The power of the invisible
Sustainable intangibles in the post-BEPS world
Sustainable intangibles in the post-BEPS world

Contents

04 The increased role of intangibles in business and in transfer pricing (TP)

05 Intangibles drive business success, attracting greater and more focused tax authority scrutiny

06 A broader set of attributes is recognized as central for business success and for transfer pricing purposes

07 As the who, where and how for intangible management changes, so does the approach of tax authorities in allocating intangibles returns

09 Looking at implications for business

09 Implications for operating model design

10 Implications for TP compliance

10 Implications for the TP model support

11 Further change ahead

12 What is business doing about this?

14 Key conclusions and observations
Introduction

We stand on the brink of a technological revolution that will fundamentally alter the way we live, work, and relate to one another. In its scale, scope and complexity, the transformation will be unlike anything humankind has experienced before.¹

Companies adopting new business models that are lean on people and tangible assets but heavy on intangible assets and that provide the interface between service or product providers and consumers (i.e., platform models), are quickly becoming some of the biggest in the world, and traditional “bricks-and-mortar” companies are scrambling to adapt and find their new role.²

At the same time, from a regulatory perspective, there is a big push by governments to tax the income created by these new intangible business models, starting with the Organisation for Economic Co-operation and Development’s (OECD’s) Base Erosion and Profit Shifting (BEPS) project, which aims to ensure that “profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation”.³,⁴

In this changing world, staying ahead of the competition while mitigating the risk of challenges is key. This requires a good understanding of what the intangible value drivers are for a company, clear insights into the processes that drive and develop these, and a conscious choice on how these are managed and controlled. The potential consequences of getting it wrong include unplanned and chaotic ownership of key assets for tax purposes, substantial complexity in determining an acceptable allocation of taxable profits between competing tax authorities, and significant reputational risks. Lastly, it can be argued that any lack of clarity as mentioned above suggests that a corporation may not be applying the right level of focus on one of its most fundamental value drivers, and thus its core business.

² As further discussed for transfer pricing purposes, intangibles comprise not only intellectual property (IP) but also any value-creating asset which is neither financial or physical and can be protected commercially.
In this article, we will:

1. Outline the evolution in the role and management of intangibles from a business and operational perspective, and how the BEPS changes in the transfer pricing treatment of intangibles respond to these business developments.

2. Discuss the implications of these changes for the (tax) compliance and design of operating models.

3. Outline the strategies that are available for responding to the changes, and illustrate our over-riding message that a structured and business-led approach that can adapt to business changes is key to a sustainable intangibles (tax) structure.
The increased role of intangibles in business and in transfer pricing (TP)

Businesses are transforming at an accelerating pace as new technologies are developed and deployed. As a result, there has been a substantial increase in the importance of intangibles; the nature of those intangibles, and the ways in which they are managed, have changed. The BEPS initiative was launched in response to some of these developments. But even without the BEPS initiative, it must be recognized that the business context for which tax compliance and planning strategies are framed has changed radically.

Recognizing that value increasingly comes from software, data and services, and seeking to avoid becoming a mere commodity supplier of “things”, a leading global engineering company founded in the nineteenth century is repositioning to become a supplier of technology and services. In the future, its web-enabled smart hardware will be updated frequently, drawing on massive amounts of data and artificial intelligence (AI). To realize its strategy, it is promoting a culture of openness and willingness to risk failure; and partnering with developers of complementary technologies such as mapping and voice control.

There are three key points to highlight in this area and these are discussed in greater detail in the following sections:

1. Intangibles drive business success, attracting greater and more focused tax authority scrutiny.

2. A broader set of attributes is recognized as central for business success and for transfer pricing purposes.

3. As the who, where and how for intangible management changes, so does the approach of tax authorities in allocating intangibles returns.
Intangibles drive business success, attracting greater and more focused tax authority scrutiny

“Intellectual property (IP) is now the most valuable asset class on the planet” states a World Intellectual Property Organization (WIPO) publication dated 2016. The analysis continues: “Up to the 1980s, tangible assets accounted for 80 percent of company value; the rest was made up by intangibles, including IP. Thirty years later, the reverse is true with 80 percent of company value made up of intangibles.”

In response, as noted in the introduction and reflected in EY’s 2016 survey of 623 transfer pricing executives in 36 jurisdictions across 17 industries, tax authorities are increasingly focusing on intangibles issues in controversy. While the key source of controversy remains the transfer pricing of goods and services, taxpayers expect a shift in the emphasis of controversy toward transfer pricing of intangibles and permanent establishments (PEs), both areas of key focus for the BEPS project. Current experience, as well as ongoing developments with respect to the taxation of intangible related returns, suggest that if anything, this may be an understatement.

Leading sources of tax controversy in transfer pricing

Which have been your most important areas of tax controversy in the last three years?

<table>
<thead>
<tr>
<th>Area of Controversy</th>
<th>2016</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer pricing of goods and services</td>
<td>72%</td>
<td>64%</td>
</tr>
<tr>
<td>Transfer pricing of intragroup financial arrangements</td>
<td>39%</td>
<td>44%</td>
</tr>
<tr>
<td>Transfer pricing of intangible property</td>
<td>32%</td>
<td>33%</td>
</tr>
<tr>
<td>Indirect tax – VAT or GST*</td>
<td>28%</td>
<td>34%</td>
</tr>
<tr>
<td>Permanent establishments</td>
<td>27%</td>
<td>30%</td>
</tr>
<tr>
<td>Indirect tax – customs valuation or duty*</td>
<td>14%</td>
<td>34%</td>
</tr>
<tr>
<td>Transactional taxes</td>
<td>12%</td>
<td>22%</td>
</tr>
<tr>
<td>Factors relating to fiscal residence</td>
<td>10%</td>
<td>10%</td>
</tr>
</tbody>
</table>
A broader set of attributes is recognized as central for business success and for TP purposes

Although patented products remain important intangibles, there has been a shift in emphasis toward intangibles which are more difficult to define and protect, and which are constantly evolving, for example:

► Marketing intangibles, which are constantly evolving as businesses adapt to changing market requirements and opportunities
► “Know-how”, including lessons from failed initiatives (negative know-how)
► Data (and the insights provided through applying analytics and AI on this data) are recognized as a critically valuable input to all areas of the business
► Composite intangibles, i.e., combinations of different intangibles forming, for example, a business model, have greatly increased in importance
► Customer interfaces which use digital enablers, predictive analytical tools and AI to transform existing businesses, improve business value and further facilitate innovations should themselves be seen as intangibles

As a result, the traditional value chain has evolved into an interactive value circle, with data and insights at the center.

Companies are increasingly acting as part of an ecosystem or value-web, where improved insights will drive different levels and types of collaboration, all fueled through greater insight and the ability to rapidly adapt to business opportunities and fence off competitive threats. These new types of IP, as well as changes in the processes and contributors to the development of the IP, put pressure on traditional, static tax models aimed at capturing the value of this IP.

In a transfer pricing analysis, legal ownership remains the starting point. However, in response to the developments discussed above, the OECD’s new TP guidance does not follow either a legal or an accounting approach to the definition of intangible assets which, if “owned” by an entity, should be remunerated. Rather, it defines an intangible as:

...Something which is not a physical or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.7

The updated definition for transfer pricing purposes includes all intangibles as normally understood, but not synergies arising from the existence of a group of companies or market characteristics, for example, proximity to markets or low labor costs.

As the who, where and how for intangible management changes, so does the approach of tax authorities in allocating intangibles returns

When the development and maintenance of intangibles was the sole preserve of easily identifiable “people in white coats” working in, for example, R&D centers, it was relatively easy to determine where intangibles were developed. And, until relatively recently, tax authorities accepted that legal ownership and the financing of the development of intangibles conferred a right to the profits arising from their exploitation after “routine” returns had been allocated to easily identifiable development, production and sale entities.

Now, it is much more difficult to understand where and by whom intangibles were developed; and tax authorities have created a new framework for allocating the returns to intangibles which focuses not only on who developed the intangible (functional contributions) but also on the precise nature of their roles.

The relevant business developments here include:

| **Intangibles may be developed or refreshed by cross-functional virtual teams assembled from multiple geographies, often to undertake a specific project, for example, “manufacturing” becoming involved much earlier in product development.** |
| **Important contributions may be made by managers with another important “day job”, for example, a territorial sales manager taking a leadership responsibility for a brand.** |
| **Intangibles may be developed in coalition with third parties including users.** |
| **The application of AI to increasingly complex decision-making processes.**

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*Example areas are design, trend-spotting, range definition, material selection, social media testing, price definition, pattern creation and mathematical fit testing.*
The OECD’s new TP guidance places considerable emphasis on the governance of development, enhancement, maintenance, protection and exploitation (DEMPE) functions in determining the allocation of the profits derived from intangibles. After rewarding functional contributions, which can be priced using conventional transfer pricing methods, the new TP guidance implies that the residual returns or losses should be captured by the entity(ies) controlling the important risks associated with DEMPE functions (control test). The notion of control is based on transfer pricing principles established in Chapter 1 of the OECD TP Guidelines on the treatment of risk.\(^9\)

To meet the control test, an entity must have the capacity and capability to make the relevant decisions and must actually do so. Neither setting a policy environment for the relevant decisions nor formalizing decisions made in other locations is sufficient to meet the control test.\(^10\) The OECD TP Guidelines do ascribe “special significance” to certain “important functions”, all of which are governance/control functions:

- Design and control of research and marketing programs
- Direction of and establishing priorities for creative undertakings including the direction of research
- Control over strategic decisions regarding intangibles development
- Management and control of budgets
- Important decisions on the defense and protection of intangibles
- Ongoing quality control over the functions undertaken by independent contractors and associates\(^11\)

But where and by whom these decisions are being made may not be easy to identify. Nor can it be assumed that the locus of decision-making will be unchanging. And when artificial intelligence (AI) is being applied, is the entity exercising (automated) control activities the “owner” of the intangible, or is it the entity that defines the rule setting of the AI?

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11 See Paragraphs 6.56, Chapter VI of “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”, OECD, July 2017. These are examples. The key point is that the new TP guidance requires analysis of contributions to intangibles aligned with the facts of the case.


Looking at implications for business

The business developments and the OECD’s new TP guidance previously outlined have implications for operating model design as well as for transfer pricing and broader tax strategies.

Implications for operating model design

It has always been the case that the design of the operating model, and more particularly the locations in which key managers are located, drives where profits should be recognized for tax purposes. This also makes sense from the perspective that while companies work across borders, the corporate tax sovereignty of a country, in principle, stops at the border.

But, as outlined above, the BEPS changes mean that multinationals can expect even greater scrutiny from tax authorities of the locus of control of the business processes which drive their profits.

Moreover, given the pace of business evolution, the value attributed to the new kinds of intangibles (including the AI related and business model related intangibles) will become an increasing focus for tax authorities. We expect that tax authorities will further refine their frameworks for addressing the role of key intangibles within the future value chain and the changing role of existing functions. In particular, the role of business concepts or ideas and access to capital is expected to intensify as they become key determinants of success. Furthermore, access to customer data and the ability to efficiently utilize it to better serve the customers will become a major driver for operating models, with related permanent establishment, withholding tax and indirect tax effects.

While we would not advocate allowing “tax to drive the business”, having an integrated design considering all of the different layers of the operating model as shown below is key in order to create a robust, sustainable model from a business and tax perspective.

Applying this layered-operating model will also “force” companies to articulate a clear vision and a set of business processes, metrics and control frameworks to purposely manage and create intangibles. Given the immense value represented by intangibles, this clear sense of purpose and managerial focus on intangibles should drive incremental business performance.

Operating model layers

Furthermore, given the continuing developments, this also means planning for agility in the governance model, and accommodating the fast pace of change and the emergence of new business models.
Implications for TP compliance

Some tax authorities have repeatedly sought to claim that the entity they are auditing “owns” unrecognized intangibles (for example, local marketing intangibles) or makes under-rewarded contributions to intangibles. By broadening the definition of intangibles and the breadth of compensable contributions, the OECD’s new TP guidance provides tax authorities with a toolkit for making these challenges.

Taxpayers need to be a step ahead, which means identifying, evaluating and documenting intangibles and functional contributions as outlined in the diagram below.

Within this new reality, the key emphasis will be on steps three and four, i.e., who is contributing to the creation of intellectual property (IP), where are they located and what is their contribution. This will, in most cases, not be a simple exercise. Given the increasing mobility of people, as well as the above mentioned developments with respect to the nature of intangibles and the way they are created (for example, through small, single project cross-border teams, third party collaborations or even AI), having a robust and dynamic framework and TP method to capture this will be key.

Implications for the TP model support

Most transactions are still priced using “one-sided” transfer pricing methods. A reliable measure of the profits that one party to the transaction, if independent, would realize is determined and “residual profit” is captured by the other party to the transaction. The exception, of course, is where more than one party makes contributions that cannot be reliably valued with the benchmarks available and the profit split method is then selected.

This approach is under pressure because of the increased transparency to tax authorities of total value chain profit and where it is recognized for tax purposes, as a result of country-by-country reporting requirements under BEPS Action 13.12

But more fundamentally, in a world of multiple intangibles and contributions from across the business, traditional methods may break down, and it becomes more and more likely that profit split methods will be applied. This is not a regulatory change; it is really the result of changes in business reality that make the traditional transfer pricing methods more difficult to apply.

This issue is particularly important for companies in which the control of relevant governance processes is not highly centralized.

Further change ahead

One of the key drivers of the OECD BEPS project was the perceived base erosion and profit shifting from online activities. On 5 October 2015, the OECD released its final report on the tax challenges of the digital economy under Action Item 1 of its BEPS project. The document does not recommend specific measures to address the digital economy and therefore acknowledges that special rules designed exclusively for the digital economy would prove unworkable. It does identify key features of the “new” business models of the digital economy that may exacerbate BEPS, including e-commerce, app stores, online advertising, cloud computing (including “content-as-a-service” generally) and participative networked platforms. Identified broader tax challenges of the digital economy include intangibles relevant topics, such as how to attribute value created from the generation of data through digital products and services and determining the share of profit attributable to these value drivers.

While Action Item 1 does not provide a final answer to the challenges of intangibles in the digital economy, it reflects the due attention to the new topics as well as a journey towards a more holistic approach to the definition of intangibles and their contribution to the value chain. An updated version of the report is expected in the coming months, which will likely include a more advanced analysis and more directive recommendation, given that this was one of the most contentious areas at the start of the project, which has only been grazed by the existing measures. Furthermore, at an EU level, further steps with respect to taxing the digital footprint of companies are already under consideration.

14 Following the public consultation in September, October 2017, the Task Force on the Digital Economy (TFDE) is expected to deliver an interim report on the implications for taxation of digitalization to the G20 Finance Ministers in April 2018.
What is business doing about this?

As a result of the regulatory and business changes, companies may have a significant mismatch between the geographic recognition of returns for tax purposes and the locus of contributions to intangibles (as defined by the OECD’s new TP guidance) in their operating models. Further adding to this is the fact that the business strategy and even business model may be subject to (or need to) change.

Understanding whether there is a “mismatch”, as just defined, is both essential in deciding whether action is needed and in determining the urgency and direction of change. This requires an understanding of the nature, ownership and importance of intangibles and an analysis of contributions to these intangibles, ultimately mapped to entities or countries. Once this is done, there are essentially three approaches available to address mismatch, as depicted below: protect, enhance or transform.

Three approaches to address mismatch: Protect, Enhance or Transform

To further illustrate the above, the example overleaf outlines a company which has taken steps within this journey. Although this example had sector and company specific considerations, the fundamental questions and challenges faced are something that applies for (almost) all companies, regardless of sectors or locations.
Example

A US-based diversified industrial products company has three different business units and a regional management model. Legal and economic ownership of intangibles is centralized in the US. R&D within the company is a separate, cross-business unit function that has significant local activities especially with respect to the localization of intangibles, with limited central governance in place. In light of a recent acquisition as well as new collaboration projects, it is expected that the IP development process will become more fragmented going forward.

In order to respond to the changed rules and environment, the company decided to move to a regional operating model, with intangibles ownership and management also set up on a regional basis. This included a transfer of the existing ownership of intangibles as well as a redesign of the existing intangibles development process and its governance, which is split between a more routine, commercial related development function and a more fundamental R&D process, steered and managed within the regional hubs. This allowed the company to have a level of central IP ownership and control to drive strategic intangible development, while making optimal use of the localization possibilities. To further support this, the commercial function was set up as a single entity with local branches, creating flexibility with respect to location and movement of personnel and activities.
Key conclusions and observations

Innovation, disruption and (product or service) differentiation are essential ingredients to win in today’s challenging business environment.

The intangibles created by these three ingredients are potentially the most valuable assets of businesses in this day and age, regardless of whether a traditional company is re-inventing itself or a company has been born in the digital age.

Tax and transfer pricing guidelines have been updated and are continuing to evolve to better recognize and capture this value, but to also better reflect various business functions that contribute to these intangibles. No longer can we identify a single function as being the owner of and responsible for these intangibles, but rather this value is created by different participants along a company’s value chain, if not in an ecosystem.

Successful companies therefore need to design their operating models around three key themes:

1. Develop an effective set of specific processes, roles, metrics and governance to invent, fund, own, enhance and exploit intangibles.

2. Establish, measure and manage an ecosystem of employees, suppliers, contractors and alliance partners to work on this – including a specific view on the concept of “location”, i.e., where the actual value is created.

3. Recognize the updated OECD TP Guidelines for intangibles, including the clarified DEMPE process definition, and align the business and after-tax outcomes to this.

However, it is the simultaneous optimization of these three themes that truly allows companies to design winning operating models. While this is not an easy task, it appears that the incredibly high pace of innovation and disruption, combined with the new TP guidelines, has moved the debate on intangibles to a higher level of sophistication and importance.

So, the big question is, what action are you taking?
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