OECD project on intangibles: Revised Discussion Draft released

July 31, 2013

In brief

Approximately one year after publication of the first Discussion Draft on the Revision of Chapter VI of the OECD Guidelines on Intangibles (Intangibles) (see also our PKN of June 6, 2012), the OECD released on 30 July 2013 its Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles. This comes shortly after the release of the OECD’s Action Plan on Base Erosion and Profit Shifting (BEPS) on July 19 where work on intangibles is listed as one of the actions (Action 8). Interested parties are invited to comment on the Revised Discussion Draft by 1 October 2013.

The Revised Discussion Draft has been prepared on the basis of the numerous comments the OECD received on the prior Discussion Draft and contains several important changes. The overarching part of the documents provides additional guidance on the question of how to correctly allocate what may be described as the “return related to an intangible” (or intangible related return). The Revised Discussion Draft states that although contractual relationships between related parties will continue to serve as a starting point for any transfer pricing analysis, the location where material functions related to intangible assets are performed is considered to be key. This focus on functional value creation is being formalised by the OECD through the concept of “important functions”, which in content consist of the crucial activities and decisions identified under the prior Discussion Draft.

In detail

In essence, the legal owner of an intangible will be entitled to all returns attributable to the intangible only if, in substance, it performs and controls the important functions related to the development, enhancement, maintenance and protection of the intangible; provides all assets necessary for the development, enhancement, maintenance and protection of the intangible; bears and controls all of the risks and costs related to the development, enhancement, maintenance and protection of the intangible. The Revised Discussion Draft clarifies that legal ownership by itself does not confer any right to ultimately retain any return from exploiting the intangible.

The OECD takes the view that the legal owner is free to outsource certain intangible asset-related functions. In those cases, however, the legal owner will need to control the functions outsourced and compensate those on an arm’s length basis. However, to the extent that all or part of the important functions are being outsourced to or are being performed by one or more members of the MNE group other than the legal owner, all or a substantial part of the return attributable to the intangible would need to be allocated to the parties actually performing the important functions. The revised guidance leaves no doubt that the mere funding of intangible-related costs (and the funding risk related thereto) without the assumption of any
further risks, any control over the use of the funds provided or the actual performance of funded activities will only entitle the funder to a risk-adjusted rate of anticipated return on the capital invested. No entitlement to the premium profit generated through the intangible should be granted in such case.

The Revised Discussion Draft confirms a major take-away of the prior Discussion Draft namely that in matters involving the transfer of intangibles or rights in intangibles, it is important not to simply assume that all residual profit after routine returns should necessarily be allocated to the owner of the intangibles. Instead, the Revised Discussion Draft calls for a functional analysis that provides a clear understanding of the MNE’s global business processes and how the intangibles interact with other functions, assets and risks that comprise the global business.

This implies that a one-sided comparability analysis may not provide a sufficient basis for evaluating a transaction involving intangibles and that the reliability of a one-sided transfer pricing method will be substantially reduced if the tested party performs “important functions”. Under such circumstances, the comparable uncontrolled price method and the profit split method are clearly appreciated. Moreover, it may be helpful to revert to other (i.e. non-OECD recognized methods), which should however not be used to substitute OECD-recognised methods and an in-depth functional analysis.

Additional guidance has furthermore been included with regard to the utilization of valuation techniques. In this respect, the Revised Discussion Draft clearly states that it might be appropriate to determine and use a range of present values evaluated from the perspective of the transferee and the transfeer. The indicative use of values determined for accounting purposes (e.g. as part of a purchase price allocation) is recognised but it is stated that such valuations are not determinative for transfer pricing purposes and should therefore be utilised with caution within the framework of a transfer pricing analysis.

The most notable other changes are the addition of a new section addressing features of the local market, locations savings, assembled workforce and corporate synergies; explanatory changes to the definition of intangibles; the inclusion of a section on transfer pricing aspects of the use of corporate names and the addition of several new examples and the revision of some of the examples of the prior Discussion Draft providing practical guidance on how to apply the considerations for intangible property. Those changes are further summarised and analysed below.

**Changes to definitional aspects on intangibles**

The Revised Discussion Draft includes expanded guidance on the categories of intangibles, which continue to be broadly split into marketing (“customer-facing”) and trade intangibles (intangibles not being marketing intangibles). Furthermore, a short definition on “unique and valuable intangibles” has been added, although the Discussion Draft makes it clear that the classification of an intangible will not impact the level of transfer pricing analysis to be performed or the transfer pricing methodology to be used. It views that intangibles intend to address “something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances”. The Discussion Draft confirms that it remains important to distinguish intangibles from market conditions or circumstances that are unable of being owned or controlled by a single enterprise.

**Amendments to Chapter I and II: Introduction of new comparability features and the use of “other methods”**

In relation to the above, the Revised Discussion Draft, provides additional guidance on the application of the arm’s length principle in the context of location savings and other local market features, assembled workforce, as well as MNE group synergies. The Discussion Draft recognizes that these elements can have a material impact on the arm’s length pricing of related party transactions and that it should be further considered how independent parties would e.g. share advantages or disadvantages related thereto.

**Location savings and other local market features**

The OECD had addressed the potential impact of location savings such as lower labor or real estate costs within the context of Chapter IX on business restructurings, but now states that the principles related thereto would as such apply to all situations where such location savings are present. If location savings exist and are not passed on to third party customers, then the question as to how these advantages would be shared among related parties is seen to be best addressed by the use of comparable entities and transactions in the local market. If it is not possible to identify reliable local
market comparables, comparability adjustments may be required in order to account for the existence of location savings.

Furthermore, other local market features not resulting in location savings (such as the size of the market or the purchasing powers of local households) may affect arm’s length pricing and require comparability adjustments. The OECD furthermore emphasizes that it will be important to distinguish between features of the local market and contractual rights or government licenses which may be necessary to exploit a local market (e.g. regulatory licenses for investment management business). Such valuable contractual rights and government licenses may constitute intangibles, and the contributions of both the local group member and other group members in supplying capabilities necessary to obtain such rights or licenses should be assessed.

Assembled workforce

The Revised Discussion Draft states that a “uniquely qualified or experience cadre of employees” may affect the arm’s length price of services provided between related parties. To the extent possible, the benefits or detriments of such employee group should be determined in comparison with the workforce of companies engaged in comparable transactions (which in practice might be difficult to achieve). The wording suggests that the mere transfer of workforce, if not “along with other assets” would not give rise to a separate compensation by default. Rather, the existence of assembled workforce may result in time and expense savings for the service recipient and should then be reflected in the arm’s length price. There is also a recognition of the fact that workforce transferred may create potential liabilities and limit the transferee’s ability to structure its business going forward.

MNE group synergies

Member of a multinational enterprise (MNE) may benefit from group synergies which would not be available to independent companies in similar circumstances. Examples thereof are combined purchasing power, economies of scale and increased borrowing capacity. The wording on such group synergies clarifies that under the arm’s length principle, remunerations are only considered to be appropriate if there has been a “deliberate concerted group action” which provides MNE members with “material” advantages, e.g. under the example of a centralised purchasing organisation. Benefits of group synergies should then generally be shared by MNE members in proportion to their contribution to the creation of the synergy.

The use of “other methods”

In addition, the Revised Discussion Draft foresees that Chapter II of the OECD Transfer Pricing Guidelines (Transfer Pricing Methods) would be amended in a way to provide tax administrations with the possibility to use methods other than the five recognised OECD-methods (this option was under the initial version limited to MNE groups). However, such “other methods” should not substitute the five recognised OECD methods, and the Revised Discussion Draft also takes a critical stand on the use of rules of thumb which are not considered to provide an adequate substitute for a complete functional and comparability analysis.

Ownership of intangibles and intangible-related returns

There have been material changes to Section B of the Discussion Draft dealing with the ownership of intangibles, the functions, assets and risks related to intangibles, as well as the entitlement to intangible–related returns.

Recharacterisation of transactions

The Revised Discussion Draft now explicitly includes the notion that in “exceptional circumstances” as described in Chapter I of the OECD Transfer Pricing Guidelines, it may be necessary to recharacterise transactions related to intangible assets in order to reflect arm’s length conditions. Chapter I foresees recharacterisation of transactions if the economic substance of the transaction differs from its form or in case the arrangements impede the determination of an arm’s length transfer price.

Specific fact patterns

The Revised Discussion Draft furthermore includes more in-depth consideration of specific fact patterns related to intangible assets which are often observed in practice. This includes considerations of distributorship and R&D arrangements, but also the appropriateness of intra-group charges for the mere use of the company name.

- Distribution arrangements: Careful consideration is required of the compensation of a related-party marketer/distributors for possibly enhancing the value of a trademark, including the review of which party bears the cost of the marketing activities and the substance of the (future) rights of the distributor.
- R&D arrangements: In case of the deployment of unique skills or if the contract R&D entity bears risks related to blue sky research, then a cost plus modest mark up will not
always correspond to the value of the service rendered.

- Use of company name: In general, no payment should be recognised from a transfer pricing perspective for “simple” recognition group membership or the use of group names. However, such payments may be appropriate if there is a clear “financial benefit” to the group entity.

**Examples**
The Revised Discussion Draft continues to include a large number of examples destined to illustrate the application of the principles outlined. The majority of examples have been retained, whereas some have been updated in order to align them to the adjusted guidance. Further examples have been added on comparability considerations and the utilisation of valuation techniques.

**Further work**
Further work of the OECD is expected on the issue of hard-to-value intangibles; and the ongoing work on Transfer Pricing Documentation is expected to facilitate the value chain analysis required under the lines of the Revised Discussion Draft.

**The takeaway**

**PwC observations**
The functional value creation is at the forefront of the Revised Discussion Draft. Where transfer pricing may traditionally have been seen as the mere grappling of pricing on a transactional basis, it is undoubtedly clear that a thorough analysis of the corporate value chain will form the starting point of a transfer pricing exercise. Where the proceedings on Article 7 (Permanent Establishment) put forward the notion of “Significant People Functions” it appears as if the term “important people functions” lies at the heart of the Article 9 (arm’s length principle) proceedings. A strong emphasis is put on a thorough comparability analysis which comprises a functional analysis. In the absence of a CUP, it appears as if a rather mechanical application of one-sided methods, leaving the residual profit to the non-tested party, will become under pressure provided the tested party engages in more than mere executing functions. In those circumstances the Revised Discussion Draft empathizes more with the use of valuation techniques and Profit Splits.

The discussion related to § 40 of the June 2012 Discussion Draft has provoked changes as crystallized in the new § 80. An MNE is free to outsource functions to its affiliates though if there is no performing of important functions and controlling of corresponding risk, financial capacity will not suffice to be entitled to a more than risk adjusted return on capital. This is where the messages contained in the BEPS Comprehensive Action Plan released on July 19, 2013 glimmer through in a most visible way, and could very well converge through proposed changes to the Transfer Pricing Guidelines envisaged under the BEPS Action Plan. It is probably also in this context that cases where the OECD will support the disregarding (or requalification) will be found. Even though the limitation to “exceptional cases” will stand, there is more pressure put on the taxpayer to substantiate that the transaction(s) would also be plausible to independent parties. Finally, although the OECD issued its White Paper on Documentation as a separate Report, the two probably come together when the two-tiered approach in the Documentation
Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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