OECD issues final guidance on transfer pricing for intangibles under BEPS Action 8

Executive summary

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) issued its final report on transfer pricing under Actions 8-10 of its Action Plan on Base Erosion and Profit Shifting (BEPS). The document, Aligning Transfer Pricing Outcomes with Value Creation, contains revisions to section D of Chapter I of the OECD Transfer Pricing Guidelines, guidance on commodity transactions, revisions to Chapter VI of the OECD Transfer Pricing Guidelines regarding intangibles, revisions to Chapter VII of the OECD Transfer Pricing Guidelines regarding low value-adding intra-group services, revisions to Chapter VIII of the OECD Transfer Pricing Guidelines regarding cost contribution arrangements, and scope of work for guidance on the transactional profit split method.

This Alert discusses the new chapters on Intangibles (Chapter VI) and Cost Contribution Arrangements Chapter VIII), as well as a new section on risk and the control of risk that will be included in Chapter I and is relevant to intangible related risk (the 2015 Guidance).

This is the final update to the OECD Transfer Pricing Guidelines, with respect to intangibles, that is expected from the BEPS project. However, one section within Chapter VI part D (on the application of the transactional profit split method for pricing intangibles transactions) is likely to be revised when the OECD completes its new guidance on this transfer pricing method, anticipated to be early in 2017.

EY is hosting a series of webcasts that will provide a comprehensive review of the final BEPS reports and outlook for country action. The final transfer pricing guidance under Actions 8-10 will be addressed in the webcast on 12 November at 10am EST.
Detailed discussion

**Context**

In the BEPS Action Plan the OECD expressed the view that multinational groups have in some instances been able to use or misapply transfer pricing rules to separate income from the economic activities that produce that income and to shift it to low-tax environments and that this often has resulted from arrangements involving intangibles. Action 8 therefore had the objective of developing rules to prevent BEPS from arising from the movement of intangibles among group members. The new version of Chapter VI contains guidance focused on ensuring that the profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation, as well as a new approach to address transfers of hard-to-value intangibles.

The 2015 Guidance is based on and consistent with the interim version of Chapter VI issued in the 2014 Action 8 Deliverable¹ and also with interim discussion drafts on CCAs and hard-to-value intangibles issued during 2015.² However, some elements are new, in particular the framework for analyzing risk and the control of risk. In developing the 2015 Guidance, the OECD has taken note of the significant discussions with business representatives and the guidance reflects an effort to ensure that it is practical to implement. In particular, a positive change from the 2014 Action 8 report is the provision of a framework for establishing appropriate arm's length prices in the common intragroup situation where an entity owns and funds the development of intellectual property while the development, enhancement, maintenance, protection and exploitation functions are performed by affiliates.

An additional significant change made by the OECD since the 2014 Action 8 report has been the redevelopment of the approach for determining arm’s length prices and terms for transactions to avoid the need for “re-characterization” or the non-recognition of transactions in the great majority of cases. Under the new Chapter I framework, once a transaction has been accurately delineated for transfer pricing purposes, application of non-recognition will be limited to exceptional circumstances. Accordingly, almost all references to the non-recognition of transactions have been removed from the version of Chapter VI issued in the 2015 Guidance.

**Defining intangibles for transfer pricing purposes**

Section A explains that difficulties can arise in transfer pricing from a definition of intangible assets which is too narrow or too broad. Too narrow a definition might result in governments or taxpayers arguing that something falls outside the definition. The consequence might be to permit the use or transfer without compensation where that transfer would have been compensated at arm’s length. Too broad a definition might have the opposite result.

The 2015 Guidance therefore defines an intangible asset for transfer pricing purposes as something “which is not a physical or 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.” Such a definition is absent from the 2010 OECD Guidelines (which is the most recent complete edition of the OECD Guidelines in book form), although the definition given in the 2015 Guidance is the same as the definition included in the 2014 Action 8 report.

**Special considerations for intangibles**

The version of Chapter VI issued in the 2015 Guidance has the same structure as earlier OECD documents on intangibles issued as part of the BEPS project. It contains four sections (A-D) providing guidance on:

A. Identifying intangibles
B. Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles
C. Transactions involving the use or transfer of intangibles
D. Supplemental guidance for determining arm’s length conditions in cases involving intangibles

1. Version of Chapter VI issued in the 2014 Action 8 Deliverable
2. Interim discussion drafts on CCAs and hard-to-value intangibles issued during 2015
The 2015 Guidance provides some examples of types of intangible that fall within this definition, including both intellectual property, such as patents and trademarks, that can be registered, but also other assets such as know-how, trade secrets, and contractual rights. Furthermore, the guidance notes certain factors that may contribute to the income earned by an enterprise but are not themselves intangibles, such as group synergies and the specific characteristics of local markets. These latter factors should be treated as comparability factors in a transfer pricing analysis, according to chapter I of the OECD Guidelines.

Chapter VI also updates the Glossary to the OECD TP Guidelines by replacing the definition of “marketing intangible” in that glossary with the definition “An intangible ... that relates to marketing activities, aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned.”

The 2015 Guidance is clear that the purpose of providing a definition of intangibles is exclusively to provide clarity to tax authorities and taxpayers on identifying intangibles for transfer pricing purposes. It is not intended to have any impact on other tax matters, such as the definition of “royalties” under Article 12 of the Model Tax Convention, or on the recognition of income, capitalization of intangible development costs, amortization, or other tax matters relating to intangibles.

Identifying which entities are entitled to the returns from exploiting intangibles

Section B of Chapter VI contains guidance dealing with the fundamental question of which entity or entities within a multinational group should share in the economic returns from exploiting intangibles. The 2015 Guidance clarifies and confirms previous work, stating that mere legal ownership of an intangible does not by itself confer any right to the return from its exploitation. Instead, the economic return from intangibles, and the costs and economic burdens associated with intangibles, will be allocated to the entities that perform and control the important value-creating functions of developing, enhancing, maintaining, protecting and exploiting the intangibles (the DEMPE functions).

The new guidance in Chapter VI sets out a framework for analyzing transactions involving intangibles, which draws upon and is consistent with the guidance developed on identifying the commercial or financial relations between associated enterprises that is contained in the updated version of Chapter I of the OECD Guidelines and also was issued as part of the 2015 Guidance. This analytical framework is aimed at "accurately delineating the controlled transaction" for transfer pricing purposes, in order to determine the arm's length price and other terms for the transaction.

In essence, the application of this framework to transactions involving intangibles will have the following consequences:

- Where an enterprise that is not the legal owner of an intangible performs value-creating DEMPE functions in relation to the intangible, it can expect arm's length remuneration. The nature of this remuneration will take into account which enterprise assumes and controls the risk associated with the DEMPE functions.
- Where an associated enterprise contractually assumes the risk associated with the DEMPE functions (for example, where it takes on the financial risk associated with intangible development, or where it assumes the risk of defending an intangible against legal challenge) then the financial consequences of the risk will be allocated to that enterprise, so long as it functionally exercises control over the risk. If the enterprise does not exercise control over the risk then the risk should be allocated to the enterprise that does exercise control.
- For an enterprise to exercise control over a risk means that it must have the capability to make the decision to take on, lay off, or decline the risk-bearing opportunity, and the decision-making capability to decide whether and how to respond to risk associated with the opportunity. The day to day risk management functions can be outsourced to other enterprises, so long as the enterprise...
controlling the risk has the capacity to take the decision to outsource the risk and oversee the performance of the risk management activity.

The 2015 Guidance clarifies how the application of this framework will determine the arm’s length return where an entity within an MNE group bears financial risk associated with intangible development through financing the development activity. An entity that funds the development of an intangible but does not perform or control any DEMPE functions relating to the intangible can generally expect a risk-adjusted return on its funding (i.e., an expected return similar to the return that could be achieved by funding a comparable project of similar risk). Where the entity does not exercise control over the financial risks associated with the funding, then it is entitled to no more than a risk-free return.

While the 2015 Guidance is largely consistent with the 2014 Action 8 report, the novel part of the 2015 Guidance is the framework for analyzing intangibles transactions and allocating the associated risks in accordance with the control of the risks, along with the specific guidance on the return that can be expected for providing funding for the development of intangibles.

Transactions involving the use or transfer of intangibles
Section C of the 2015 Guidance is essentially unchanged from the 2014 Action 8 report. It sets out the two general types of transaction where identifying the intangibles concerned and accurately delineating the transaction undertaken will be necessary for transfer pricing purposes. These are (i) transactions involving transfers of intangibles or rights in intangibles; and (ii) transactions involving the use of intangibles in connection with the sale of goods or the provision of services.

Supplemental guidance on pricing intangibles transactions
Section D contains guidance on applying the principles set out in Chapters I-III of the OECD Transfer Pricing Guidelines to determine the arm’s length conditions (terms and pricing) for transactions involving intangibles. The guidance here is essentially unchanged from the 2014 Action 8 report and makes the following key points:

- Due regard should be given to the perspectives of both parties to the transaction, the options realistically available, and the attribution of risks. A “one-sided” comparability analysis, focusing only on one party to the transaction, will generally be insufficient to evaluate the transaction, including in those situations for which a one-sided transfer pricing method is ultimately determined.
- There is seldom a correlation between the cost of developing an intangible and its value once developed. Pricing methods based on cost are generally discouraged. Instead, the comparable uncontrolled price method or the transactional profit split method are likely to be the most useful transfer pricing methods in matters involving transfers of intangibles. In some circumstances one-sided methods can be utilized to indirectly value intangibles by determining values for some functions using those methods and deriving a residual value for intangibles.
- In using the CUP method, particular caution should be taken with database comparables. It is important to assess whether there is sufficient information on database comparables to properly test their comparability to the tested transaction.

Transactions involving the use of company names
The final part of section B contains guidance on applying the principles to specific types of intangibles transactions, one of which addresses situations where a payment is made for the use of a company name. The guidance here, which is unchanged from the 2014 Action 8 report, observes that determining the arm’s length payment will require considering the financial benefit of using the name as well as the contribution made to the value of the name by both the legal owner and user. In particular, it cannot be assumed that when an acquired business is rebranded to use the name of the acquirer, any payment should be made. Furthermore, if the acquirer is using the market position and capabilities of the acquired business to promote its own brand name, arm’s length compensation might instead be payable to the acquired business.
Financial valuation techniques based on discounted cash flow forecasts can be a useful tool in evaluating intangible transactions in the absence of reliable comparable uncontrolled transactions and may prove more reliable than any other pricing method. Where valuation techniques are utilized, it is necessary to apply such techniques in a manner that is consistent with the arm’s length principle and the principles of the OECD TP Guidelines. Caution should be applied in using financial forecasts and valuations prepared for other purposes, and care should be taken to understand and validate the assumptions underlying any valuation model, as small changes in the valuation parameters can have a significant impact on the resulting estimate of intangible value.

Specific guidance on hard-to-value intangibles
Section D of Chapter VI in the 2015 Guidance contains a specific transfer pricing approach to be taken in relation to “hard-to-value” intangibles (HTVIs). This is new guidance that has been developed since the 2014 Action 8 report, and it largely follows the discussion draft released in June 2015.

HTVIs are defined as “intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist; and (ii) at the time the transaction[s] was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.” Transactions involving HTVIs may typically involve, among other features, some of the following features:

- The intangible is only partially developed at the time of transfer
- The intangible is not expected to be used commercially until several years following the transaction
- The intangible is expected to be exploited in a manner that is novel at the time of transfer and the financial projections are highly uncertain
- The intangible concerned does not itself fall within the definition of HTVI but is integral to the development or enhancement of another intangible within the definition of HTVI
- The intangible, in absence of reliable comparables and the financial projections being highly uncertain, has been transferred to an associated enterprise for a lump sum payment
- The intangible is either used in connection with or developed under a CCA or similar arrangements.

The guidance notes that the asymmetry of information between taxpayers and tax administrations about the potential value of HTVIs, as well as the time that may have elapsed since the time the transaction was entered into, make it particularly difficult for tax administrations to test the pricing of the transaction. The transfer pricing approach in the 2015 Guidance is intended to protect tax administrations from the negative effects of information asymmetry, while also allowing taxpayers to demonstrate that the pricing of HTVIs is at arm’s length through a thorough transfer pricing analysis.

The 2015 Guidance authorizes tax administrations to use ex post evidence on the financial outcomes of an intangible transaction (i.e., information gathered in hindsight about how valuable an intangible has turned out to be) as presumptive evidence on the appropriateness of the ex ante pricing arrangements. Tax administrations may use such ex post evidence to determine the pricing arrangements that would have been made at the time of the transaction between independent enterprises, including any contingent arrangements (such as milestones payments or stepped royalties) that might have been agreed.

However, such presumptive evidence may not be used where certain circumstances or safe harbors apply, including:

- Where the taxpayer can demonstrate that ex ante projections used at the time of the transfer to determine the pricing arrangements were reliable, taking into account risks and reasonably foreseeable events that might have affected
the outcomes. The taxpayer also needs to provide reliable evidence that any significant difference between the projections and actual outcomes is due either to unforeseeable developments, or to the playing out of foreseeable outcomes whose probabilities were originally reasonably estimated.

- The difference between financial projections and actual outcomes does not reduce or increase compensation arising from the HTVI by more than 20% of the compensation determined at the time the transaction was entered into.

- A commercialization period of five years has passed and the difference between financial projections and actual outcome in this period has not been more than 20%.

- The transfer of an HTVI is covered by a bi- or multilateral advance pricing agreement.

**Cost contribution arrangements**

The 2015 Guidance also includes a new version of Chapter VIII covering Cost Contribution Arrangements (CCAs). The objective here is to align the guidance on CCAs with the new guidance elsewhere on the control of risk, and on intangibles transactions. In particular, the guidance seeks to ensure that the outcomes of a CCA arrangement and the returns to participants should be similar to any other arrangement that has similar economic characteristics and where the participants make similar contributions. The guidance is based on the draft report on CCAs issued in April 2015, although some aspects have clearly been refined in light of the discussions with business representatives at the OECD.

A CCA is defined as “a contractual arrangement among business enterprises to share the contributions and risks associated with the joint development, production or the obtaining of intangibles, tangible assets or services” in the expectation of mutual benefit from the pooling of resources and skills for each of the participants.

**Eligibility to participate in a CCA**

In line with the 2010 OECD Guidelines, the expectation of mutual benefit remains a pre-requisite to participate in a CCA. Participants must expect to benefit from the output of the CCA, for example by being able to exploit the rights acquired or services developed in their own businesses. Where this is not the case (for instance, where an enterprise solely performs an activity such as research and development (R&D) it should be treated as a service provider external to the CCA and compensated on an appropriate basis.

What is novel in the 2015 Guidance is that control has also become a pre-requisite for an enterprise to exercise control over the risks it assumes under the CCA, and the financial capacity to assume those risks. This means that they must be capable of (and actually perform) making the decision to take on the initial risk of participation in the CCA, and have the ongoing decision-making capacity (and actually perform it) to decide on whether or how to respond to the risks associated with the CCA.

It is not necessary for the CCA participants to perform all or part of the CCA activities through their own personnel. In some cases, the participants in a CCA may decide to outsource certain functions. The guidance is also clear that if the objective of the CCA is to develop an intangible, it is sufficient for one of the CCA participants to exercise control over the DEMPE functions relating to the intangible. Other participants providing funding should control the financial risk attached to its contributions.

**Measuring the value of contributions to a CCA**

A further aspect of the 2015 Guidance is that the value of the contributions made by CCA participants must be in proportion to their reasonably anticipated benefits from the CCA. Where contributions are not in proportion to reasonably anticipated benefits, true-up payments may be required. The value of each participant’s contribution should be determined in line with the value that would be placed on it by independent enterprises in comparable circumstances. Although this is to a certain extent consistent with the 2010 OECD TP Guidelines, the 2015 Guidance extends the previous guidance by making it clear that in most cases it cannot be assumed that the costs contributed
or incurred by CCA participants are an accurate measure of their contribution.

While contributions should be measured based on value, the 2015 Guidance also recognizes that it may be more practical for taxpayers to pay current contributions at cost (as opposed to contributions of pre-existing value). If this approach is adopted, the pre-existing contributions should recover the opportunity cost of the ex ante commitment to contribute resources to the CCA (e.g., the present value of the arm's length mark-up over the costs). Where the difference between the value and costs is relatively insignificant, for practical reasons current contributions of a similar nature may be measured at cost in such cases for services CCAs. However, this approach may not be appropriate where the contribution of different participants differ in nature (for instance, where some participants contribute services and others provide intangibles or other assets).

Distinctions will need to be drawn between contributions of pre-existing value and current contributions. For example, the value of any pre-existing patented technology contributed by a participant would to be determined under the arm's length principle (utilizing the revised guidance on risk and intangibles as appropriate) and incorporated within the full value of the contribution. The value of current R&D activity being contributed would be based on the current value of those functions.

Implications
Multinational enterprises should evaluate whether their existing transfer pricing policy is aligned with the broad definition of intangibles as included in the new guidance, in particular for the newly defined marketing intangibles. Furthermore, they should establish whether their policy correctly reflects comparability factors like market specific characteristics and synergies.

The aim of the OECD's work in this area is to ensure that transfer pricing results reflect the reality of what is happening, aligning profits with the value-creating functions and the control of risks. In groups that have separated the functions that contribute to value creation (i.e., the DEMPE functions associated with intangibles) from the entities that realize the profits from value drivers (such as the legal owners of intangibles), the relevant contributions of each entity will need to be carefully assessed in the light of the framework for assessing which entity within the group controls the economically significant risks. This should be documented appropriately in the group's master file and local file transfer pricing documentation.

In addition, the guidance in Chapter VI on valuing and pricing transactions involving intangibles, including the new guidance on HTVIs, makes it clear that groups will need to employ robust valuation techniques and may need allow for adjustments to pricing depending on the outcome of foreseeable contingent events. This also will need to be carefully documented in the local file documentation for the relevant entities.

Multinational enterprises making use of CCAs or similar arrangements should evaluate their existing arrangements, in particular the eligibility of participants, the control over risk and the measurement of the contributions.

Webcasts
EY is hosting a series of eight tax webcasts that will provide a comprehensive review of the final BEPS reports and the outlook for country action:

• OECD BEPS Project Outcomes: Highlights and Next Steps – 15 October, 10am EDT
• New Reporting under BEPS Action 13 – 20 October, 10am EDT
• Digital Economy Developments and BEPS Action 1 – 27 October, 12 noon EDT
• Permanent Establishment Developments and BEPS Action 7 – 5 November, 10am EST
• Transfer Pricing and BEPS Actions 8-10 – 12 November, 10am EST
• Anti-abuse Measures under BEPS Actions 3, 5, 6 and 12 – 19 November, 10am EST
• Financial Payments and BEPS Actions 2 and 4 – 3 December, 10am EST
• Dispute Resolution and BEPS Action 14 – 10 December, 10am EST

For more information and to register for the webcast series, click here.
Endnotes


For additional information with respect to this Alert, please contact the following:

**Ernst & Young Belastingadviseurs LLP, Transfer Pricing, Rotterdam**
- Ronald van den Brekel  +31 88 407 9016  ronald.van.den.brekel@nl.ey.com

**Ernst & Young LLP (United Kingdom), Transfer Pricing, London**
- Ben Regan  +44 20 7951 4584  bregan@uk.ey.com

**Ernst & Young LLP, Transfer Pricing, Washington, DC**
- Chris Faiferlick  +1 202 327 8071  chris.faiferlick@ey.com
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