The Revised OECD Discussion Draft on Transfer Pricing Aspects of Intangibles

In the second article of a series on the transfer pricing aspects of intangibles, the authors examine and summarize the most crucial changes made to the Discussion Draft of 6 June 2012. These changes are discussed in more detail, and conclusions and some recommendations for potential improvements are provided.

1. Introduction

On 6 June 2012, the OECD published a Discussion Draft titled Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions (the Discussion Draft), together with a request for comments. Numerous comments were received and a public consultation on the Discussion Draft was held in November 2012. Based on the comments received, Working Party No. 6 prepared a Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (the Revised Discussion Draft), which was released on 30 July 2013. The Revised Discussion Draft includes many changes and replaces the Discussion Draft. The OECD requested that interested parties submit written comments on the Revised Discussion Draft, with the deadline for comments on 1 October 2013. This was the last opportunity for the public to comment on the OECD’s revised chapter VI before it is released in its final form in 2014.

The OECD held a public consultation on the Revised Discussion Draft and other transfer pricing matters on 12 and 13 November 2013. According to the OECD press release dated 13 November 2013 (the OECD Press Release), the topics discussed during the two-day public consultation included public comments concerning:
- the revised discussion draft on transfer pricing aspects of intangibles;
- the white paper on transfer pricing documentation;
- the Base Erosion and Profit Shifting (BEPS) Action Plan requirement to adopt a system of country-by-country reporting of selected company financial data to tax administrations; and
- the appropriate scope of other transfer pricing aspects of the BEPS Action Plan.

The Chair of Working Party No. 6 of the OECD Committee on Fiscal Affairs stated in the OECD Press Release that representatives from business, from academia, from non-governmental organizations and the press, and government officials were present at the public consultation. She also expressed that Working Party No. 6 very much appreciates the input received and the candid discussion of the open points at the consultation, which will enable the OECD to finalize the guidance on intangibles and documentation by September 2014 in accordance with the BEPS Action Plan.

The OECD’s project on intangibles is an important part of the OECD’s Action Plan (the Action Plan) on BEPS released on 19 July 2013, and is specifically listed as one of the BEPS actions in that Action Plan. The preamble to the Revised Discussion Draft states that:

“This work on intangibles is closely related to other BEPS actions contained in the Action Plan, including specifically work on allocation of risks and capital for transfer pricing purposes, work on re-characterisation of transactions that might not occur between unrelated parties, work on transfer pricing methods including profit splits, work on interest deductibility and financial transactions and work on the digital economy. Some of the text and examples contained in this Revised Discussion Draft raise BEPS issues that the OECD intends to address through the various actions contained in the Action Plan.

These two statements suggest that the Revised Discussion Draft is still a work in progress and the ongoing BEPS discussions will shape the future of transfer pricing aspects of intangibles going forward.

This article is the second in a series on the OECD’s project on the transfer pricing aspects of intangibles. The first article examined the Discussion Draft from a Dutch transfer pricing perspective and described the changes proposed in the Discussion Draft. The present article will examine the most crucial changes made to the Discussion Draft of 6 June 2012, and will summarize the main changes. These changes are discussed in more detail and commented on, and conclusions and some recommendations for potential improvements are provided.

The text of the Revised Discussion Draft, which does not substantively deviate from the text of the Discussion Draft, is not addressed in more detail; interested readers should instead refer to the authors’ earlier article.

The Revised OECD Discussion Draft on Transfer Pricing Aspects of Intangibles

In the second article of a series on the transfer pricing aspects of intangibles, the authors examine and summarize the most crucial changes made to the Discussion Draft of 6 June 2012. These changes are discussed in more detail, and conclusions and some recommendations for potential improvements are provided.

1. OECD, Action Plan on Base Erosion and Profit Shifting, Action 8 (OECD 2013), International Organizations’ Documentation IBFD
2. Main Changes: Summary

Following the release of the Discussion Draft on the Transfer Pricing Aspects of Intangibles on 6 June 2012, numerous comments were received and a public consultation was held on the Discussion Draft in November 2012. Based on the comments received, Working Party No. 6 prepared the Revised Discussion Draft, which includes numerous changes to the Discussion Draft of 6 June 2012. The changes contained in the Revised Discussion Draft include:

- the addition of a new section addressing features of the local market, location savings, assembled workforce and group synergies;
- changes to the definition of intangibles;
- revisions to Section B of the Draft that adopts a more transactional approach, while retaining a clear focus on the importance of functions performed, assets used and risks assumed;
- the inclusion of a section on transfer pricing aspects of the use of company names;
- a reorganization of the material in Section D of the Draft providing supplementary guidance on methods and comparability analysis; and
- the addition of several examples to the Annex and the revision of some of the examples from the prior Discussion Draft.

3. Main Changes: Detailed Analysis

3.1. Comparability factors

The Revised Discussion Draft proposes the inclusion of additional guidance on location savings, other local market features, assembled workforce and group synergies in Chapters I-III of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). The Revised Discussion Draft states that these are not intangibles, but should be included in the comparability analysis, as they can be important comparability factors. It suggests the following steps if any location savings or market advantages or disadvantages are identified:

- where local comparables are present: use local comparables as the most reliable measure to determine how location savings are shared at arm’s length, or the impact of market advantages or disadvantages; and
- in the absence of local comparables: a functional analysis must be prepared.

Although this may appear to reduce the compliance burden for taxpayers, identifying local comparables and making reliable use of local comparables can be challenging undertakings.

Regarding the assembled workforce, the Revised Discussion Draft notes in paragraph 14 that an assembled workforce should be included in a comparability analysis if the workforce is composed of uniquely qualified or experienced employees. Furthermore, example 18 in the Annex to the Revised Discussion Draft illustrates how the interaction between intangibles and access to an assembled workforce may be important in a transfer pricing analysis.\(^4\)

The Revised Discussion Draft also provides additional explicit guidance on how group synergies should be treated from a transfer pricing perspective. Paragraph 18 of the Revised Discussion Draft provides the following examples of activities as a result of which group synergies may arise:

- combined purchasing power or economies of scale;
- combined and integrated computer and communication systems;
- integrated management;
- elimination of duplication;
- increased borrowing capacity; and
- numerous similar factors.

The OECD makes a distinction between incidental benefits that are solely attributable to their being part of a larger concern and not to any specific activity being performed, and those benefits that arise from specific efforts taken by the group. The OECD refers to the latter efforts as being the deliberate, concerted action of group members or the performance of any service or other function by group members. Here reference is made to paragraph 7.13 of the OECD Guidelines when concluding that an associated enterprise is not required to pay for incidental benefits.

Finally, paragraph 18 of the Revised Discussion Draft recognizes the availability of negative group synergies, but provides no guidance on how to address them. Paragraph 20 states that a negative synergy may be created when a parent company demands that a group company use computer or communication systems that are not the most efficient for its business. The authors believe that this refers to group-wide ERP\(^5\) and other systems that are costly to develop and roll out. All members of the multinational enterprise (MNE) group are often required to use these systems, even if they are more expensive than an existing local ERP installation. This would seem to be a negative group synergy that is brought about by the deliberate actions of the group. It would be reasonable to treat negative group synergies in a way that is consistent with positive group synergies, for example, allocated to the different members of the group in proportion to their use.

3.2. Definition of intangibles

Neither the current chapter VI nor the Discussion Draft defines intangibles. The Revised Discussion Draft provides a definition of intangibles that is transfer pricing specific. It also provides examples of what would and what would not constitute an intangible.

The Revised Discussion Draft defines intangibles in paragraph 40 as:

> Something which is not a physical asset 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

________________________


The Revised OECD Discussion Draft sets out what is required in order for an asset to qualify as an intangible:

- it must not be a tangible asset or a financial asset;
- it must be capable of being used in commercial activities;
- it must be capable of being owned or controlled by a single entity. This does not include local market conditions, such as the high purchasing power in a particular country, nor does it include MNE group synergies that are not owned or controlled by a single member of an MNE group;
- its use or transfer would be compensated in transactions between independent parties;
- it need not be an intangible for accounting purposes;
- it need not be an intangible for general tax or treaty withholding purposes (article 12 of the OECD Model);
- it need not be legally protected; and
- it need not be separately transferable.

Other examples of intangibles listed in the Revised Discussion Draft are patents, know-how and trade secrets, trademarks, trade names and brands, rights under contracts and government licences, licences and similar limited rights in intangibles and goodwill and going concern value. The OECD’s examples of intangibles are clear and precise, the only exception being goodwill and going concern. According to the Revised Discussion Draft, goodwill and going concern value cannot be segregated or transferred separately from other business assets. The Revised Discussion Draft states in paragraph 61 that it is not necessary to establish a precise definition of goodwill and going concern for transfer pricing purposes. However, it is important to recognize that an important and monetarily significant part of the compensation paid between independent enterprises when some or all of the assets of an operating business are transferred, may represent compensation for something referred to in one of the alternative descriptions of goodwill or going concern value. This last statement seems to imply that the exact scope of goodwill and any going concern value that must be paid remains unclear. However, it is clear that not all residual measures of goodwill and going concern value as defined in financial statements valuations are to be considered.

The Revised Discussion Draft reiterates, in paragraphs 63 and 64, that group synergies and market-specific characteristics are not intangibles.

### 3.3. Entitlement to intangible-related returns

#### 3.3.1. Introduction

Although Section B of the Revised Discussion Draft adopts a more transactional approach, it retains a clear focus on the importance of functions performed, assets used and risks assumed. Paragraph 63 of the Revised Discussion Draft states that the right of members of the MNE group to receive compensation for the functions performed, assets used or contributed, and risks assumed may be conceptually framed as an allocation of all or a portion of the intangible-related returns to the members involved in those functions, risks and assets. Analysed from this perspective, the key issues in the Revised Discussion Draft include the following:

- written contracts are important and the legal ownership referred to in such written contracts will be respected only if it is consistent with substance. If no legal owner of the intangible can be identified, the member of the MNE which controls decisions on the use and transfer of intangibles and which has the capacity and expertise to do so will be considered the legal owner;
- legal rights and contractual agreements form the starting point. However, entitlement to intangible-related returns should be determined based on functions performed, risks assumed and assets employed; and
- a member of an MNE need not physically perform all of the functions related to the development, enhancement, maintenance and protection of an intangible by its own employees in order to be entitled to retain returns attributable to the intangibles, provided that it:
  - exercises control over any outsourced functions and assumes risks related to those functions;
  - remits an arm’s length remuneration to the related parties that actually perform those functions; and
  - performs the more important functions related to the development, enhancement, maintenance and protection of that intangible as described in paragraph 79.

#### 3.3.2. Important functions

According to the Revised Discussion Draft, depending on the facts and circumstances, important functions generally include design and control of research and marketing programmes; management and control of budgets; control over strategic decisions regarding intangible development programmes; important decisions regarding defence 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 the authors’ opinion, more guidance is needed as to when the important functions become so essential as to attract intangible-related returns, for example, how much design or how much budget management make those functions important, and whether a threshold even applies. Furthermore, this new approach is not in line with the principle contained in chapter IX of the OECD Guidelines that the starting point should be arm’s length arrangements. Finally, as stated in paragraph 81 of the Revised Discussion Draft, the reliability of a one-sided transfer pricing

---

6. OECD Ctr. for Tax Policy and Admin., supra n. 3, para. 61.
7. OECD Ctr. for Tax Policy and Admin., supra n. 3, para. 71.
8. OECD Ctr. for Tax Policy and Admin., supra n. 3, para. 79.
method will be substantially reduced if the party performing the important functions is treated as the tested party. This would potentially result in more use of the transactional profit split method in future. The latter seems generally to be encouraged in the Revised Discussion Draft.

3.3.3. Assets

The Revised Discussion Draft states that group members which contribute assets used in the development, enhancement, maintenance and protection of an intangible are entitled to relevant returns. Funding is listed as one type of asset. The Revised Discussion Draft goes on to state that a party which provides funding, but does not control the risks or perform other functions associated with the funded activity, generally does not receive returns equivalent to those received by an otherwise similarly situated investor that also performs and controls important functions and bears and controls important risks associated with the funded activity.

The Revised Discussion Draft acknowledges, in paragraph 83, that funding and risk-taking are integrally related, but at the same time suggests analysing them separately, as there is no standard set of risks assumed in the funding of intangibles and because the risks assumed will vary based on, for example, contractual terms and the conduct and solvency of the relevant group members, and therefore must be determined on the basis of all the facts and circumstances.

The Revised Discussion Draft concludes by stating that bearing a funding risk without the assumption of any further risk, and without any control over the use of the contributed funds or the conduct of the funded activity, would generally entitle the funder to only a risk-adjusted rate of anticipated return on its invested capital. The Revised Discussion Draft seems to be suggesting that an entity the sole function of which is that of funding should receive a lower remuneration than entities performing important functions and assuming risks. This approach is similar to the investor model under the US cost-sharing regulations.

3.3.4. Risks

The Revised Discussion Draft makes reference in paragraphs 9.10 through 9.46 to assessing the allocation of intangible-related risks among members of an MNE. In order for a member of an MNE that is the legal owner of intangibles to be entitled to intangible-related returns, it must either:

- bear and control the risks associated with the development, enhancement, maintenance and protection of intangibles; or
- pay an arm’s length compensation to the associated members of the group that bear and control such risks.

Some specific risks that may be important for intangibles are listed in paragraph 87 of the Revised Discussion Draft, namely:

- risks related to the development of intangibles;
- the risk of product obsolescence;
- infringement risk; and
- product liability.

Finally, it is emphasized that there should be no mismatch between the contractual allocation of risks and the allocation of the relevant risk-associated costs among related enterprises.

3.3.5. Summary

In summary, the legal owner of an intangible is entitled to all returns attributable to the intangible only if, in substance, it:

- performs and controls all of the important functions described in paragraph 79 relating to the development, enhancement, maintenance and protection of the intangibles;
- controls other functions outsourced to independent enterprises or associated enterprises and compensates those functions on an arm’s length basis;
- provides all assets necessary to the development, enhancement, maintenance and protection of the intangibles; and
- bears and controls all of the risks and costs related to the development, enhancement, maintenance and protection of the intangible.

3.4. Payment for company names

The Revised Discussion Draft includes a new section on the transfer pricing aspects of the use of company names. According to the Revised Discussion Draft, as a general rule, no payment should be recognized for transfer pricing purposes for simple recognition of group membership or the use of the group name merely to reflect the fact of group membership. Cross-reference is made to paragraph 7.13 of the OECD Guidelines where passive association is compared with active promotion.

A payment would be expected, however, where one member of the group is the owner of a trademark or other intangible for the group name, and where the use of the name provides a financial benefit to members of the group other than the member legally owning the intangible. Furthermore, paragraph 100 of the Revised Discussion Draft states that such payments may be appropriate where the goodwill owned by a group member in respect of the business is represented by an unregistered trademark, use of that trademark by another party would constitute misrepresentation, and the use of the trademark provides a clear financial benefit to a group member other than the group member owning the goodwill and unregistered trademark.
The Discussion Draft suggests that the following elements be considered when determining the payment for a group name:

- the financial benefit to the user of the name attributable to use of that name;
- the costs and benefits associated with other alternatives; and
- the relative contributions to the value of the name made by the legal owner and the entity using the name in the form of functions, assets used and risks assumed.

In the authors’ opinion, by introducing payment for company names, the OECD has added to the complexities surrounding transfer pricing analysis, as well as created an additional compliance burden for taxpayers: it is, after all, a time-consuming task to determine what benefits are enjoyed by group members through the use of a name, or which group members contributed to the creation of a name that gains market recognition only over a long period of time. Organizations today are very dynamic and prone to many changes over short periods of time. The long period required to create name recognition in the marketplace makes it difficult to estimate which group member contributed to the reputation of that company name. However, there may be very obvious examples where the use of a particular company name or corporate logo creates a benefit to the user. Other important points regarding company names as referred to in the Revised Discussion Draft include:

- where an existing successful business is acquired by another successful business and the acquired business begins to use a name, trademark or other branding indicative of the acquiring business, it should not be automatically assumed that such use requires payment. If there is a reasonable expectation of financial benefit to the acquired company from using the acquiring company’s branding, the amount of any payment should be determined on the basis of the level of that anticipated benefit; and
- it may also be the case that the acquiring business will leverage the existing position of the acquired business to expand the business of the acquirer in the territory of operation of the acquired business by causing the acquired business to use the acquirer’s branding. In that case, consideration should be given to whether the acquirer should make a payment to, or otherwise compensate, the acquired business for the functions performed, risks assumed and assets used (including its market position) in connection with the expanded use of the acquirer’s name.

3.5. Supplementary guidance on methods and comparability analysis

In the Revised Discussion Draft, the supplementary guidance on methods and comparability analysis has been reorganized. Reference is made to the fact that the guidance provided in chapters I-III, for example, the nine-step process, applies to transactions involving intangibles. However, as this guidance is sometimes not sufficient to tackle intangible-related issues, additional guidance is provided.

In a comparability analysis, options realistically available to each party to a transaction must be considered, and therefore one-sided analysis is ruled out for transactions involving intangibles. In conducting a comparability analysis with regard to a transfer of intangibles, the revised Discussion Draft, in paragraph 134, stresses the need to consider:

- the unique features of intangibles, in particular when applying CUP analysis; and
- whether potential comparables in fact exhibit a profit potential similar to the entity involved in controlled transactions.

A non-exhaustive list of factors that may be essential for a comparability analysis performed for a transfer pricing analysis of intangibles includes:

- exclusivity;
- the extent and duration of legal protection;
- geographic scope;
- useful life;
- stage of development;
- right to enhancements, revisions and updates; and
- expectation of future benefits.

In paragraph 164 of the Revised Discussion Draft, the risk areas listed in paragraph 87 are reiterated (see section 3.3.4.) without providing any detailed guidance on how to address the implications of those risks.

In selecting the most appropriate method, the Revised Discussion Draft states that the principles of chapter II should also apply to intangibles. The Revised Discussion Draft further notes that:

- the application of one-sided methods, for example the resale price method or TNMM, is generally not reliable for directly valuing intangibles;\(^\text{14}\)
- cost-based valuations are generally not reliable if used to determine the arm’s length price for partially developed intangibles;\(^\text{15}\)
- the application of a general rule of thumb does not provide an adequate substitute for a complete functional and comparability analysis conducted according to the principles of chapters I through III;
- the Revised Discussion encourages the use of the CUP and profit split methods where applicable;
- valuation techniques can be used either as part of one of the five approved methods or as a separate mechanism for determining an arm’s length price; and
- valuations of intangibles contained in purchase price allocations performed for accounting purposes are not determinative for transfer pricing purposes, and should be utilized in a transfer pricing analysis with caution and careful consideration of the underlying assumptions.\(^\text{16}\)

\(^{13}\) OECD Ctr. for Tax Policy and Admin., supra n. 3, paras. 102, 103.

\(^{14}\) OECD Ctr. for Tax Policy and Admin., supra n. 3, para. 159.

\(^{15}\) OECD Ctr. for Tax Policy and Admin., supra n. 3, para. 161.

\(^{16}\) OECD Ctr. for Tax Policy and Admin., supra n. 3, para. 173.
Section D.3 of the Revised Discussion Draft provides some specialized guidance on arm’s length pricing in situations where valuation is extremely uncertain at the time of the transaction and where this work will be carried out under future BEPS work. As such, the Revised Discussion Draft retains the language of the initial Discussion Draft where it is implied that controlled taxpayers should follow the practices that would lead to an arm’s length result.

4. Conclusion

The Revised Discussion Draft and the changes contained therein can be summarized as follows:

- the Revised Discussion Draft reflects the influence of chapter IX of the OECD Guidelines and the BEPS Action Plan;
- it has been expanded in both volume and scope (223 paragraphs – an additional 107 paragraphs with 27 examples, as opposed to the 39 paragraphs of chapter IV);
- it allows for the application of additional methods;
- it reflects the interests of emerging economies, such as China and India;
- a more systematic approach is followed;
- it leaves room to recharacterize transactions;
- a definition of intangibles is provided for transfer pricing purposes, together with guidance on what constitutes an intangible and what does not;
- legal ownership is not leading, and control functions predominantly create an entitlement to intangible-related returns or economic ownership; and
- in terms of methods:
  - valuation techniques are explicitly acknowledged;
  - there is more focus on the comparability issues surrounding the CUP method; and
  - the OECD’s position on the profit split method may potentially result in greater use of this method.

Although the Revised Discussion Draft is a substantial improvement on the Discussion Draft, there are some crucial issues that still need clarification. Moreover, the changes lack sufficient substance to achieve the OECD’s objectives. However, considering that the OECD has been continuously working on improving the transfer pricing guidelines, one can expect that more detailed guidance on complex issues such as the transfer pricing treatment of hard-to-value intangibles will be provided as part of future BEPS work. In the preamble to the Revised Discussion Draft, it is stated that this version should be considered a work in progress and parts of it may be revised during the course of the work on BEPS. Moreover, the OECD Press Release states that after considering the discussion at the two-day public consultation on 12 and 13 November 2013, Working Party No. 6 of the OECD Committee on Fiscal Affairs will finalize its revised guidance on intangibles and documentation in accordance with the September 2014 due date under the BEPS Action Plan. It will certainly be interesting to see how future BEPS work will influence the transfer pricing aspects of intangibles.