more comprehensive, and consistent with the realities of business, allowing a satisfactory application of the arm's length principle to intangible transactions (particularly, from the point of view of governments, to aggressive transfers of intangibles to tax havens) without generating difficulties disproportionate to the size and nature of the transactions in question, and allowing a reasonable degree of legal certainty. It is also essential for the new guidelines to be subject to the broadest and strongest international consensus possible, hence the importance of involving the 34 member States and non-OECD economies such as Argentina, Brazil, China, Colombia, India, Malaysia, Russia, Singapore and South Africa, and of the support from the business community.

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The views expressed in this article are those of the author, not necessarily those of the OECD and its members.

NOTES

[1] See www.oecd.org/ctp/tp/intangibles.

[2] See www.oecd.org/ctp/tp.

[3] The OECD currently has 34 member countries. Observer countries to the Committee on Fiscal Affairs are Argentina, China, India, the Russian Federation and South Africa. In addition, Brazil, Colombia, Indonesia, Malaysia and Singapore are invited to participate as *ad hoc* Observers in this project.

[4] See *www.oecd.org/document/52/0,3746,en_2649_45675105_47445940_1_1_1_1,00.html*

[5] See www.oecd.org/ctp/tp/pe

[6] See the Indian case *Maruti Suzuki India Ltd v. ACIT Transfer Pricing Officer of New Delhi*, W.P. (C) 6876/2008; decision of the Supreme Court of India dated October 1, 2010.

[7] Notwithstanding the exceptional circumstances discussed at TPG 1.64-1.69.