OECD issues updated guidance under BEPS Action 8 on transfer pricing aspects of intangibles

Executive summary

On 16 September 2014, the Organisation for Economic Co-operation and Development (OECD) released, as part of a series of deliverables pursuant to the Action Plan on Base Erosion and Profit Shifting (BEPS), draft recommendations under Action 8 (Transfer Pricing Aspects of Intangibles). The report entitled, Guidance on Transfer Pricing Aspects of Intangibles (the Report) contains revised standards for transfer pricing of intangibles and additional standards with respect to comparability and transfer pricing methods.

The first part of the Report contains amendments to Chapter I (The Arm’s Length Principle) of the OECD Transfer Pricing Guidelines relating to the transfer pricing treatment of location savings and other local market features, assembled workforce, and the existence of multinational enterprise (MNE) group synergies. The second part of the Report contains an entirely revised Chapter VI (Special considerations for intangibles) of the OECD Transfer Pricing Guidelines (the 2014 Guidance). It provides guidance on: (i) the definition of intangibles, (ii) identifying and characterizing specific controlled transactions involving the use or transfer of intangibles, and (iii) determining arm’s length conditions in cases involving intangibles.

The Report also includes interim guidance on ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles, the application of profit split methods, and arm’s length pricing when valuation is highly uncertain at the time of the transaction. This part of the 2014 Guidance remains in draft because of the interactions between this work and the work to come on other transfer pricing elements of the BEPS project. The Report indicates that this interim guidance will be finalized in connection with the 2015 BEPS work on risk, recharacterization, and hard to value intangibles.
Key features of the 2014 Guidance and key differences compared to the revised discussion draft on transfer pricing aspects of intangibles issued on 30 July 2013 (the Revised Discussion Draft),¹ include:

- The definition of an intangible, which includes a new definition of “marketing intangibles” and otherwise follows the definition in the Revised Discussion Draft.
- The statement that it is not necessary to define when goodwill or ongoing concern value may or may not constitute an intangible. If features of a business allow a company to charge higher prices, such contribution should be compensable, regardless of the terminology used.
- The interim guidance on ownership, the thrust of which is that legal ownership as such and the funding of the development of an intangible, without performing and controlling all of the functions, would not lead to an entitlement to the returns derived from the exploitation of such intangible. The allocation of returns should be in line with value creation.
- The introduction of the exploitation of the intangible as one of the five categories of functions, risks and assets which need to be assessed when determining if an MNE group member is entitled to any return derived.
- New guidance on how profits or losses relating to unanticipated events (ex post returns) should be shared between MNE group members contributing to the development, enhancement, maintenance, protection and exploitation of the intangible.
- The use of valuation techniques as part of the five OECD transfer pricing methods or as a useful tool.
- New and revised examples to illustrate the updated guidance.

In the next several months, additional work will be undertaken in connection with risk, recharacterization, cost contribution arrangements (CCAs) and hard to value intangibles, which will lead to partial revisions of Chapters I, II, VI, VIII and IX of the OECD Transfer Pricing Guidelines. In this process, so-called “special measures” which deviate from the arm’s length principle may be considered. Some examples of potential special measures are included in the Report.

Detailed discussion

The discussion below describes the context in which the 2014 Guidance has been issued, and its role as part of the OECD BEPS Action Plan. In addition, it provides further detail on key areas implicated in the Intangibles Guidance and on changes to the prior OECD intangibles as outlined in the Revised Discussion Draft.

Context

The transfer pricing for intangibles is one of the most challenging topics in the transfer pricing area, both from a theoretical perspective and because of the number and size of the disputes that have arisen. Therefore, the OECD announced the start of a project on transfer pricing aspects of intangibles in July 2010, to be carried out by OECD Working Party No. 6 which is responsible for transfer pricing. This 2014 Guidance is the result of a long process of discussion drafts, comments and public consultations.

The OECD’s work on intangibles is a specific Action in the OECD BEPS Action Plan and is closely related to other Actions on transfer pricing, including work on allocation of risks and capital for transfer pricing purposes, work on re-characterization of transactions that might not occur between unrelated parties, and work on transfer pricing methods including profit splits in the context of the global value chains of MNEs. Some of the text and examples contained in the 2014 Guidance raise issues that the OECD expects to address further through other BEPS Actions. Accordingly, the report contains interim guidance on ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles, the application of profit split methods, and arm’s length pricing when valuation is highly uncertain at the time of the transaction. The interim guidance will be finalized in connection with the 2015 BEPS work on risk, recharacterization, and hard to value intangibles, which is expected to be completed by September 2015.
The Report identifies the following as among the special measures that will be considered during the course of the 2015 work:

- Providing tax administrations with authority in appropriate instances to apply rules based on actual results to price transfers of hard to value intangibles and potentially other assets
- Limiting the return to entities whose activities are limited to providing funding for the development of intangibles, and potentially other activities, for example by treating such entities as lenders rather than equity investors under some circumstances
- Requiring contingent payment terms and/or the application of profit split methods for certain transfers of hard to value intangibles
- Requiring application of rules analogous to those applied under Article 7 of the OECD Model Tax Convention and the so-called Authorized OECD Approach to certain situations involving excessive capitalization of low function entities

The Report indicates that no decisions have yet been made regarding which special measures will be adopted or whether such measures are consistent with Article 9 of the OECD Model Tax Convention. The Report further notes that this list of special measures is not necessarily comprehensive and that other measures may also be considered.

**Features of the local market, location savings, assembled workforce and group synergies**

The 2014 Guidance sets out the OECD’s view on how comparability factors such as local market features (including location savings), assembled workforce and MNE group synergies should be treated for transfer pricing purposes. The Report introduces a new section to be included in Chapter I of the OECD TP Guidelines, including five new examples.

The thrust of the Report is that these are all comparability factors that should be taken into account in a transfer pricing analysis, but that are not themselves intangibles. However, in certain situations, these features can involve intangibles. For example, where a regulatory license or permit is required to operate in a specific market or industry and the license or permit is tradable, it may constitute an intangible that would entitle the license holder to a greater share of the benefits of operating in that market. In addition, in the context of “assembled workforce,” the transfer or secondment of employees may result in the transfer of valuable know-how from one associated enterprise to another. In each case, the question of arm’s length compensation for these intangibles will depend on the facts and circumstances.

With respect to group synergies, the report focuses on how structural advantages or synergy benefits enjoyed by an MNE (such as scale economies, integrated management, elimination of duplication, etc.) would be shared at arm’s length. Where group synergy benefits accrue to an associated enterprise simply by being part of the MNE group, the report suggests that these benefits should not be separately compensated or reallocated among group members. In some instances however, synergistic benefits may result from deliberate concerted group actions. For example, where the MNE group takes active steps to activate group synergy benefits (for instance, by organizing central purchasing), the OECD takes the position that synergy benefits should be shared in proportion to their contribution to the creation of such synergy (e.g., purchase volumes in the case of advantages of economy of scale resulting from high volume purchasing). The Report contains specific examples regarding the determination of interest rates for members of an international group, illustrating how to deal with the effects of implicit support by the group.

According to the Report, this new section in Chapter I of the Transfer Pricing Guidelines can be considered as final guidance.

**Definition of intangibles for transfer pricing purposes**

The 2014 Guidance confirms the definition of an intangible for transfer pricing purposes as “something which is not a physical asset or a financial asset, and 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.” This definition is unchanged from the one provided in the Revised Discussion Draft. The 2014 Guidance includes a new definition of the term “marketing intangible,” which was not contained in the Revised Discussion Draft: “an intangible (within the meaning of paragraph 6.6) 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. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.” Finally, the 2014 Guidance maintains the definition of “unique and valuable” intangibles as “those intangibles (i) that are not comparable to intangibles used by or available to parties to potentially comparable transactions, and (ii) whose use in business operations (e.g. manufacturing, provision of services, marketing, sales or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible.”

Section A of new Chapter VI provides illustrations of certain categories of intangibles. Further, the 2014 Guidance also states that it is not necessary to define when goodwill or ongoing concern value may or may not constitute an intangible. If features of a business allow a company to charge higher prices, such contribution should be compensable, regardless of the terminology used.

Interim guidance on which entities are entitled to the return derived from exploiting intangibles
Section B of new Chapter VI provides guidance on which of the entities in an MNE group should be entitled to retain the economic profits from exploitation of intangibles. Section B is considered as interim guidance because of the strong links with the 2015 OECD work on risk, recharacterization, capital and possible special measures. It is expected that the further work by OECD in these areas in 2015 will lead to changes to Section B.

Similar to the Revised Discussion Draft, the interim guidance provided in section B adopts a transactional approach, with a clear focus on substance and stressing the importance of functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles. The reference to “exploitation” of an intangible is a new addition, as the Revised Discussion Draft did not include “exploitation” in the list of categories of functions, risks and assets which need to be assessed when determining if an MNE group member is entitled to any return derived.

The 2014 Guidance states that the legal ownership of an intangible by itself does not confer any right to retain the return from exploiting an intangible, even where this return may initially accrue to the legal owner as a result of its legal or contractual rights. Instead, the return ultimately retained by the legal owner depends on the contributions it makes to the anticipated value in the intangibles, relative to the contributions made by other group members, through functions performed, assets used, and risks assumed that contribute to the value of the intangible. If the legal owner performs no relevant functions, uses no relevant assets, and assumes no relevant risks, but acts solely as a title holding entity, the legal owner will not ultimately be entitled to any portion of the return derived by the MNE group from the exploitation of the intangible other than arm’s length compensation, if any, for holding title.

The 2014 Guidance distinguishes between ex-ante and ex-post returns, clarifying that the compensation that must be paid to members of the MNE group that contribute to the development, enhancement, maintenance, protection and exploitation of intangibles is generally determined on an ex-ante basis. The allocation of actual ex-post profit or loss will depend on the facts and circumstances of the case. In addition, the 2014 Guidance elaborates on the determination of an appropriate return for entities that fund intangible development.
The interim guidance states that an entity that provides funding but does not control the risks or perform the functions associated with intangible development would generally, at arm’s length, not receive a return equivalent to the return earned by a similarly situated investor who also controls the risks and/or performs the functions associated with the creation of value in the intangibles.

Transfer pricing aspects of the use of company names
The final part of section B of new Chapter VI is now devoted to providing guidance on applying the principles established in that section to different circumstances, including situations where a payment should be made for the use of the group name. The guidance follows the principle that the quantum of any payment for the use of a company name should depend on the amount of the financial benefit received from using the name and that the relative contribution made by the owner and user of the name, as assessed through an analysis of functions, assets and risks.

One observation here is that where one existing successful business is acquired by another and rebranded to use the name or trademark of the acquirer, there should be no automatic assumption that payment should be made by the acquired business. A second observation is that in those circumstances, it may be the case that the acquirer is using the market position of the acquired business to promote its own brand name, in which case the acquirer might need to compensate the acquired business additionally for the functions, risks and assets (including market share) deployed by the acquired business to promote the acquirer’s name.

Final guidance on the identification and characterization of specific transactions involving intangibles
Section C of new Chapter VI describes the two main types of transactions considered relevant for purposes of identification and characterization of specific transactions involving intangibles: (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 for pricing intangibles transactions including use of valuation techniques
Section D of new Chapter VI provides detailed supplemental guidance in applying the principles of Chapters I through Chapter III of the OECD Transfer Pricing Guidelines to transactions involving intangibles, including hard to value intangibles. The transfer pricing treatment of hard to value intangibles will be subject to additional revisions as part of the work on BEPS Actions 9 and 10. The revised (and final) guidance is expected to be released in January 2015.

In addition to this supplemental guidance, this section acknowledges explicitly that the application of a valuation technique, either as part of one of the five approved OECD methods or as a useful tool, may prove more reliable than any other transfer pricing method. The discussion in this section stresses that where valuation techniques are used in a transfer pricing analysis involving the transfer of intangibles or rights in intangibles, 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 Transfer Pricing Guidelines. In particular, due regard should be given to the principles contained in Chapters I - III, including options realistically available, perspectives of both parties, attribution of risk, and aggregation of transactions. Therefore, valuation techniques used for other purposes should not be used without further consideration.

Implications
As indicated above, the output with respect to Action 8 contains both final and interim guidance. The element that is final, to be implemented in 2015, contains clear guidance to be used in transfer pricing analyses. It stresses the importance of a thorough comparability analysis. Consequently, a transfer pricing policy based on the generic features of a group of entities without due regard to the specific circumstances of the transactions may be
challenged. Even though the guidance will only be implemented in 2015 in connection with other related BEPS work, in practice, tax authorities' behavior may be expected to be affected by the guidance before such implementation.

With regard to the element that is still in interim form, further guidance will be published in 2015. Although important decisions will have to be made with respect to the section of the guidance that addresses ownership of intangibles, the direction the OECD is taking clearly shows a focus on alignment between ownership and functions performed.

Global businesses will want to continue to monitor developments with respect to this Action 8 and will want to review their transfer pricing policy, in particular the alignment between ownership and functions performed, to be prepared for potential future changes.

Endnotes

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