Post-BEPS Application of the Arm’s Length Principle to Intangibles Structures

The arm’s length principle, as embedded in article 9 of the OECD Model Convention, is not an anti-avoidance rule and has been misidentified as the primary tool to tackle certain abusive behaviours of multinational enterprises. This article refers to the new OECD guidelines on intangibles as background and provides an overview of the new approaches to transfer pricing analysis in the context of intellectual property; analyses the impact thereof on existing business models; and defines the limitations imposed by the arm’s length principle, as a general principle of international tax law, on making transactional adjustments and disregarding intellectual property arrangements by the tax authorities.

1. Introduction

The transfer pricing of intangibles has always been of major importance to multinational enterprises (MNEs). The significant attention devoted to this issue with the recent initiative of the OECD and G20 to counter tax base erosion and profit shifting (BEPS) seems to be long overdue. In particular, the issue with transfer pricing is that it is technically a neutral concept, but it has often been erroneously identified as an abusive practice of MNEs allowing them to shift profits generated by intangibles to so-called tax havens. The arm’s length principle embedded in article 9 of the OECD Model Tax Convention on Income and on Capital (OECD Model) has been misidentified as the primary tool to tackle such abusive behaviour of MNEs. However, the arm’s length principle is not itself an anti-avoidance rule.

In view of the above, the following theses are defended in this article:

First, the anti-avoidance measures are prerogatives of domestic law based on the substance-over-form doctrine and are applied unilaterally; the arm’s length principle as a bilateral concept is aimed at the appropriate allocation of profits between source and residence countries and, by its nature, cannot be used to tackle tax abusive practices. The role of the principle in a tax treaty context is to put related parties on an equal footing with unrelated parties, regardless of the existence of abuse in either of these two situations.

Second, the arm’s length principle is a general principle of tax treaties, and its interpretation cannot be limited to the methodological guidance of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) only. Instead, its interpretation should be based on the general principles of interpretation laid down in the Vienna Convention on the Law of Treaties.

In order to avoid uncertainty for both taxpayers and tax authorities in the application of the transfer pricing rules based on the arm’s length principle, especially post BEPS, the boundaries of the principle for its proper application in a transfer pricing analysis should be clearly defined in the Commentary on Article 9 of the OECD Model.
particular, it is recommended to add a precise statement to the Commentary on the OECD Model that the scope of the arm’s length principle is limited to profit adjustments and that it does not cover transactional adjustments, as the latter, if not accepted by the country of the counterparty to a transaction, would most likely result in double taxation. As such, this would be contrary to the very nature of the arm’s length principle – which is to eliminate double taxation. At the same time, the OECD Guidelines, while a methodological tool to help taxpayers and tax authorities in the application of the arm’s length principle under article 9 of the OECD Model, cannot by themselves be a substitute for the Commentary.11

This article – by referring to the new OECD guidelines on intangibles as background – provides an overview of the new approaches to transfer pricing analysis in the context of intellectual property (IP); analyses the impact of such new approaches on existing business models; and defines the limitations imposed by the arm’s length principle, as a general principle of international tax law, on making transactional adjustments and disregarding IP arrangements by the tax authorities. The author concludes that in order to enhance efficiency of the arm’s length principle, the transfer pricing analysis under the new OECD Guidelines should be perceived as the new transfer pricing guidance within the framework of article 9 of the OECD Model, which should be subordinated to the current (and potentially updated in the near future) Commentary on Article 9.

2. Overview of New Guidance on Intangibles

New guidance on intangibles under Action 8 of the BEPS Action Plan is provided in the OECD/G20 Final Reports on Actions 8-10, Aligning Transfer Pricing Outcomes with Value Creation (the Actions 8-10 Final Reports)12 as part of the final BEPS package for reform of the international tax system published on 5 October 2015 (the 2015 Final Reports). The guidance in the Actions 8-10 Final Reports takes the form of revisions to chapters I, II, VI, VII and VIII of the OECD Guidelines.13 In respect of Action 8, the provisions of the previous version of chapter VI of the OECD Guidelines are deleted in their entirety and replaced by the language of the “Intangibles” section of the Actions 8-10 Final Reports.14

The new chapter VI of the OECD Guidelines is structured as follows:
- identifying intangibles;
- ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles;
- transactions involving the use or transfer of intangibles; and
- supplemental guidance for determining arm’s length conditions in cases involving intangibles.

It also contains the general summary section, Revisions to Chapter VI of the Transfer Pricing Guidelines; additional guidance in chapter II of the OECD Guidelines resulting from the revisions to chapter VI; and examples to illustrate the guidance on intangibles in the Annex to chapter VI.

2.1. Identifying intangibles

Section A of the new chapter VI defines an intangible item 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 it occurred in a transaction between independent parties in comparable circumstances.”15 Neither accounting nor legal definitions of intangibles are decisive for transfer pricing purposes. Moreover, “the determination that an item should be regarded as an intangible for transfer pricing purposes does not determine or follow from its characterization for general tax purposes, as, for example, an expense or an amortisable asset.”16

As stated in the Actions 8-10 Final Reports, “rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.” Such a ring-fenced definition of intangibles in the OECD Guidelines is aimed at meeting the requirements of the arm’s length principle under article 9 of the OECD Model (2014) by making the transfer pricing notion of intangibles universally interpreted in a cross-border situation and thus preventing the potential risk of double taxation due to inconsistent definitions under domestic tax laws.

New guidance on intangibles also provides definitions of two commonly used categories of intangibles, namely marketing intangibles and trade intangibles.17 A marketing intangible is defined as “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.”18 Such marketing intangibles, depending on the context, could include trademarks; trade names; customer lists; customer relationships; and proprietary market and customer data that

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11. According to the OECD Model, Commentary on Article 9, “[…] the [OECD] Committee [on Fiscal Affairs] has spent considerable time and effort (and continues to do so) examining the conditions for the application of this Article; its consequences and the various methodologies which may be applied to adjust profits where transactions have been entered into on other than arm’s length terms. Its conclusions are set out in the report entitled Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which is periodically updated to reflect the progress of the work of the Committee in this area.” (Emphasis added.)

12. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project (OECD 5 Oct. 2015), International Organizations’ Documentation IBFD.


14. Considering that the Actions 8-10 Final Reports are a revision of ch. VI OECD Guidelines (2010), all references to the particular paragraphs of the Intangibles section of the Actions 8-10 Final Reports are parenthetically stated as paragraphs of the “OECD Guidelines” in subsequent citations.

15. Actions 8-10 Final Reports, supra n. 12, at 67 (OECD Guidelines, para. 6.6).

16. Actions 8-10 Final Reports, supra n. 12, at 67 (OECD Guidelines, para. 6.7).

17. Actions 8-10 Final Reports, supra n. 12, at 69 (OECD Guidelines, para. 6.16).

18. Actions 8-10 Final Reports, supra n. 12, at 69 (OECD Guidelines, Glossary, “Marketing intangible”).
are used or aid in marketing and selling goods or services to customers.

A trade intangible is defined as “a commercial intangible other than a marketing intangible.” This category is provided to facilitate the discussion for purposes of transfer pricing analysis, rather than to delineate with precision various classes or categories of intangibles or to prescribe outcomes that turn on such categories.

The Actions 8-10 Final Reports also refer to “unique and valuable” intangibles to emphasize the problems that might arise when intangibles are not comparable to those used by or available to the parties to potentially comparable transactions and the use of which in business operations is expected to yield greater future economic benefits than would be expected in the absence of the intangibles.

Items often considered in transfer pricing analyses involving intangibles, including licensing and similar limited rights in intangibles, are provided as illustrations in section A.4 of the new chapter VI of the OECD Guidelines. These illustrations should be considered and evaluated in the context of the comparability analysis, with the objective of better understanding how specific intangibles and items not treated as intangibles contribute to the creation of value in the context of an MNE’s global business.

Notably, location savings and other local market features, assembled workforce and MNE group synergies are not regarded as intangibles for transfer pricing purposes, and are now officially addressed in amendments to chapters I-II of the OECD Guidelines as comparability factors.

2.2. Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles

2.2.1. Analytical framework for transfer pricing analysis of intangibles

Section B of the new chapter VI provides an analytical framework to ensure that all members of an MNE group are appropriately compensated for the functions they perform, the assets they contribute and the risks they assume. Such framework for analysing transactions involving intangibles between associated enterprises requires the following steps:

- identify the intangibles used or transferred in the transaction with specificity, and the specific, economically significant risks associated with the development, enhancement, maintenance, protection and exploitation of the intangibles (the so-called DEMPE functions);
- identify the full contractual arrangements, with special emphasis on determining legal ownership of intangibles based on the terms and conditions of legal arrangements, including relevant registrations, licence agreements, other relevant contracts and other indicia of legal ownership, and the contractual rights and obligations, including contractual assumption of risks in the relations between the associated enterprises;
- identify the parties performing functions, using assets and managing risks related to DEMPE functions by means of a functional analysis, and in particular which parties control any outsourced functions, and control specific, economically significant risks;
- confirm the consistency between the terms of the relevant contractual arrangements and the conduct of the parties, and determine whether the party assuming economically significant risks controls the risks and has the financial capacity to assume the risks relating to the DEMPE functions;
- delineate the actual controlled transactions related to the DEMPE functions in light of the legal ownership of the intangibles; the other relevant contractual relations under relevant registrations and contracts; and the conduct of the parties, including their relevant contributions of functions, assets and risks, taking into account the framework for analysing and allocating risk, and
- where possible, determine arm’s length prices for these transactions consistent with each party’s contributions of functions performed, assets used and risks assumed.

Being consistent with the definition of intangibles, as provided in section 2.1. of this article, the Actions 8-10 Final Reports distinguish between an intangible and any licence relating to that intangible, in that they are considered to be different intangibles, each having a different owner.

2.2.2. Legal ownership and contractual arrangements

In terms of ownership, the Actions 8-10 Final Reports specifically state that legal ownership is respected for transfer pricing purposes. Only where no legal owner is identified under applicable law or contracts, will the member of the MNE group that controls decisions concerning the exploitation of intangibles and that has the practical capacity to restrict others from their usage, be considered the legal owner of such intangibles for transfer pricing purposes. The legal owner of intangibles will be entitled to retain

24. As provided in OECD Guidelines, para. 1.60, sec. D.1.2.1. of the new ch. I. Actions 8-10 Final Reports, supra n. 12, at 22.
25. As provided in OECD Guidelines, sec. D.1.2.1. of the new ch. I. Actions 8-10 Final Reports, supra n. 12, at 75.
27. Actions 8-10 Final Reports, supra n. 12, at 76 (OECD Guidelines, para. 6.41) ("For example, Company A, the legal owner of a trademark, may provide an exclusive licence to Company B to manufacture, market, and sell goods using the trademark. One intangible, the trademark, is legally owned by Company A. Another intangible, the licence to use the trademark in connection with manufacturing, marketing and distribution of trademarked products, is legally owned by Company B. Depending on the facts and circumstances, marketing activities undertaken by Company B pursuant to its licence may potentially affect the value of the underlying intangible legally owned by Company A, the value of Company B’s licence, or both.")
all ex ante returns derived from the exploitation of such intangibles only if it:

- performs and controls all of the DEMPE functions;
- provides all assets, including funding, necessary for the DEMPE functions; and
- assumes all risks related to the DEMPE functions.\(^{28}\)

The OECD’s emphasis on functional value creation does not imply that it is essential for the legal owner to perform all the DEMPE functions on its own in order to be entitled to all – or be attributed a portion – of the return derived by the MNE group from the exploitation of the intangibles. Nevertheless, it is expected that the legal owner (i) is able to exercise control over the risks\(^{29}\) and (ii) has financial capacity to undertake the related risks.

To the extent that the legal owner neither exercises control over the intangibles-related risks nor has financial capacity to undertake the related risks, it would not be entitled to any ongoing benefit attributable to the outsourced functions. As a result, depending on the facts and circumstances, the compensation to be provided to other MNE group members actually performing or controlling DEMPE functions might constitute all or a substantial part of the return anticipated to be derived from the exploitation of the intangible.

### 2.2.3. Remuneration under the arm’s length principle

Although determining legal ownership and contractual arrangements is a critical first step of the transfer pricing analysis, the OECD separates it from the second step – remuneration under the arm’s length principle. In order to determine the appropriate arm’s length remuneration to members of a group (including the legal owner\(^ {30}\)) for their functions, assets and risks, the Actions 8-10 Final Reports provide for the analytical framework which is established by three concepts, namely (i) the taxpayer’s contractual arrangements, (ii) the legal ownership of intangibles and (iii) the conduct of the parties. Similar to any other type of transaction, the analysis of transactions involving intangibles must take into account all of the relevant facts and circumstances present in a particular case, and price determination must reflect the realistic alternatives of the relevant group members.\(^ {31}\)

The reference to arm’s length remuneration generally assumes the anticipated (ex ante) returns and remuneration. The entitlement of any member of the MNE group to profit or loss relating to differences between actual (ex post)\(^ {32}\) and a proper estimation of anticipated (ex ante)\(^ {33}\) profitability will depend on which entity or entities in the MNE group, in fact, assume the risks as identified when delineating the actual transaction.\(^ {34}\) To the extent that one or more members of the MNE group other than the legal owner perform functions, use assets or assume risks related to the DEMPE functions, such associated enterprises must be compensated on an arm’s length basis for their contributions.

In its recommendations on the allocation of the intangible-related returns, the OECD follows the so-called investor model. Under this model, a party that provides funding without controlling the risk (or performs other activities associated with the funded activity or asset) generally should not receive anticipated returns equivalent to those received by an otherwise similarly situated investor that performs and controls significant functions and bears and controls significant risks associated with the funding activity.

When identifying an investment-related risk with specificity, it is essential to distinguish between the following categories of risks: (i) financial risks related to the funding provided for the investments and (ii) the risks linked to the operational activities for which the funding is used. The OECD then clarifies that a party providing funding thereby exercising control over the financial risk related to the provision of funding, but without the assumption of (including control over) any other specific risk, should generally expect only a risk-adjusted return on its funding, but not more.\(^ {35}\)

### 2.2.4. Application of the arm’s length principle in commonly occurring business settings

Section B of the new chapter VI also discusses the specific fact patterns where the above recommendations are applicable in relation to the development and enhancement of marketing intangibles; research and development (R&D) and process improvement arrangements; and payments for the use of the company name. In particular, it provides guidance on the application of the arm’s length principle in the following commonly occurring business settings with

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28. Actions 8-10 Final Reports, supra n. 12, at 84 (OECD Guidelines, para. 6.71).
29. In assessing the notion of control in relation to intangibles, the same principles as those for determining control over risk apply. For details, see the guidance in OECD Guidelines, sec. D.1.2.1 of the new ch. 1.
30. Actions 8-10 Final Reports, supra n. 12, at 76 (OECD Guidelines, para. 6.42) (“The return ultimately retained by or attributed to the legal owner depends upon the functions it performs, the assets it uses, and the risks it assumes, and upon the contributions made by other MNE group members through their functions performed, assets used, and risks assumed.”).
31. Such principles are illustrated by examples 1-6 in the Annex to the new ch. V1 OECD Guidelines.
32. Actual (or ex post) remuneration refers to the income actually earned by a member of the group through the exploitation of the intangible.
33. Anticipated (or ex ante) remuneration refers to the future income expected to be derived by a member of the MNE group at the time of a transaction.
34. For more discussion of ex ante and ex post approaches to the determination of the arm’s length remuneration, see sec. D.1.2.1 of the new ch. 1 OECD Guidelines. In particular, in para. 1.78, it is emphasized by the OECD that ‘ex ante contractual assumption of risk should provide clear evidence of a commitment to assume risk prior to the materialisation of risk outcomes. Such evidence is a very important part of the tax administration’s transfer pricing analysis of risks in commercial or financial relations, since, in practice, an audit performed by the tax administration may occur years after the making of such up-front decisions by the associated enterprises and when outcomes are known. The purported assumption of risk by associated enterprises when risk outcomes are certain is by definition not an assumption of risk, since there is no longer any risk. Similarly, ex post reallocations of risk by a tax administration when risk outcomes are certain may [unless specifically mentioned otherwise] be inappropriately.’ Actions 8-10 Final Reports, supra n. 12, at 28.
35. Actions 8-10 Final Reports, supra n. 12, at 81 (OECD Guidelines, para. 6.61).
regard to intangibles:36 distribution arrangements, R&D arrangements and use of the company name.

With regard to distribution arrangements, the transfer pricing analysis should assess whether the marketer/distributor is to be compensated only for providing promotion and distribution services, or whether it should also be compensated for enhancing the value of the trademarks and other marketing intangibles by virtue of its functions performed, assets used and risks assumed. If the efforts of the distributor exceed those of an independent distributor, additional remuneration in the form of higher distribution profits, a reduced royalty rate or a share in the profits associated with the enhanced value of the trademark (or other marketing intangibles) needs to be considered.37

With regard to R&D arrangements, the transfer pricing analysis should identify whether the R&D service provider possesses unique skills and experience relevant to the research; assumes risks; uses its own intangibles; or is controlled or managed by a party other than the legal owner of the intangibles. If so, the relevant cost plus a modest markup will not reflect the anticipated value of – or the arm’s length price for – the contribution of the research team in all cases. These principles similarly apply in situations where a member of an MNE group provides manufacturing services that may lead to process or product improvements on behalf of an associated enterprise that will assume legal ownership of such process or product improvements.38

The Actions 8-10 Final Reports also specifically state that, as a general rule, no payment should be made for simple improvements.38 With regard to R&D arrangements and use of the company name, the transfer of intangibles or rights in intangibles in combinations with other business transactions.

With regard to the transfer of intangibles or rights in intangibles, the transfer may involve all rights in the intangibles in question (e.g. a sale of the intangible or a perpetual, exclusive licence of the intangible) or only limited rights (e.g. a licence or similar transfer of limited rights to use an intangible which may be subject to geographical restrictions, limited duration or restrictions with regard to the right to use, exploit, reproduce, further transfer or further develop).

Regardless of whatever “label” is applied by the taxpayer to the transfer of intangibles, such label does not control the transfer pricing analysis. Instead, the facts and circumstances of the transaction should be analysed.41

The issues of particular significance for transfer pricing analysis are restrictions imposed in licence and similar agreements on the use of intangibles. As such, it is critical to consider whether the transferee receives the right to use the transferred intangible for the purpose of further research and development. The nature of such limitations on further development of transferred intangibles, or on the ability of the transferee and the transferor to derive an economic benefit from such enhancements, can affect the value of the rights transferred and the comparability of two transactions involving otherwise identical or closely comparable intangibles. Such limitations must be evaluated in light of both the written terms of agreements and the actual conduct of the affected parties. The conduct of the parties is decisive for tax authorities when assessing a written specification that a licence is non-exclusive or of limited duration; if not consistent with the actual conduct of the parties, such written specification need not be respected.42

With regard to the transfer of combinations of intangibles, two related issues are discussed: the interactions between different intangibles and the importance of ensuring that all intangibles transferred in a particular transaction have been identified.43

-- transfers of intangibles or rights in intangibles, and
-- the use of intangibles in connection with the sale of goods or the provision of services.

The first type of transactions discussed in the new chapter VI includes the transfer of intangibles or rights in intangibles, the transfer of combinations of intangibles and the transfer of intangibles or rights in intangibles in combinations with other business transactions.

With regard to the transfer of intangibles or rights in intangibles, the transfer may involve all rights in the intangibles in question (e.g. a sale of the intangible or a perpetual, exclusive licence of the intangible) or only limited rights (e.g. a licence or similar transfer of limited rights to use an intangible which may be subject to geographical restrictions, limited duration or restrictions with regard to the right to use, exploit, reproduce, further transfer or further develop).

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36. Actions 8-10 Final Reports, supra n. 12, at 85 (OECD Guidelines, ch. VI, sec. B.4.).
37. Actions 8-10 Final Reports, supra n. 12, at 85 (OECD Guidelines, ch. VI, sec. B.4.1.).
38. Actions 8-10 Final Reports, supra n. 12, at 86 (OECD Guidelines, ch. VI, sec. B.4.2.).
39. Actions 8-10 Final Reports, supra n. 12, at 87 (OECD Guidelines, ch. VI, sec. B.4.3.).
40. Significantly, the new guidance does not consider a brand to be identical to a trademark, as the former can represent a combination of intangibles and/or other items including trademarks, reputational characteristics and goodwill. If features of a business such as the reputation for producing high-quality products or providing high-quality services allow that business to charge higher prices than an entity lacking such reputation, such features might need to be taken into consideration to determine an appropriate compensation. Moreover, the reputational value transferred to or shared with an associated enterprise in connection with a transfer or licence of a trademark or other intangible should be taken into account for determining appropriate compensation.
41. Actions 8-10 Final Reports, supra n. 12, at 88 (OECD Guidelines, para. 6.89) (“For example, in the case of a transfer of the exclusive right to exploit a patent in Country X, the taxpayer’s decision to characterise the transaction either as a sale of all of the Country X patent rights, or as a perpetual exclusive licence of a portion of the worldwide patent rights, does not affect the determination of the arm’s length price if, in either case, the transaction being priced is a transfer of exclusive rights to exploit the patent in Country X over its remaining useful life. Thus, the Report emphasises that the functional analysis should identify the nature of the transferred rights in intangibles with specificity.”).
42. Actions 8-10 Final Reports, supra n. 12, at 89 (Example 18 in the annex to ch. VI OECD Guidelines illustrates the recommendations provided in this paragraph).
43. Actions 8-10 Final Reports, supra n. 12, at 89 (OECD Guidelines, para. 6.94) (“For example, a pharmaceutical product will often have associated with it three or more types of intangibles. The active pharmaceutical ingredient may be protected by one or more patents. The product will also have been

Post-BEPS Application of the Arm’s Length Principle to Intangibles Structures

2.3. Transactions involving the use or transfer of intangibles

Section C of the new chapter VI discusses two general types of transactions where the identification and examination of intangibles will be relevant for transfer pricing purposes, namely:

-- transfers of intangibles or rights in intangibles, and
-- the use of intangibles in connection with the sale of goods or the provision of services.
The interactions between each of these classes of intangibles, as well as which parties performed functions, bore the risks and incurred the costs associated with securing the intangibles, are therefore very significant when performing the transfer pricing analysis with regard to a transfer of the intangibles. It is vital to consider the relative contribution to value creation where different associated enterprises hold rights in the intangibles used.

An example of ensuring that all intangibles are transferred could be presented by the transfer of rights to use a trademark under a licence agreement, whereas it will usually imply the licensing of the reputational value (sometimes referred to as goodwill) associated with that trademark, where it is the licensor that has built up such goodwill. Any licence fee would thus require consideration of both the trademark and the associated reputational value. As specifically mentioned in the Actions 8-10 Final Reports, any attempts to artificially separate trademarks or trade names from the goodwill or reputational value that is factually associated with the trademark or trade name should be identified and critically analysed.

With regard to the transfer of intangibles or rights in intangibles in combinations with other business transactions, the reliability of available comparables will be a key factor in considering whether transactions should be combined or segregated.

The second type of transactions, which involves the use of intangibles, includes situations where intangibles may be used by one or both parties to a controlled transaction in connection with the intra-group manufacture of goods, their marketing or the performance of services on behalf of an associated enterprise.

Through a testing process and a government regulatory authority may have issued an approved to market the product in a given geographic market and for specific approved indications based on that testing. The product may be marketed under a particular trademark. In combination these intangibles may be extremely valuable. In isolation, one or more of them may have much less value. Another example is the trademark without the patent and regulatory marketing approval. It may have limited value since the product could not be sold without the marketing approval and generic competitors could not be excluded from the market without the patent. Similarly, the value of the patent may be much greater once regulatory marketing approval has been obtained than would be the case in the absence of the marketing approval.

Actions 8-10 Final Reports, supra n. 12, at 90 (Example 20 in the annex to ch. VI illustrates the recommendations provided in this paragraph).

Actions 8-10 Final Reports, supra n. 12, at 90 (Example 21 in the annex to ch. VI illustrates the recommendations provided in this paragraph).

Actions 8-10 Final Reports, supra n. 12, at 91 (OECD Guidelines, para. 6.101). An example of potential necessity for segregation provided by the OECD is a business franchise arrangement where a combination of services and intangibles is exchanged for a single fee may not reflect the uniqueness of the services and intangibles; where reliable comparables cannot be identified for the entire service/intangible package, it may be necessary to segregate the various parts of the package of services and intangibles for separate transfer pricing consideration. At the same time, in some cases, for example, transfers of rights in software may be combined with an undertaking by the transferor to provide ongoing software maintenance services, which may include periodic updates to software. In such cases, where services and transfers of intangibles are intertwined, determining arm’s length prices on an aggregate basis may be necessary. Actions 8-10 Final Reports, supra n. 12, at 91 (OECD Guidelines, para. 6.105). For example, a car manufacturer uses valuable proprietary patents to manufacture the cars that it then sells to associated distributors. Considering that the patents significantly contribute to the value of the cars, they should be taken into account in the comparability analysis. Although the patents are not transferred to the associated distributors, they are used in the manufacturing and may affect the value of the cars.

In particular, sec. D.1 provides general supplemental guidance related to all transactions involving intangibles. Sec. D.2. provides supplemental guidance specifically related to transactions involving the transfer of intangibles or rights in intangibles. Sec. D.3. provides supplemental guidance regarding transfers of intangibles or rights in intangibles the value of which is highly uncertain at the time of the transfer. Sec. D.4. provides an approach to pricing hard-to-value intangibles. Sec. D.5. provides supplemental guidance applicable to transactions involving the use of intangibles in connection with the sale of goods or the provision of services in situations where there is no transfer of rights in the intangibles.

Actions 8-10 Final Reports, supra n. 12, at 93 (OECD Guidelines, para. 6.113) (“For example, a transferor would not be expected to accept a price for the transfer of either all or part of its rights in an intangible that is less advantageous to the transferor than its other realistically available options (including making no transfer at all), merely because a particular associated enterprise transferee lacks the resources to effectively exploit the transferred rights in the intangible. Similarly, a transferee should not be expected to accept a price for a transfer of rights in one or more intangibles that would make it impossible for the transferee to anticipate earning a profit using the acquired rights in the intangible in its business. Such an outcome would be less favourable to the transferee than its realistically available option of not engaging in the transfer at all.”). For more details on non-recognition, see OECD Guidelines sec. D.2. of the new ch. 1.

2.4. Supplemental guidance for determining arm’s length conditions

The supplemental guidance for use in applying the principles of chapters I-III to determine arm’s length conditions for controlled transactions involving intangibles is provided in section D of the new chapter VI of the OECD Guidelines.

2.4.1. Options realistically available

One of the key messages of the supplemental guidance is that the transfer pricing analysis must consider the perspectives of each party to a transaction when looking for comparables. In particular, the options realistically available to each of the parties to the transaction should be taken into account before arriving at the appropriate comparable for the relevant transaction.

According to the new guidance, a comparability analysis focusing only on one side of a transaction may not provide a sufficient basis for evaluating a transaction involving intangibles, including in those situations for which a one-sided method is ultimately determined. At the same time, the specific business circumstances of one of the parties should not be used to dictate an outcome contrary to the realistically available options of the other party.

The OECD builds its new guidance on the assumption that MNE groups seek to optimize resource allocations. If situations arise in which there are assertions that either the current use of an intangible or an alternative use of the intangible based on the realistically available options, does not optimize resource allocations, it may be necessary to consider whether such assertions are consistent with the true facts and circumstances of the case. If not, the transactions may be disregarded by the tax authorities under the criterion for non-recognition, or otherwise adjusted. As such, the importance of taking all relevant facts and circumstances into account in accurately delineating actual
transactions involving intangibles is specifically emphasized in the new chapter VI of the OECD Guidelines.\textsuperscript{51}

\subsection*{2.4.2. Group synergies}

For the transfer pricing analysis, it is critical to understand the MNE's global business by identifying all factors that contribute to value creation, including the risks assumed by each member, specific market characteristics, location, business strategies and MNE group synergies. The group synergies that can be attributed to "deliberate concerted group actions"\textsuperscript{52} should generally be shared between the members of the group in proportion to their contribution to the creation of the synergy.\textsuperscript{53}

The OECD explicitly disregards a rule of thumb\textsuperscript{54} in relation to the transfer pricing aspects of intangibles. A rule of thumb cannot be used to prove that a price or apportionment of income is arm's length, also in relation to an apportionment of income between a licensor and a licensee of intangibles.\textsuperscript{55} At the same time, the OECD accepts that, under limited circumstances, transfer pricing methods based on costs may be utilized, particularly where the intangibles are not unique and valuable (for example, in cases involving the development of intangibles used for internal software systems).\textsuperscript{56}

\subsection*{2.4.3. Valuation of intangibles}

With regard to valuation of intangibles for transfer pricing purposes, the Actions 8-10 Final Reports state that it is not the intention to set out a comprehensive summary of the valuation techniques utilized by valuation professionals, nor to endorse or reject one or more sets of valuation standards. Rather, valuation techniques can be seen as useful tools in a transfer pricing analysis where reliable comparable uncontrolled transactions are not available.\textsuperscript{57} In particular, the application of income-based valuation techniques (i.e. discounted value of projected future income streams or cash flows methods) are considered to be particularly useful when properly applied.\textsuperscript{58}

According to the Actions 8-10 Final Reports, depending on the facts and circumstances, valuation techniques may be used by taxpayers and tax administrations as a part of one of the five OECD transfer pricing methods described in chapter II, or as a tool that can be usefully applied in identifying an arm's length price. However, where valuation techniques are utilized 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 Guidelines.\textsuperscript{59}

In the case of transactions involving intangibles for which valuation is highly uncertain at the time of the transaction, the Actions 8-10 Final Reports provide a number of mechanisms that independent enterprises might adopt to address the high level of uncertainty at the time of the transaction.\textsuperscript{60} The OECD specifically defines so-called "hard-to-value intangibles" as those for which, at the time the transaction was entered into by related parties, no reliable comparable exists and 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.\textsuperscript{61} This also includes intangibles used in connection with or developed under a cost contribution arrangement.\textsuperscript{62}

\begin{itemize}
  \item \textsuperscript{51} Actions 8-10 Final Reports, supra n. 12, at 93 (OECD Guidelines, para. 6.114).
  \item \textsuperscript{52} Actions 8-10 Final Reports, supra n. 12, at 47-48. According to OECD Guidelines para. 1.159, “[i]n some circumstances, however, synergistic benefits and burdens of group membership may arise because of deliberate concerted group actions and may give an MNE group a material, clearly identifiable structural advantage or disadvantage in the marketplace over market participants that are not part of an MNE group and that are involved in comparable transactions. Whether such a structural advantage or disadvantage exists, what the nature and source of the synergistic benefit or burden may be, and whether the synergistic benefit or burden arises through deliberate concerted group actions can only be determined through a thorough functional and comparability analysis.”
  \item \textsuperscript{53} Actions 8-10 Final Reports, supra n. 12, at 48 (OECD Guidelines, para. 1.162).
  \item \textsuperscript{54} Actions 8-10 Final Reports, supra n. 12, at 116 (para. 2.9A of additional guidance in ch. II resulting from the revisions to ch. VI of the OECD Guidelines: “The application of a general rule of thumb does not provide an adequate substitute for a complete functional and comparability analysis conducted under the principles of Chapters I–III. Accordingly, a rule of thumb cannot be used to evidence that a price or an apportionment of income is arm’s length.”)
  \item \textsuperscript{55} Actions 8-10 Final Reports, supra n. 12, at 100 (para. 6.141 OECD Guidelines: “[... ] a rule of thumb cannot be used to evidence that a price or apportionment of income is arm’s length, including in particular an apportionment of income between a licensor and a licensee of intangibles.”)
  \item \textsuperscript{56} Actions 8-10 Final Reports, supra n. 12, at 100 (OECD Guidelines, para. 6.143).
  \item \textsuperscript{57} Actions 8-10 Final Reports, supra n. 12, at 103 (OECD Guidelines, para. 6.156).
  \item \textsuperscript{58} Actions 8-10 Final Reports, supra n. 12, at 102 (OECD Guidelines, para. 1.153).
  \item \textsuperscript{59} In particular, the Actions 8-10 Final Reports refer to the principles contained in chs. 1–III OECD Guidelines, including those related to realistically available options, economically relevant characteristics including assumption of risk (see sec. D.1 of the new ch. I) and the aggregation of transactions (see ch. III, paras. 3.9 to 3.12), stating that they fully apply to situations where valuation techniques are utilized in a transfer pricing analysis. In addition, the recommendations of the OECD on the selection of transfer pricing methods apply in determining when such techniques should be used (see OECD Guidelines, ch. II, paras. 2.1 to 2.11). The principles of secs. A, B, C, and D.1 of the new ch. VI also apply where use of valuation techniques is considered.
  \item \textsuperscript{60} Actions 8-10 Final Reports, supra n. 12, at 108, 109 (OECD Guidelines, paras. 6.183 & 6.185). For example, in case of unforeseeable or unpredictable events, parties could opt to adopt short-term agreements with price adjustment clauses, or to adopt payment structures involving contingent payments. If independent parties would have agreed to include a mechanism to address high uncertainty in valuing the intangible (e.g. a price adjustment clause) or would have considered subsequent events so fundamental that their occurrence would have led to a prospective renegotiation of the pricing of a transaction, the tax authorities should be permitted to determine the pricing of a transaction involving an intangible or rights in an intangible on the basis of such mechanism.
  \item \textsuperscript{61} Actions 8-10 Final Reports, supra n. 12, at 110 (OECD Guidelines, paras. 6.189-6.190). Within this definitional scope, the following intangibles are considered hard-to-value intangibles: intangibles that are only partially developed at the time of the transfer; intangibles that are not anticipated to be exploited commercially until several years following the transaction; intangibles that do not fall within the hard-to-value definition but that are integral to the development or enhancement of other intangibles falling within the definitional scope; intangibles that are expected to be exploited in a manner that is novel at the time of the transfer; intangibles meeting the hard-to-value definition transferred to an associated enterprise for a lump-sum payment; and intangibles used in connection with or developed under a cost contribution arrangement or similar arrangement.
  \item \textsuperscript{62} Detailed guidance on cost contribution arrangements is provided in the Actions 8-10 Final Reports in the form of revisions to ch. VIII OECD Guidelines.
\end{itemize}
2.4.4. Ex ante pricing and ex post re-assessment

As a solution for defining proper remuneration for such situations, the OECD suggests allowing tax authorities to consider ex post outcomes as presumptive evidence about the appropriateness of ex ante pricing arrangements. According to the OECD, an approach consistent with the arm’s length principle would be required where the tax authorities can assess whether the pricing arrangements as set by the taxpayers are at arm’s length, taking into account an appropriate weighting of the foreseeable developments or events that are relevant for the valuation of the intangibles or whether this is not the case.63

At the same time, the OECD explicitly states that the situation that may lead to ex post re-assessment by the tax authorities should be distinguished from the situation in which hindsight is used by taking ex post results for tax assessment purposes without considering whether the information on which the ex post results are based could or should reasonably have been known and considered by the associated enterprises at the time the transaction was entered into.64

2.4.5. Information asymmetry

The Actions 8-10 Final Reports also take into account that, because of information asymmetries, it proves difficult for a tax administration to evaluate the reliability of the information on which a taxpayer priced its transaction, especially in relation to intangibles with a highly uncertain value at the time of the transfer.

To address the above-mentioned challenges, an approach to pricing hard-to-value intangibles has been developed which allows the taxpayer to demonstrate that its pricing is based on a thorough transfer pricing analysis and leads to an arm’s length outcome, while the approach at the same time protects the tax administrations from the negative effects of information asymmetry. It does so by ensuring that tax administrations can consider ex post outcomes as presumptive evidence of the appropriateness of ex ante pricing arrangements, and the taxpayer cannot demonstrate that the uncertainty has been appropriately taken into account in the adopted pricing methodology.65

Such insufficiently clear guidance from the OECD, where the statement “could or should reasonably have been known and considered” is often applied, might result in significant tax disputes. It is probably in expectation of this that the OECD indicates that it would be vital to permit resolution of cases of double taxation arising from application of the approach for hard-to-value intangibles through access to the mutual agreement procedure under an applicable tax treaty.66

As is evidenced by such detailed description of approaches to defining the intangibles as well as delineating and pricing the relevant transactions, the OECD Guidelines represent a set of transfer pricing recommendations which, although being pretty much detailed, are at the same time unable to define the horizons (or boundaries) of the arm’s length principle. The need for such a clear-cut distinction between the general principle of tax treaties and the anti-avoidance measures is illustrated in the section below by the IP structures and the legal uncertainty associated with their existence following the BEPS initiative.


The changes in chapter VI of the OECD Guidelines initiated by Action 8, as described in the preceding section of this article, could have a substantial impact on intra-group business structures in general and on IP structures in particular.

3.1. Typical IP structures

IP can generally be exploited by a company in two ways: it can be used in its own business either as a full-risk manufacturer or a principal under, for example, toll or contract manufacturing arrangements, or by charging a royalty to another group company that uses the IP in its own business. While it is relatively easy for MNEs to ensure that new IP is created wherever desired, it is far less so to transfer the existing IP without adverse tax consequences. The most commonly used approach to transfer IP within a group is to “freeze” the existing IP by granting a licence over it to a new IP company in return for a periodic royalty, while ensuring that the new IP is generated at the level of the new IP company. Over time, the existing IP may lose value and eventually the objective of moving it tax neutrally may be achieved.67

From a transfer pricing perspective, an IP company is a company that owns IP rights, isolated from another company with which the IP company has direct or indirect equity links. The business object of IP companies does not

63. *Actions 8-10 Final Reports, supra n. 12, at 109-110, 111 (OECD Guidelines, paras. 6.188 & 6.193).* Such ex post re-assessment will not apply to intangibles falling within the above-mentioned definitional scope when at least one of the following exemptions applies: (i) the taxpayer provides: details of the ex ante projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price and the appropriateness of its consideration of reasonably foreseeable events and other risks and the probability of occurrence; and reliable evidence that any significant difference between the financial projections and actual outcomes is due to (a) unforeseeable developments or events occurring after the determination of the price that could not have been anticipated at the time of the transaction or (b) the playing out of probability of occurrence of foreseeable outcomes and that those were not significantly overestimated or underestimated at the time of the transaction; (ii) the transfer is covered by a bilateral or multilateral advance pricing arrangement; (iii) any significant difference between the financial projections and actual outcomes does not have the effect of decreasing or increasing compensation of the hard-to-value intangible by more than 20% of the compensation determined at the time of the transaction; (iv) a commercialization period of five years has passed following the year in which the hard-to-value intangible first generated unrelated-party revenues for the transferee and in which commercialization period any significant difference between the financial projections and actual outcomes was not greater than 20% of the projections of that period.

64. *Actions 8-10 Final Reports, supra n. 12, at 109-110 (OECD Guidelines, para. 6.188).*

65. *Actions 8-10 Final Reports, supra n. 12, at 64.*

66. *Actions 8-10 Final Reports, supra n. 12, at 112 (OECD Guidelines, para. 6.195).*

normally involve the direct use of the creative work protected under IP law, but rather these entities license their IP rights to an affiliate company (parent company or subsidiary), or even (exceptionally) to a company outside the group. An IP company is typically located in a country that has a favourable tax regime and operates as an investment company. In particular, by transferring ownership and management of the intellectual property to an offshore entity, a company is able to advance its intellectual property exploitation strategy and raise capital.

IP structures usually have a genuine business purpose. As is recognized by the OECD, even if an IP holding structure leads to a reduction of a company’s tax burden, the MNE may structure its operations as it sees fit, as long as the arm’s length principle is respected (i.e. as long as third parties are also involved in such transactions). Typically, IP is transferred to an IP company, as its function is to protect all of the group’s intangible assets. As such, MNEs may transfer their intangible assets (e.g. patents, trademarks, know-how, customer relationships) and risks with the profit potential attached to them to a central entity (IP company) within the group.

A frequently observed business model involves a company providing contract R&D services (an R&D company) to another group company that owns the resulting IP (the IP company) and licences such IP to the group operating companies. The IP owner may be separated from the group headquarters, whereas the latter provides management services to R&D and IP companies. The legal owner of the right to exploit an intangible ordinarily will be considered the owner, but other overriding considerations may cause ownership of the intangible right to shift to another person. Thus, legal ownership may be acquired by operation of law or contract under which the legal owner transfers all or part of its rights to another party.

3.2. What does ownership mean?

The notion of “ownership” for transfer pricing purposes includes legal and economic ownership. Ownership is of particular importance for intangibles, as it is aimed at defining the level of remuneration the “owner” deserves and thus the level of profits to be allocated to such owner and respectively to the particular jurisdiction where it is located. Following the OECD rationale in the Actions 8-10 Final Reports, one can conclude that economic ownership is more substantial and thus more significant than legal ownership, especially if the latter is nominal in nature, i.e. where it concerns the mere holding of legal title. In cases where an intangible asset is not legally protected, it is only the economic owner that can be sought to be appropriately remunerated.

The question of ownership in a transfer pricing analysis, apart from seeking to prove its existence (either nominal or substantial), is also heavily debated in the BEPS communications from the perspective of how the owner should be remunerated. For example, if legal ownership or ownership by agreement is inconsistent with the economic substance represented by the DEMPE concept introduced within the BEPS initiative, the remuneration of the legal owner would depend on how significant its involvement in the DEMPE functions is. At the same time, such DEMPE rationale could be misinterpreted in a way that the property owner may expect only a zero-return if the management of such property is performed by others.

This “zero-valued-ownership” approach to identification of the value of intangibles “denies the essence of ownership which includes the right to possess, the right to use, the right to manage, the right to the income and capital of the property” and, in effect, favours labour more than capital. Such an approach would not be sustainable from the perspective of Adam Smith’s labour theory of value (value), which claims that the labour spent on creation of an item should already be accounted for in its acquisition price for the owner, and that it is up to the owner to exploit such item, including intangibles, on its own or to allow the exploitation by others, e.g. via licensing of intangibles. In either of these two scenarios, the owner deserves not a zero-return, but its market equivalent, unless the property owned cannot be commercialized.

68. However, there may be some exceptions where the IP holding companies would need to use the IP themselves or otherwise risk losing it. See e.g. M.I Cowan & W. Newberry Jr, Reevaluating the Intellectual Property Holding Company, 14 Mgt. Acct. Q. 3 (2015), at 31 (“If an IP [holding company] does not use a trademark itself, the trademark is susceptible to removal from the US Patent and Trademark Office’s register for non-use. Use of a trademark by the licensee is considered use of the mark by financial, quality, or other control. Financial control occurs if the licensee is a subsidiary of the owner and is subject to the owner’s financial control, while quality control occurs where the owner enforces quality standards. Thus, the easiest way to address this issue is to structure the corporate enterprise with the IP holding company and the operating companies as subsidiaries.”).


71. Actions 8-10 Final Reports, supra n. 12, at 104 (OECD Guidelines, para. 9.163).

72. OECD Guidelines (2010), para. 9.2 of ch. IX.

73. In addition, Cottani also defines the third category – ownership by agreement that may cover the (partial) transfer of rights, e.g. through licensing. Such third category may, however, be considered a subcategory of legal ownership, as from a legal perspective only a legal owner, that can also meet the characteristics of economic owner, has legal authority to grant exclusive or non-exclusive right to use the property it possesses under the licensing agreement. G. Cottani, Introduction – Transfer Pricing, Topical Analysis IBFD (2014).


75. A. Smith, Wealth of Nations, Book 1, ch. V, at 48, available at: http://www.libiblio.org/ml/libri/s/Smith_A_WealthOfNations_.pdf (“The real price of everything, what everything really costs to the man who wants to acquire it, is the toil and trouble of acquiring it. What everything is really worth to the man who has acquired it, and who wants to dispose of it or exchange it for something else, is the toil and trouble which it can save to himself.”).
As a matter of law, ownership should always be remunerated at more than zero. The question of the amount of such remuneration, as a matter of fact, should be addressed in the transfer pricing analysis based on the comparability and/or valuation exercise, as indicated in the supplemental guidance of the Actions 8-10 Final Reports, as described in section 2.4. of this article. Interpreting the application of the arm’s length principle as claiming a zero-return for the property owner would result in treating the principle as an anti-avoidance measure, and would thus be indicative of its clear misinterpretation.

### 3.3. Role of IP owner under new guidance

Essentially, the new guidance in chapter VI provides for a shift from the formalistic view on ownership of intangibles towards a more functional approach to the transfer pricing analysis under which the determination of the entity within the group that should be entitled to intangible-related returns is made by means of a functional analysis. The general premise of the OECD communications in the area of transfer pricing is that the outcomes in cases involving intangibles should reflect the functions performed, assets used and risks assumed by the parties. This suggests that neither legal ownership nor the bearing of costs related to the development of intangibles, taken separately or together, entitle an entity within an MNE group to retain the benefits or returns with regard to intangibles without more.

To acknowledge that a company economically owns an asset, the substance requirement supposes that certain functions are performed and certain risks are borne by this company. Namely, according to the new OECD guidelines on intangibles:

> “… [t]he arm’s length principle […] require[s] that all members of the group receive appropriate compensation for any functions they perform, assets they use, and risks they assume in connection with the development, enhancement, maintenance, protection, and exploitation of intangibles [DEMPE functions].” It is therefore necessary to determine, by means of a functional analysis, which member(s) perform and exercise control over development, enhancement, maintenance, protection, and exploitation functions, which member(s) provide funding and other assets, and which member(s) assume the various risks associated with the intangible. Of course, in each of these areas, this may or may not be the legal owner of the intangible.”

Also, the OECD in its new guidance on intangibles recognizes that the entity may have the significant (DEMPE) functions performed by independent or associated enterprises, provided that it controls those functions. According to this guidance:

> “…[w]here the legal owner outsources most or all of such important functions to other group members, attribution to the legal owner of any material portion of the return derived from the exploitation of the intangibles after compensating other group members for their functions should be carefully considered tak-

At the same time, neither article 9 of the OECD Model (2014) nor the OECD Guidelines suggest disregarding the legal ownership of the intangible,79 but rather ensuring that each associated enterprise under the particular IP structure of an MNE group obtains an arm’s length share in the benefits derived from the intangible, based on what independent parties would have agreed in comparable circumstances. The new guidance suggests that a pure owner of IP that assumes no risks and performs no functions should be entitled to simply an adjusted rate of anticipated return on capital, but no more.

Although the OECD’s approach to defining “intangible” and “ownership” for “transfer pricing purposes” seems to be difficult to apply in practice, it is not necessarily so; it is just that transfer pricing – as grounded in the arm’s length principle – establishes its own purposes, which condition the responses to them.80 Following the new guidance, “ownership”, for transfer pricing purposes, corresponds to “entitlement”, which may or may not align with – or even correspond to – the legal notion of ownership.

### 3.4. Compensation for funding activities

In addition to the above-mentioned issues of intangibles and ownership, for a transfer pricing analysis of existing IP structures the question of funding is also of particular importance. When assessing the appropriate anticipated return for funding, the OECD Guidelines, as mentioned, follow the investor model and state the following:

> “…[a] party that provides funding, but does not control the risks or perform other functions associated with the funded activity or asset, generally does not receive anticipated returns equivalent to those received by an otherwise similarly-situated investor who also performs and controls important functions and controls important risks associated with the funded activity.”

The key message of the guidance in this regard is that the funding alone, without control of risks as well as relevant functions, does not entitle to the intangible-generated return. In this regard, it seems that the OECD in its work on intangibles “has performed a valuable service by correcting the apparently widespread misapprehension” under which for decades it was erroneously believed that according to generally applicable principles of international tax law, bearing the financial costs of business activities entitles a party, for tax purposes, to income derived from those activities.82

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78. Actions 8-10 Final Reports, supra n. 12, at 80 (OECD Guidelines, para. 6.57, with reference to Examples 16 and 17 in the annex to the new ch VI and the guidance on functional analysis in sec. D.1.2. of the new ch I).
79. Notwithstanding the exceptional circumstances discussed in the OECD Guidelines, paras. 1.64-1.69. Actions 8-10 Final Reports, supra n. 12, at 23-24.
80. J.S. Wilkie, The Definition and Ownership of Intangibles: Inside the Box? Outside the Box? What is the Box?, 4 World Tax J. 3 (2012), at 239, Journals IBFD.
81. Actions 8-10 Final Reports, supra n. 12, at 81 (OECD Guidelines, para. 6.59).
82. M. Durst, The OECD Discussion Draft on Transfer Pricing for Intangibles, Viewpoints, Tax Notes Int'l. (July 2012), at 449.
As such, the new guidance seeks to fulfil the main aim of Action 8 of the BEPS Action Plan which is to limit the return that is due to entities the main activities of which are to fund the development of intangibles “without more”, i.e. without any control over the financial risk associated with the funding by the party providing such funding. If pre-BEPS such statement was not that clearly made in the OECD Guidelines, which allowed more vulnerability in allocation of profit within an MNE, now, when the new guidance is in place, it would thus be difficult, if not impossible, to allocate a significant portion of the intangibles-related returns to a purely ‘cash box’ company. Therefore, the business rationale to keep such companies, if any are present in existing IP structures, should be reconsidered.

To conclude, under the new OECD guidelines on intangibles, it is possible to answer the question as to how to allocate profits between an IP company that owns a group’s intangibles and other group entities, only by undertaking a robust, properly documented functional analysis.

4. Limitations Imposed by the Arm’s Length Principle on Disregarding IP Arrangements

IP structures, despite having generally a genuine business purpose, are nevertheless under constant scrutiny by tax authorities, as they effectively allow taxpayers to drain off profits from high-tax to low- or no-tax jurisdictions or to jurisdictions that provide beneficial tax regimes for IP structures (so-called IP boxes). Some countries perceive such structures as abusive and are attempting to combat them by general or special anti-avoidance rules (GAARs or SAARs).83

Although there is no doubt that it is reasonable to apply such anti-avoidance measures in case of abuse, it is debatable in tax literature whether the arm’s length principle embedded in all income tax treaties as a basis for transfer pricing rules is, by its nature, an anti-avoidance measure suitable to tackle tax avoidance and evasion.84

83. In the United States, for example, states can eliminate the tax benefits of an IP holding company by arguing it is a sham under the economic substance doctrine. Beyond this general approach – or in combination with it – states use one or more of the following categories of anti-IP holding company measures: mandatory combined reporting (where affiliated corporations engaged in the same business are required to file a combined tax return and thus eliminate intercompany income and deductions, such as royalty payments from an operating company to a related IP holding company), add-back statutes (where an add-back statute disallows deductions for royalties, interest, or other payments to an affiliated IP holding company), if the other holds the intellectual property and an add-back statute applies, the royalty deduction at the level of the operating company is eliminated and the maintenance costs are not deductible because they are incurred by the out-of-state IP holding company, leaving the taxpayer worse off than if the IP holding company did not exist) and economic nexus rules (where, rather than disallowing the royalty deduction on the in-state operating company’s tax return, some states assert nexus and tax an appropriate share of the income of the out-of-state IP holding company by arguing that such holding company has economic nexus by virtue of using its intellectual property in the state). For discussion on this issue, see e.g. Cowan & Newberry, supra n. 68.

84. Tax avoidance should be distinguished from tax evasion and tax minimization. See e.g. F. Vanistendael, Legal Framework for Taxation, in Tax Law Design and Drafting (V. Thuron ed., International Monetary Fund 1996), vol. 1, at 30-31 (“Tax evasion or tax fraud is an offense against the tax laws that is punishable by criminal sanctions. It consists of clear violations of the tax laws, such as fabricating false accounts or other documents, keeping parallel accounts, not reporting income, or smuggling or dissimulating goods or assets. The tax consequences of these acts can of course be corrected by the tax administration, but in addition these acts may give rise to criminal sanctions. The statutory measures taken to combat such violations of the tax law are generally not considered to be antiabuse measures. Tax avoidance, on the other hand, is a behavior by the taxpayer that is aimed at reducing tax liability, but that does not constitute a criminal offense. The distinction between tax avoidance and tax evasion is critical, although sometimes confused, particularly by nonlawyers. Such confusion may be understandable in an economic or moral context, but it is basically wrong in a legal context of administration and implementation of tax law. In principle, most countries recognize the right of the taxpayer to arrange his or her affairs in such a way as to pay less tax. In addition to tax evasion and tax avoidance, there is an activity that can be called tax minimization, which can be defined as behavior that is legally effective in reducing tax liability. It can consist in factual behavior by which taxes are avoided such as not consuming certain products (not smoking tobacco or not drinking alcoholic beverages) subject to tax or not earning certain types of income. This factual avoidance of the tax burden is considered as perfectly legal and is not subject to statutory antiavoidance measures. By contrast, tax avoidance typically consists of factual, but of legal behavior, that is, molding factual situations in legal forms that bear less tax than other legal forms. The difficult question is whether a particular instance of such behavior is considered tax avoidance or tax minimization.”).

85. J. Wittendorff, The Transactional Ghost of Article 9(1) of the OECD Model, 63 Bull. Int’l Taxn. 3 (2009), at 118 (“The OECD Commentary may, in particular, qualify as a primary means of interpretation by providing the ‘ordinary meaning’ of treaty terms under Art. 31(1) or the ‘special meaning’ according to Art. 31(4) Vienna Convention.”).

86. Para. 7 OECD Model: Commentary on Article 1.


93. Paras. 22.1 and 22.2 OECD Model: Commentary on Article 1.

With regard to the second purpose – preventing tax avoidance and evasion – the Commentary describes situations for which treaty provisions have been designed to cover different forms of abuse.87 Such provisions include: conduit company cases, in which the treaty benefits would be disallowed as a response to the abusive behaviour;88 provisions that are aimed at entities benefiting from preferential tax regimes;89 provisions that are aimed at particular types of income,90 anti-abuse rules dealing with source taxation of specific types of income,91 and provisions that are aimed at preferential regimes introduced after the signature of the convention.92
The Commentary further states that jurisdictions which adopt controlled foreign company provisions or anti-avoidance rules in their domestic tax laws are seeking to maintain the equity and neutrality of these laws internationally, in an environment where tax burdens significantly differ, and such measures should be used only for this purpose. As a general rule, these measures should not be applied where the relevant income has been subjected to taxation that is comparable to that in the country of residence of the taxpayer.94

It is explicitly stated in the Commentary that to the extent that the application of the above-mentioned rules “results in a recharacterisation of income or in a redetermination of the taxpayer who is considered to derive such income”, the provisions of the OECD Model – including article 9 – will be applied taking into account these changes.95 As such, the Commentary specifically states that the arm’s length principle under article 9 does not incorporate any of the anti-avoidance measures, i.e. substance over form, economic substance or GAAR, and cannot by itself be applied in the practice of income tax treaties as an anti-avoidance rule.96 Therefore, even if the BEPS Final Reports envisage the possibility of transactional adjustments, such adjustments first and foremost should be performed under the provisions of domestic law, if any.

The boundaries of the arm’s length principle are established by the general principles of equity and neutrality, and avoidance issues fall outside the scope of the principle.97 This position is also supported by the case law of a number of countries, in particular cases concerning the risk allocation between associated enterprises, realistic alternatives to actual transactions, the form of payment for intangibles and the form of financing.98

Article 9 of the OECD Model (2014) would normally not restrict domestic substance-over-form rules, and transactional adjustments based on domestic substance-over-form rules must be made a priori to the application of article 9(1).99 However, article 9 would restrict the application of domestic anti-avoidance rules with regard to related-party transactions if such transactions are of a genuine nature and do not constitute an abuse. In the situation where the structure of a transaction is adjusted under a domestic rule solely based on the claim that the price between the two related parties is not set at arm’s length, the boundaries of the arm’s length principle would not allow the an overly broad application of the domestic rules by recharacterizing the transaction. If such transaction meets certain standard conditions, it should not be recharacterized,100 but rather repriced in accordance with arm’s length conditions.

At the same time, in addition to the Commentary on Article 9 of the OECD Model (2014), the 2010 OECD Guidelines provide two exceptions under which transactional adjustments – and therefore application of the arm’s length principle as an anti-avoidance tool – seem to be allowed, namely where (i) the economic substance of a transaction differs from its form101 and (ii) the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure of which practically impedes the tax authorities from determining an appropriate transfer price while the form and substance of the transaction are the same.102 Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have agreed had the transaction been structured in accordance with the economic and commercial reality of parties transacting at arm’s length.

In the Actions 8-10 Final Reports, out of the two above-mentioned conditions (the economic substance requirement and the commercial rationality test), only the latter is retained in the revised OECD Guidelines and is worded as follows:

The transaction as accurately delineated may be disregarded, and if appropriate, replaced by an alternative transaction,103 where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the

96. This view is also supported by Wittendorff, supra n. 85, at 117.
97. OECD Guidelines (2010) para. 1.64 (Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured).”
98. Wittendorff, supra n. 85, at 117.
99. Wittendorff, supra n. 85, at 118 (‘For example, if an interest-free loan was recharacterised as equity under the domestic rules, the provisions of Article 9 under the relevant double tax treaty cannot be invoked as the arm’s length principle would not be applicable.’).
100. For discussion, see M. Correia, Taxation of Corporate Groups (Kluwer Law International 2013), at 108-111.
101. OECD Guidelines (2010), para. 1.65 (‘An example of this circumstance would be an investment in an associated enterprise in the form of interest-bearing debt when, at arm’s length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital.’).
102. OECD Guidelines (2010), para. 1.65 (‘An example of this circumstance would be a sale under a long-term contract, for a lump-sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract (as indicated in paragraph 1.11). While in this case it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in their entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises. Thus, in the case described above it might be appropriate for the tax administration, for example, to adjust the conditions of the agreement in a commercially rational manner as a continuing research agreement.’).
103. E.g. A.J. Bakker & G. Cottani, Fourth Issues Note: Sting in the Tail, 16 Intl. Transfer Pricing J. 1 (2009), at 83 (‘By resorting to the concept of ‘disregarding’, it seems that the rationale of the 2010 OECD transfer pricing provision is almost akin to that of a specific anti-avoidance clause. On the other hand, by “recharacterizing” a transaction, it seems that the tax authorities effect a mere reclassification of the controlled transaction potentially leading to a profit adjustment, although without arguing the existence of an abusive transaction. With the latter term, legitimate business reasons justifying the structuring of the controlled transaction are present. As a result, a domestic anti-avoidance provision should not be invoked in the event of a recharacterization by the tax authorities of a controlled transaction.’).
options realistically available to each of them at the time of entering into the transaction. It is also a relevant pointer to consider whether the MNE group as a whole is left worse off on a pre-tax basis since this may be an indicator that the transaction viewed in its entirety lacks the commercial rationality of arrangements between unrelated parties.

Notably, when undertaking an analysis of whether the actual transaction, as structured by the taxpayer, possesses the commercial rationality of arrangements, such analysis should be conducted from the perspective of whether it would be agreed between unrelated parties under comparable economic circumstances, not merely whether the same transaction can be observed between independent parties. For example, certain IP structures may not be found in third-party settings. According to the OECD, “[t]he non-recognition of a transaction that possesses the commercial rationality of an arm’s length arrangement is not an appropriate application of the arm’s length principle.”

With the above statement, although while emphasizing that the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognized, the OECD is de facto allowing structural adjustments under the auspices of the arm’s length principle.

At first glance, it seems that the OECD attempts to go outside the boundaries of the arm’s length principle, particularly by accommodating a substance-over-form principle, which is rather a prerogative of domestic laws. As such, the overall trend of the OECD seems to be shifting the focus in international taxation from the prevention of double taxation to the prevention of tax avoidance.

Moreover, it seems that the arm’s length principle is unjustifiably blamed for not coping with the new role where instead of – or rather, in addition to – preventing economic double taxation, it is also supposed to be used to combat abusive practices. This clearly goes beyond the boundaries of a general principle of international tax law aimed at the elimination of economic double taxation and promoting trade between countries.

To avoid the above-mentioned misinterpretation of the principle under article 9 of the OECD Model, one should bear in mind that the arm’s length principle was initially concerned exclusively with the appropriate allocation of profits between the countries to prevent economic double taxation. As anti-avoidance measures are the prerogative of domestic law and are thus applicable unilaterally, the arm’s length principle in the context of bilateral income tax treaties cannot, by its nature, be used to tackle abusive practices. Under the 2015 Final Reports, the introduction of more specific guidance on the delineation of a transaction should thus either set a standard (and establish limits) for domestic rules or, if no specific domestic rules with regard to the recognition of the intercompany transaction are in place, it should provide the framework for the delineation to be made at the treaty level.

It should be made clear that the OECD Guidelines are the methodological tool to help taxpayers and tax authorities in the application of the arm’s length principle under article 9 of the OECD Model, while the Commentary should serve as a transfer pricing framework for the arm’s length principle for its proper application in transfer pricing analysis. The Commentary is particularly suitable for accommodating such framework, as OECD members would be able to enter their reservations and observations and non-
5. Conclusion

In light of the new OECD guidelines on intangibles, the transfer pricing viability of IP structures should be reassessed from the perspective of the financial capacity of each company in such structures (i.e. IP and R&D companies, headquarters and operating group companies) to bear the risk and to assume the risks associated with the intangibles. In particular, it would be advisable to perform such reassessment by identifying the contractual capability (based on either explicit or implicit contracts) to exercise control over the significant intangibles-related (DEMPE) functions and to assume risks in relation to functions of the IP company such as legal owner; involvement in the decision-making process with regard to the DEMPE functions of other group companies; and the level of management within the group, in particular the nature of activities performed by the group headquarters, the level of autonomy of the operating companies in their exploitation of IP rights and the overall sustainability of the IP structure.

The transfer pricing analysis under the new OECD Guidelines should therefore be seen as an adoption of the new transfer pricing recommendations based on the correct interpretation of the arm’s length principle as stated in article 9 of the OECD Model (2014). As such, the arm’s length principle under article 9 allows an adjustment of conditions of the related-party transaction to reflect those which the parties would have agreed had the transaction been structured in accordance with the economic and commercial reality of the parties transacting at arm’s length. Although, at first glance, it may be seen as a green light for tax authorities to disregard a transaction as structured by a taxpayer, this is, however, not the case. The economic and commercial rationality of arrangements should be analysed from the perspective of whether such arrangements would be in place between unrelated parties under comparable economic circumstances, and not whether the same arrangements can be observed between independent parties, especially bearing in mind that some IP arrangements may not be common for third parties to enter into. This interpretation of the arm’s length principle proves its nature as a general principle of tax treaties, and not as an anti-avoidance measure.

As discussed in this article, to secure legal certainty with the implementation of the new OECD guidelines on the arm’s length principle, it is recommended that a precise statement be added to the OECD Commentary on Article 9 of the OECD Model that the scope of the principle under this article is limited to profit adjustments and should not cover transactional adjustments as an anti-avoidance measure. The Commentary should thus serve as a transfer pricing framework for the arm’s length principle for its proper application in transfer pricing analysis. Such framework on article 9 under the OECD Commentary would secure legal certainty for both taxpayers and tax authorities through demonstrating whether a particular country (by providing its reservations and observations or by stating its position) adheres to its domestic law within or outside the OECD context, essentially staying within the boundaries of the arm’s length principle or going beyond such boundaries. This is exactly what is needed to build a bridge between OECD and non-OECD countries in the implementation of the OECD recommendations as part of the BEPS initiative.

111. Wittendorff, supra n. 85, at 113.
112. Wittendorff, supra n. 85, at 130.