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Intangible assets developed in multiple locations

Transfer Pricing challenges in the Middle East

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Introduction

How to solve a Transfer Pricing (TP) and tax problem involving intangible assets and why do they pose such challenges?

By definition, an intangible asset's value, its creation and contribution to a business is more challenging to measure because such an asset is not physical in nature and exists in contrast to a tangible asset. Tangible assets include land, vehicles, equipment, and inventory, which are usually easier to treat for tax and TP purposes. Goodwill, know-how, brand recognition, patents, trademarks, copyrights, are just some examples of intangibles that present tax and TP challenges.

Supply chain disruption, and macro-economic upheaval driven by inflation result in widespread business restructuring for many businesses operating in the Middle East (ME), and have brought into focus the issue of the treatment of intangible assets for TP and tax purposes. For multinational businesses, grappling with the development of intangible assets in more than one location and managing TP and tax risk in such scenarios, this continues to be a particularly difficult area for many tax and TP practitioners, especially in the face of increased scrutiny from tax authorities in the Middle East. TP regulations in the region are constantly evolving to include considerations relating to intangible assets. A significant development in the practice of the tax authorities is noted in the context of tax audits, particularly in the Kingdom of Saudi Arabia (KSA), where questions relating to intangible assets are increasingly being asked.

Multinational businesses operating in the region, while they may develop or use intangible assets in their operations, have not always taken precedent given the multitude of other tax and TP issues they are having to deal with. Recent trends suggest that this will need to change, especially that many multinational businesses operating in the Middle East locate their regional (or global) headquarters in the United Arab Emirates (UAE), where intangible assets are often developed and where a full Corporate Tax (CT) regime is soon to be introduced for the first time ever.

In this publication, we briefly look at the issue of the TP and tax challenges of intangible assets in a Middle East context and the historic approach adopted by the Organisation of Economic Cooperation and Development (OECD), including the orthodox analysis suggested by the OECD. This is in addition to the practical challenges posed for businesses in the region and the best practices for dealing with these challenges.

The OECD approach to intangible assets

The topic of intangible assets was part of the most significant changes done by the OECD in the Base Erosion and Profit Shifting (BEPS) action plan. This is to ensure that TP outcomes that are related to intangible assets, are consistent with the economic reality and the value creation of multinational businesses. More generally, the OECD has long recognised that intangible assets pose several challenges for both taxpayers and tax administrations.

The first of these challenges has historically centred around the definition of an intangible asset, which may differ from one jurisdiction to another depending on the legal and accounting framework of this jurisdiction. Other challenges include the virtual and sometimes unique nature of intangible assets. In such cases, the term 'Hard to Value Intangibles' (HTVI) becomes very relevant. Beyond the valuation of these intangible assets, other challenges that often arise relate to determining the legal, beneficial and economic ownership of these assets, and often, if there is more than one party involved, the TP and tax treatment can become very complicated.

The OECD project on intangibles tries to cover all the aspects that are considered essential to the understanding, management and controversy around intangible assets.

Under Action 8 of the BEPS action plan, the OECD has examined several TP issues to address the following questions:

1. how to adopt a broad and clearly delineated definition of intangible assets;
2. how to ensure that the benefits associated with the transfer and use of intangible assets are appropriately allocated on the basis of value creation (and not independently of value creation), including the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE), more on this below) of intangible assets; and
3. how to develop TP rules or special measures applicable to transfers of intangible assets that are difficult to value.

OECD's definition of intangible assets for TP purposes

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD TP Guidelines) defines the word "intangible" as something that is not a physical asset or a financial asset, that can be owned or controlled for use in commercial activities, and where its use or transfer would be compensated when the transaction occurs between independent parties in comparable circumstances.

Rather than focusing on accounting or legal definitions, the thrust of a TP analysis in a case involving intangibles should be based on the conditions that would be agreed upon between independent parties for a comparable transaction.

As highlighted by the United Nations works , a key consideration is that for the use or transfer of the intangible asset between related parties, there should be a compensation element which should be determined as if the transaction is between unrelated parties.

Additionally, what makes the definition of an intangible asset difficult is that intangible assets that are relevant for TP purposes are not always considered intangible assets from an accounting or legal perspective. An intangible asset, which has no book value, but whose economic value cannot be denied, is usually very relevant in the context of TP and tax considerations.

The DEMPE framework

In transactions involving intangible assets, it is important to check which group entities perform functions, assume risks, and use intangible assets, including activities relating to the DEMPE of the intangible assets. This is in addition to identifying the legal owner of the intangible assets. Entities of Multinational Enterprises (MNEs) that are overseeing DEMPE activities, totally or partially, should receive market-based remuneration for the functions performed, risks assumed, and assets used in relation to these activities.

The following table summarises the functions related to each of these activities:

DEMPE Pillars	Detailed functions
Development	Development of an intangible asset as well as the implementation of plans and strategies for its creation
Enhancement	Performance of certain aspects of an intangible asset to improve it, update it or upgrade it
Maintenance	Performance of assignments on an intangible asset to ensure that it continues to generate revenue for the group or, to grant its use during its lifetime
Protection	Protection of the rights attached to an intangible asset to ensure that no third party derives income from that asset
Exploitation	Generating the profits through the use, transfer or lease of the intangible assets

In addition to these key activities, in determining how profits might be allocated to those involved in the creation of intangible assets, it is also necessary to consider the financial ability of entities to finance the ownership and protection of the intangible asset and, also the other risks borne in respect of the intangible assets.

The results of a DEMPE analysis, as part of the functional analysis, allow the determination of the functional profile of the entities involved in the valuation of the asset and consequently the pattern according to which the remuneration from these intangible assets should be shared.

Challenges faced by ME businesses following the recent updates

MNEs operating in the region face several issues that relate to the development and use of intangible assets, especially given the introduction of a new UAE CT regime and increasing TP interest of tax authorities in the region. Indeed, MNEs in the region are often organized around global or regional headquarters in the UAE, and usually hold or develop intangible assets.

MNEs that have tried to conceptually deal with intangible assets for TP and tax purposes, have often had two types of approaches to the characterisation of the ownership and use of intangibles in their business:

1. A model of decentralised participation in the creation or development of the intangible assets. The ownership being centralised. (Case 1 below); or
2. Centralized ownership and development of intangible assets (Case 2 below).

[1] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Paris, January 2022, (referred to as OECD Guidelines), paragraph .6.6
[2] United Nations Committee of Experts on International Cooperation in Tax Matters Workshops

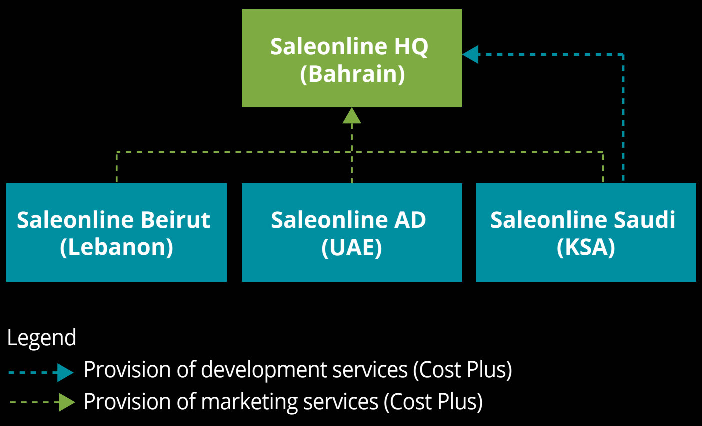
Next, we illustrate these two approaches through two practical cases. The below companies are non-existent and are created for the purpose of the practical cases only.

Case 1 – Decentralised participation in the creation or development of intangible assets

The Group Saleonline is headquartered in Bahrain and is operating e-commerce services in the UAE, KSA and Lebanon.

The fact pattern related to Saleonline can be summarised as follows:

- The management and strategy functions of the group are performed at the level of Saleonline's Head Quarter (HQ);
- Saleonline Saudi is in charge of the development and enhancement of the e-commerce solution (i.e., the platform). The software development director and their team are based in Riyadh. The third-party license providers are dealing directly with Saleonline Saudi.
- Saleonline Saudi has entered into a software development agreement with Saleonline HQ.
- Saleonline Saudi is remunerated according to a 'Cost Plus' method for software development. The third-party licenses are recharged at cost.
- Saleonline Saudi, Saleonline AD and Saleonline Beirut are also in charge of commercial and the marketing activities. Following Saleonline HQ guidelines, the commercial teams of the respective entities are in charge of setting the operational marketing actions (i.e., local events local sponsoring, local offers or sales periods, seminars and other local marketing initiatives).
- Saleonline Saudi, Saleonline AD and Saleonline Beirut have entered into a marketing services agreement with Saleonline HQ and these entities are respectively remunerated according to a 'Cost Plus' method for the marketing services they undertake.
- The remuneration for the development and marketing services is supported by benchmark analyses in relation to the level of the mark-up applied.



Based on the fact pattern, the outcomes of the DEMPE analysis can be summarized in the following table:

DEMPE Pillars	Saleonline website and related software	Saleonline Brand
Development	Saleonline Saudi	Saleonline Saudi, Saleonline AD and Saleonline Beirut Saleonline HQ is in charge of setting the strategy related to the brand
Enhancement	Saleonline Saudi	Saleonline Saudi, Saleonline AD and Saleonline Beirut
Maintenance	Saleonline Saudi	Saleonline Saudi, Saleonline AD and Saleonline Beirut
Protection	Saleonline HQ	Saleonline HQ
Exploitation	All group entities	All group entities
Conclusion	Saleonline Saudi undertakes major activities related to DEMPE for the Saleonline website and related software.	Saleonline Saudi, Saleonline AD and Saleonline Beirut undertake major activities related to DEMPE for the Saleonline brand. Saleonline HQ is responsible for setting the strategy related to the brand and granting its legal protection

In this case, the most likely TP risk will be the recharacterization of transactions between the local entities and Saleonline HQ.

The tax authorities in KSA and Lebanon, and in the near future in the UAE following the introduction of the new CT regime, may decide that the local companies are in charge of the development of the brand awareness in their respective territories, with Saleonline Saudi being a major contributor to the development of the software. On this basis, the local tax authorities may reach the conclusion that these local entities should be entitled to additional remuneration for their role in the development, enhancement and maintenance of the intangible assets.

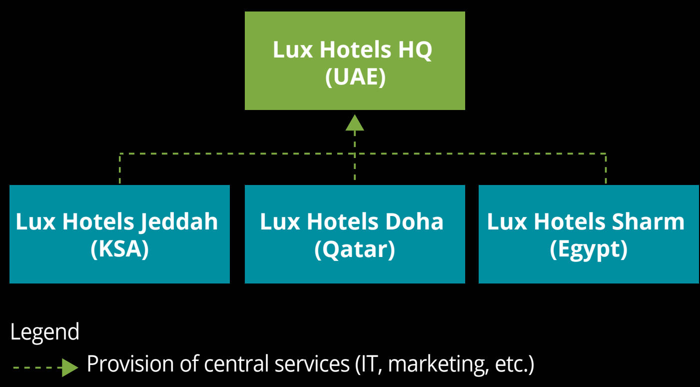
It should be noted that the tax authorities may rely on the DEMPE analysis to support such arguments. Thus, the current TP policy under which a routine remuneration is granted to the local entities under the current services agreement could be challenged.

Case 2 – Centralized ownership and development of intangible assets

The Group Lux Hotels is a UAE family group specialized in Real Estate and Hospitality and is headquartered in Dubai. The group experienced a great expansion in the 2000's through its various hotels in the UAE as well as its real estate projects in Dubai.

Since 2015, the Group's management has decided to expand internationally by opening hotels in Jeddah (KSA), Doha (Qatar) and Sharm El-Sheikh (Egypt). The fact pattern related to Group Lux Hotels can be summarised as follows:

- Lux Hotels HQ is in charge of all strategic functions within the group (corporate management, strategy, finance, brand management, commercials and marketing, legal and other central functions). Lux Hotels HQ is also in charge of the group's activities in the UAE.
- The Lux Hotels brand, which is well known in the region as providing high-end hospitality services, was nominated as the Middle East Hospitality brand of the year.
- The subsidiaries operate autonomously in their respective territories. However, they rely on the group's IT system and central commercial and marketing strategy.
- As such, the subsidiaries have entered into an agreement with the Lux Hotels HQ to cover the central services, which are remunerated on a cost-plus basis.
- The brand is used by the local companies, with no associated charge.



DEMPE Pillars	Lux Hotels Brand
Development	Lux Hotels HQ
Enhancement	Lux Hotels HQ
Maintenance	Lux Hotels HQ
Protection	Lux Hotels HQ
Exploitation	All group entities
Conclusion	Lux Hotels HQ undertakes major activities related to DEMPE for the brand.

Following the introduction of the CT and TP regulations in the UAE next year, the UAE Federal Tax Administration might likely question the absence of compensation of Lux Hotels HQ for the use of the brand.

The tax administration may indeed rely on a DEMPE analysis of the Lux Hotels' brand, in order to support its position.

Best practice for ME businesses in terms of intangible assets

In light of the above cases and the importance of an appropriate TP policy for intangible assets, it is essential for MNEs operating in the region to anticipate important considerations related to intangible assets at group level in order to manage their group wide tax risk. Below are three key steps MNEs in the region should strongly consider in respect of intangible assets:

Identify

- The intangible assets within the group (developped/ aquired, used, etc)
- The key parties involved in the creation of the intangibles assets;
- The functions performed, assets utilized and risks assumed on intangibles through a full DEMPE analysis.

Analyze

- The scope and consistency of the contractual framework;
- The consistency of economic returns derived from the intangible assets;
- The accuracy of the allocation method used to split the economic returns from the intangible assets.

Implement

- Benchmarking studies to justify the level of economic returns to intangible asset owners;
- Transfer Pricing documentation supporting the TP policy related to the intangible assets;
- Intra-group agreements that are aligned with the DEMPE analysis and the supporting economic analysis.

Summary

As the analysis above demonstrates, an intangible asset's value, its creation and contribution to a business are challenging to measure because such assets are not physical in nature and exist in contrast to tangible assets.

From the perspective of MNEs operating in the Middle East region, while they may develop or use intangible assets in their operations, dealing with the issue of intangible assets has not always been a top priority. However, recent and impending developments suggest that this will need to change, especially given that the UAE, where intangible assets are often developed, will imminently implement a full CT regime for the first time. On this basis, the issue of intangibles, tax and TP, is no longer an issue that MNEs can afford to delay or deny.

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