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OECD Release on Intangibles: Many Issues Unanswered

The OECD on September 16 issued revisions to Chapter VI of the transfer pricing guidelines, Special Considerations for Intangibles, as part of the release of base erosion and profit shifting (BEPS) deliverables. This release is a work in progress, as several important sections remain in draft form and will only be finalized as part of the 2015 BEPS deliverables. However, the release provides important guidance in the many areas that are final, and for those that are not, it provides insight into the likely direction of future guidance.

Definition of intangibles

The OECD has adopted a broad definition of intangibles in the revised guidance to preclude arguments that valuable items fall outside the scope of the definition. The expansive approach adopted by the OECD is similar to that of many countries.

The revised guidance defines an intangible as something (1) that is not a physical asset or a financial asset; (2) 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 identifying intangibles for transfer pricing purposes, the OECD 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 OECD 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 a necessary condition for an item to be characterized as an intangible for transfer pricing purposes, although it may affect the value of an item and the returns that should be attributed to it. Likewise, separate transferability is not a necessary condition for an item to be characterized as an intangible for transfer pricing purposes.

The OECD discusses several items that are characterized as intangibles for transfer pricing purposes, and some that are not:

Intangibles for transfer pricing purposes	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
Not Intangibles for transfer pricing purposes (not owned or controlled by a single associated enterprise)	Group synergies
	Market specific characteristics (e.g., local consumer purchasing power and location savings)
	Assembled workforce

The 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 revised guidance addresses the difficult question of how to allocate profits attributable to an intangible when ownership of the intangible is separated, in whole or in part, from activity that relates to the development, enhancement, maintenance, protection, or exploitation of that intangible. This may be the most important part of the revised guidance on intangibles, and it remains the most controversial, because it has the potential to require significant changes to practice under the current guidelines. However, 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.

Section B is not in final form because some aspects of the guidance might be revised following consideration of risk, hard to value intangibles, and special procedures, which will take place in the next round of BEPS work. The revised guidance is scheduled to be delivered in September 2015, although early drafts -- at least with respect to risk and capital -- are expected before the end of 2014.

The guidance in Section B recognizes that payment for use of an intangible should be made to the party with legal ownership of that intangible. However, when another party 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. There is therefore no intention 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 it does not perform. Hence, the transfer pricing questions related to payment to the legal owner for use of an intangible are not affected by the subsequent transfer pricing question of how much the legal owner should pay to parties that have participated in the development, enhancement, maintenance, or protection of those intangibles.

In discussing the issues concerning (1) the separation of ownership from activity leading to the development, enhancement, maintenance, protection, or exploitation of intangibles; (2) the determination of the party whose profitability is to be tested; and (3) what profit ultimately is allocated to the owner and to those undertaking those activities, the guidance states that the results should be driven by a functional analysis of the functions performed, assets used, and risks assumed by all group members, in accordance with Chapters I-III of the transfer pricing guidelines. The guidance is clear that the legal owner of the intellectual property might not earn any functional profit from simply owning the intangible, after compensating other members of the group for those activities.

The 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 guidance is clear that if the actual assumption or control of risk and the actual functions leading to the development, enhancement, maintenance, protection, or exploitation of intangibles differ from those stipulated in the contractual agreement, then it is the actual position that must be reviewed.

The guidelines contain a clear statement that the legal owner itself does not need to carry out all the functions related to the development, enhancement, maintenance, and protection of those intangibles. The guidance recognizes that independent parties sometimes engage others to perform these functions, and under the arm's length principle, therefore, related parties could act in a similar manner. If such outsourced activity is to be considered a "service" and priced accordingly, the guidance is clear that someone in the group, other than the service provider, should exercise control over the performance of the outsourced activity. 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 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 also be appropriately compensated.

The 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 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; and
- 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' judgment. 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 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.

The release adds new guidance on when the transfer pricing analysis should be performed. The release states that compensation must be determined on the basis of anticipated or *ex ante* information. This could raise practical considerations, because in many cases, the individuals responsible for transfer pricing analysis will not be aware of all of the intangible-creating activity and, even if they are aware, the *ex ante* internal analysis many companies prepare in deciding to create intangibles may not be adequate to perform all of the required analysis.

Valuation of intangibles

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

Realistically available options

The guidance strongly emphasizes that the comparability analysis with respect to 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 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 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 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 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, the parties' allocation of risk should not be recognized, or whether the conditions of the transaction should otherwise be adjusted. Similarly, if it is asserted that either the current use of an intangible or a proposed realistically available option does not optimize resource allocations, it may be necessary to consider whether such assertions are consistent with the true facts and circumstances of the case.

Comparability analysis

The supplemental 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 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 comparable, and whether the transferred comparable can be used as a platform to shorten the development time of future generations of the product. The guidance questions whether comparable information drawn from public or private databases is sufficiently detailed to satisfy the guidance's comparability standards.

The guidance provides that if amounts attributable to comparability adjustments represent a large percentage of the compensation for the intangible, 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 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 of the relevant factors materially contributing to the creation of value, not only intangibles and routine functions.

The OECD 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 OECD 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 OECD 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 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 OECD guidance sets a high bar on comparability, which in practice likely 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).

The guidance suggests that profit splits may be a reliable method for valuing developed intangibles in the absence of CUPs. The discussion of the profit split method is not in final form, presumably because additional guidance on the transactional profit split method will be provided as part of Action 10 on high-risk transactions due September 2015. Hopefully, the additional guidance will provide guidance on how the legal owner should share losses with entities that perform the important functions that would have permitted those entities to earn additional returns had the intangible been profitable.

The OECD further provides that 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. In applying a valuation technique, it is essential to consider the assumptions that underlie the analysis. In particular, the OECD 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; and
- Form of payment.

Potential considerations with respect to risk and capital

Current OECD guidance on the allocation of risk focuses on whether the party assuming the risk has control over the risk and financial capacity to assume the risk. Current rules focus on economic substance of any purported allocation of risk (see Paragraphs 9.22-9.32 of the OECD transfer pricing guidelines).

Proposed guidance contained in Section B recognizes that funding of the development, enhancement, protection, or exploitation of intangibles and the associated business risk are often integrally related, but requires them to be analyzed separately because the allocation of risk can be affected by contract. The release recognizes that returns attributable to funding risk depend on the stage of development of the intangible, the control over intangible-related risks, and the ability to absorb losses. The proposed guidance specifically recognizes the need to reward the party that funds the intangible, but if the functional analysis shows no functions, risks, or assets other than funding and the funding risk, then that party is entitled only to a risk-adjusted return on capital.

BEPS Action 9 requires the OECD to develop rules to prevent base erosion and profit shifting by transferring risks among, or allocating excessive capital to, group members. As part of Action 9, the OECD is discussing new guidance for the allocation of risk and the associated returns to capital. The OECD is discussing whether related taxpayers can contractually allocate risk within a multinational group. Some commentators have argued that the true bearers of risk within a multinational group are the shareholders, not any individual entity.

As part of Action 9, the OECD is addressing whether an allocation of risk between members reflects economic substance, since most entities in the same business line arguably share the risks associated with that business line; in other words, a proper functional analysis will show that the risks of developing, manufacturing, and marketing successful products are borne by the R&D center, the manufacturer, and the distributor. The OECD has also discussed whether there is a "natural" location for certain types of risk taking, at the location of the people involved in the risk-taking behavior. For example, the R&D group performing the R&D activity might be the natural place to allocate the R&D risk. The distributor performing marketing functions might be the natural place to allocate marketing risk. This line of reasoning, which heavily focuses on people functions, is consistent with the OECD's direction that transfer pricing outcomes should reflect where value is created.

If the OECD were to follow this approach in relation to structured business models perhaps with central entrepreneurs, it could significantly reduce the situations in which ex-post benchmarked returns may be used to test transfer prices, because the risk position of potential comparables is unlikely to match that of a group member. In addition, it could significantly change the profitability of entities as they move away from benchmarked returns for example, manufacturing, sales, or services and lead to more frequent use of the transactional profit split method.

Potential considerations with respect to hard-to-value intangibles

Chapter VI guidance may be further affected by the output from BEPS Action 10, which considers the transfer pricing of high-risk transactions, and by further consideration of "special measures," such as recharacterization, both of which are due to be completed in September 2015..

Tax authorities have expressed concern that some intangibles are hard to value using traditional methods and techniques, either because the intangible is unique in nature, the transaction would not happen between unrelated parties, or because the income stream that the intangible might generate is highly speculative at the time of the transaction. The OECD's Working Party 6 (which deals with multinational enterprises and transfer pricing) is expected to consider options to enhance transfer pricing guidance to address all of these situations, and because their review will be far-reaching, the discussion likely will consider areas where it is necessary to look at alternatives to the arm's length principle in specific circumstances.

The release has added new sections on the impact of unanticipated *ex post* returns, stating that it must be determined whether the unanticipated returns were actually unanticipated. If the returns are unanticipated, then those returns should generally be earned by the entity or entities that have the control and management of the relevant risks and actually bear the risk. Additional guidance in this area is expected as part of Action 10 on high-risk transactions, in particular, additional guidance on when results reasonably should have been anticipated, which may permit tax authorities to make adjustments to transactions and when they will be considered unanticipated.

It is possible that Working Party 6 could conclude that the arm's length principle cannot provide tax authorities with a solution in all circumstances, and that a non-arm's-length approach may be the only option in some cases. Changing OECD guidance to 'deem' certain outcomes as non-arm's length may cause significant problems for tax legislation in a number of countries that specifically require arm's length outcomes. In addition, such a solution would be inconsistent with the business profits article of most current multinational tax treaties, which incorporates the arm's length principle, although presumably this could be changed as part of a multilateral instrument contemplated by BEPS Action 15.

Similar problems may arise with a broadening of the circumstances in which an actual transaction may be recharacterized and an entity taxed on the basis of a fictional transaction. Current OECD rules permit tax authorities to disregard a transaction only in two circumstances: (1) when the economic substance of the transaction is different from its form; and (2) when the terms of the transaction in their totality differ from those adopted by independent parties behaving in a commercially rational manner and the actual structure practically impedes the determination of an appropriate transfer price. The current guidance therefore provides very specific and limited circumstances in which recharacterization can be applied, and the OECD has announced that it is considering whether to clarify how/when it would be appropriate to use recharacterization to prevent base erosion and profit shifting.

A significant drawback of recharacterization is that, save in the most straightforward cases, there is no single obvious transaction to recharacterize the transaction to, and no standard against which to create a recharacterized transaction so that both parties (and their respective tax authorities) would agree. As it is highly unlikely that the two parties to the transaction, or their tax authorities, would recharacterize a transaction to precisely the same fictional transaction, such a broadened rule is very likely to lead to significant uncertainty, potential double taxation, and increases in the number of requests for mutual assistance.

Effective Date

The OECD has not recommended a specific effective date for the changes. The effective date of the changes will depend on the domestic law of the adopting states. Some states have not enacted specific transfer pricing rules, and generally follow the OECD's transfer pricing guidelines. For those countries, the changes will be automatically incorporated into domestic law when final. Conversely, those countries that do have specific transfer pricing legislation, rules, or guidance will have to either enact new legislation adopting the rules or formally amend their existing rules or guidance.

Whether the changes will apply prospectively or retroactively will also be determined under local law. It is possible that final agreements at the conclusion of the BEPS project in 2015 could include effective dates for the new OECD guidelines to apply.

Comments from China perspective

Under China's current transfer pricing regime, the definitions of intangible assets are broadly consistent with those in this revised OECD guidelines. As an emerging market country, licensing of intangibles is commonly seen in China and outbound royalty payment have been the regular focus on tax authorities' radar; the transfer (sale) of intangibles are now more often but may trigger intangible valuation issues for transfer pricing purpose. At the moment, cost sharing arrangement (CSA) is not common in China, but both the tax authorities and MNEs are showing great interests.

Independent of the State Administration of Taxation (SAT)'s recent acknowledgement of BEPS Initiative, as discussed in our Tax Analysis (P197/2014 dated 29 September 2014) titled "OECD Chapter I Release: Important Guidance on Location-Specific Advantages and Passive Association", the Chinese tax authorities have already been routinely probing potential existence of local intangibles. For example, the Chinese tax authorities often claim that there are local intangibles for the following types of activities:

- Manufacturing activities: local manufacturers are very active in local client relationship development and maintenance which have resulted in customer based intangibles locally;

- Distribution: local distributors have incurred extraordinary advertisement, marketing, and sales promotion costs and thus would have local marketing intangibles; and,

- R&D: local manufacturer performs R&D activities and the results of the R&D are used for the benefit of the local manufacturer, where the 'principal' actually does not assume the majority of the R&D risks.

Similar points of views have been repeated by Chinese tax authorities in the UN Manual (released on October 2, 2012) and Administration Plan for International Taxation Compliance in 2014-2015, by Jiangsu Provincial Office of SAT in April 2014. The Chinese tax authorities put emphasis on functions performed, assets used and risks incurred at local Chinese entities and transfer pricing outcome should be in line with value creation. We have seen the Chinese tax authorities actively adopted alternate transfer pricing methods (e.g., profit split method) in making transfer pricing adjustments so the Chinese subsidiary would be compensated for excess expenditures or by entitlement to a share of the intangible returns.

In addition, Chinese tax authorities considers that local intangibles and location-specific advantages (LSAs) are often closely integrated, thus a holistic view of functions and risks should be taken. The Chinese tax authorities will consider whether LSAs could be viewed as analogous to intangibles, if without a sufficient business case to support local intangible building, in order to support additional taxable profit at the Chinese entities.

It has also been observed that in some of the recent anti-trust investigations by government authorities (e.g. the State Administration for Industry & Commerce), companies investigated were also found that their related party transactions are not in line with the arm's length principle. In accordance with an article published by China Taxation News on 12 September 2014, titled "Watch out! Anti-tax avoidance investigation will follow through anti-trust investigation", the Chinese tax authorities will investigate on whether there are residual profits generated from the subject entities' transaction arrangements, to what extent that the residual profit are due to intangibles and/or value creation by the relevant related party in China.

With respect to the transfer of intangibles, China's SAT have shown openness to sophisticated quantitative analysis and has organized extensive nationwide trainings on valuation techniques. Chinese tax authorities often claim that the intangibles under transfer are valuable and will apply the income method or market method in arriving at the transfer price. It is rare for the Chinese tax bureau to accept the cost method unless the enterprises can provide strong analysis and sufficient supporting document to justify the selection of cost method.

There is still ambiguity about CSAs in China, for example, cost sharing basis, the tax treatment on withholding tax and indirect tax, the implementation and documentation and annual adjustment, etc. In addition, the Chinese tax authorities may take into considerations of LSAs in benchmarking the routine functions undertaken by Chinese enterprises, e.g., in addition to limited or routine returns, additional compensations should be given to Chinese enterprises due to location savings on R&D activities.

The Chinese tax authorities also have showed increasing focus on the intangible issues related to those 'Go Global' outbound enterprises based in China. The Chinese tax authorities insist that the Chinese enterprises should receive intangible returns when 'exporting' their intangibles (such as trademarks, technological knowhow and client lists, etc.) to their foreign associates.

As the SAT has noted that it will study and issue its reactions to each OECD recommendation and a revised Circular 2 due in early 2015, taxpayers should pay close attention to how the OECD intangibles action will work with the SAT's existing audit approach.

In the meantime, enterprises should ensure that they are proactive in justifying the substance associated with their transfer pricing structure. It is very important for them to understand and document how the various activities are related to the creation, development and maintenance of intangibles, e.g. the creation of ideas, the R&D / advertising, marketing and promotion budget, R&D / marketing strategy, etc., and whether the Chinese entities are contributing to the value of the intangibles. Appropriate documentation is very helpful to provide support against future scrutiny by the tax authorities.

Local enterprises should revisit their current intercompany transactions to make sure that the arrangement of functions, risks and assets among associated entities are in line with value creation.

For Chinese enterprises that are licensees, they would need to revisit whether their current royalty charges to see if they are in line with the arm's length principle and whether they will be in line with realistic options.

Comments from Hong Kong perspective

Although Hong Kong is not an OECD member and that there is currently no provision in the Hong Kong Inland Revenue Ordinance that governs specifically the transfer pricing aspects of intangibles, it should be noted from past court cases that the Inland Revenue Department (IRD) is inclined to put more weight on 'substance over form' in applying GAAR measures, which is generally consistent with the OECD guidance on BEPS in the area of intangibles.

Independent of the OECD's development in BEPS, the IRD has already been consistently scrutinizing royalty payments made by Hong Kong companies for use of intangibles owned by overseas group companies, especially those located in tax haven jurisdictions, such as Bermuda and the BVI, with little economic substance and functions. As it is expected that the IRD will continue to closely follow the OECD in addressing the transfer pricing aspects of intangibles, Hong Kong companies are strongly recommended to revisit their current business models to assess the robustness of their transfer pricing policies relating to intangibles.

Conclusion

The OECD has undertaken the difficult task of providing additional guidance on the valuation of intangibles for transfer pricing purposes. Although some of the important guidance is not final, the direction of the final guidance is clear; the mere legal ownership of intangibles is unlikely to result in the legal owner receiving significant intangible returns. Companies that have entered into contracts for the development, enhancement, maintenance, protection, and exploitation of intangibles should consider reviewing those contracts in light of the new and proposed guidance.

The forthcoming guidance could have a significant impact on companies transfer pricing practices. Companies should closely monitor the forthcoming guidance and actively participate in future consultations with and present evidence of any concerns to both the OECD and their tax authorities.

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