New OECD Draft on Transfer Pricing Aspects of Intangibles

The OECD on 30 July 2013 issued a revised discussion draft on Transfer Pricing Aspects of Intangibles for public consultation. This is part of the OECD’s ongoing project to update and clarify the intangibles chapter of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and it is much changed from the initial draft issued in June 2012.

This work is a key part of the OECD’s broader project, supported by the G20, to address base erosion and profit shifting (BEPS) within the international tax system. Transfer pricing forms a significant part of the OECD’s 15-point Action Plan on BEPS; specifically, Action 8 is to ensure that transfer pricing outcomes in respect of intangibles are in line with value creation. The OECD cautions that the new discussion draft should be considered a work in progress and that parts of it may be revised during the course of the work on BEPS.

The discussion draft contains a new draft Chapter VI, Special Considerations for Intangibles for inclusion in the transfer pricing guidelines. The OECD confirms its commitment to the arm’s length principle for the pricing of intangibles in the opening remarks, and reflects that it is important that (i) the principles of the OECD transfer pricing guidelines (particularly paragraphs 1.42 to 1.69 covering inter alia functional analysis, contractual terms, economic circumstances, and recognition of the transactions actually undertaken) are applied to intangible transactions in the same way as for other transactions; and (ii) the analysis is based on an understanding of the global business and the way in which intangibles are used by the multinational business to add or create value across the entire supply chain.

Highlights of 2013 discussion draft

The revised draft contains a substantially more refined analysis of the factors affecting the valuation of intangibles and fills in many of the gaps in the first draft. However, the revised draft still contains a number of areas in which continued comment and discussion are appropriate.

In general, the revised draft makes a greater attempt to incorporate the existing guidelines. For example, it recognizes that associated enterprises might structure a transaction involving intangibles in a manner that independent enterprises would not contemplate. The revised draft relies on the traditional rules contained in the guidelines for disregarding those transactions. However, a box notes that the OECD is considering as part of the Action Plan whether additional guidance is necessary on the pricing of intangibles whose value is highly uncertain.

Broad definition of intangibles

The revised draft retains the broad definition of intangibles in the previous draft. It rejects traditional legal, accounting, tax, and treaty definitions of intellectual property of intangible assets and states that the transfer pricing definition should not be used in those contexts. The revised draft retains the two-pronged definition of intangibles in the previous draft:

1. Items that are not physical or financial assets, and
2. Items that can be owned or controlled for use in commercial activities.

The key determining factor of whether an asset that is not physical or financial constitutes an intangible is whether independent parties would pay compensation for the asset. The revised draft retains the broad definition of goodwill and going concern value, but adds new language cautioning against merely ascribing residual value to goodwill and assuming that unrelated parties would provide compensation for the unidentified residual value. The draft requires that any transfer pricing analysis relating to a transaction involving intangibles must identify the intangibles with specificity.

Items not considered intangibles

The revised draft retains the exclusion of group synergies, market specific characteristics, and work force in place from the definition of intangibles. The draft adds new guidance to Chapter 1 on those items. Location savings and other market features, such as the size and purchasing power of the local market are considered comparability adjustments. Important guidance is provided on the impact of contractual rights and valuable licenses to do business in a particular country, and new guidance is also provided on group synergies that would generally not be subject to separate compensation. Examples of group synergies address purchasing hubs and the determination of the arm’s length interest rate for intercompany loans. (The interest rate examples adopt many of the principles discussed in the Canadian case, GE Capital of Canada.)
Return on intangibles

This revised draft retains many of the basic concepts of who is entitled to intangible returns. The revised draft reiterates that the question of legal ownership is separate from that of remuneration under the arm’s length principle. The legal owner of an intangible is entitled to all returns attributable to the intangible if and only if it:

a. Performs and controls important functions (design and control of research and marketing programs, management and budgetary control over strategic decisions regarding the intangible development program, decisions regarding defense and protection and ongoing control over other functions that are outsourced) related to development, enhancement, maintenance, and protection of intangibles;

b. Provides all assets necessary to develop, enhance, maintain, and protect the intangibles; and

c. Bears and controls all related risks and costs.

The revised draft clarifies that the legal owner may outsource to related or unrelated parties many functions involved in the development of intangibles. However, if a related party performs or controls functions related to development, enhancement, or maintenance or protection of the intangible, the related party may be entitled to a share of the anticipated intangible return. Similarly, the revised draft states that when the legal owner outsources most or all of the important functions to related parties, the entitlement to a material portion of the intangible returns is highly doubtful.

The revised draft recognizes for the first time that funding intangible development and bearing the risk associated with the outcome are entitled to compensation. The draft cautions that funding intangible development and bearing the risk of success without any control over the use of the contributed funds generally would entitle the funder to a risk-adjusted rate of anticipated return on its capital invested, but no more. Presumably, the funder would be entitled only to its ex-ante expected return but no more. Any remaining ex-post returns would belong to the other related parties that performed all other important functions. The funder would incur losses if the development activity was unsuccessful.

The revised draft adds a new section on returns attributable to research and development and use of a company’s name. The revised draft reiterates previous Article VII guidance that use of a corporate name simply to denote membership in a group is not compensable. To receive compensation, the legal owner must demonstrate the financial benefit received by the user and the relative contribution of the user and the legal owner to the value. Interestingly, the revised draft states that in an acquisition, it should not be assumed that the acquiring company would pay for the use of the name. The draft suggests that, in some circumstances, the acquiring company may receive a greater benefit from the acquired company using the name and, therefore, the acquiring company should make a payment to the acquired company.

Transfer pricing methods

The revised draft retains the requirement that any analysis should consider “options realistically available”; in other words, a two-sided transfer pricing analysis in which the alternatives of both parties are considered. The revised draft newly states that the reliability of a one-sided analysis for companies performing the important functions discussed above is likely to be substantially reduced. Thus, the reliability of transfer pricing analysis that considers only the return to a contract research organization that determines the design of the research, makes strategic decisions, and manages and controls the research budget is likely to be substantially reduced. The revised draft cautions that valuation for accounting purposes may be inherently conservative. Thus, purchase price allocation performed for accounting purposes are not determinative for transfer pricing. Specific reference to D.1.(vi) intangibles, which were to be valued in an unspecified special method, no longer exists.

In general, the description of the methods and considerations to be taken into account are now more consistent in tone and approach with the other sections of the guidelines. This draft reiterates that depending on the facts, any of the five OECD transfer pricing methods may constitute the most appropriate method. It provides no new guidance on the application of the profit split method, even though the revised draft suggests that a profit split method would be the most reliable method in many cases.

The revised draft cautions against the use of allocating nonroutine income in perpetuity in situations in which the intangible in question has an indeterminate useful life. The draft requires a thorough analysis of the useful life of an intangible based on facts and circumstances. It recognizes that an intangible may have value as a platform beyond such time when products incorporating such intangible cease to be marketed.
Timetable and next steps

Interested parties are invited to submit comments on the discussion draft by 1 October 2013. Comments should be sent in Word format to TransferPricing@oecd.org. The OECD intends to hold a further public consultation on the revised discussion draft in Paris in November 2013.

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