

Introduction to the post-BEPS transfer-pricing aspects of intangibles

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1. General remarks

In the last decades, intangibles have become one of the most relevant factors to consider when running a global business¹ and, therefore, are of great interest to tax administrations. This applies in particular to the developed economies that are often technology exporting countries where intangibles are crucial for the full realization of all of the benefits coming from new products and services. Undoubtedly, however, intangibles are becoming increasingly relevant for those developing or less developed economies that are on a changing track from a technology recipient to a technology provider.

With the increasing importance of intangibles for economies,² their tax treatment has also been under scrutiny, which includes *inter alia* the transfer pricing issues connected with intangibles. As with other types of transactions, MNEs are seeking the best ways to optimize their business arrangements related to intangibles in order to obtain the most tax-efficient treatment. On the other hand, tax authorities have become increasingly concerned with the ease that intangibles can be used in aggressive planning to obtain tax benefits and result in base erosion and profit shifting (BEPS).

The OECD has well noticed the above problem caused by intangibles. Long before the official launch of the BEPS Project, the OECD examined certain impacts of intangibles in the context of business restructurings in 2005.³ The OECD eventually concluded its main findings with respect to transfer-pricing aspects of intangibles in Action 8 of the BEPS Project⁴ in 2015 and subsequently adopted these changes in the OECD Transfer Pricing Guidelines (OECD TP Guidelines) in 2017.⁵ In the OECD TP Guidelines, Chapter VI is specifically tailored to determine the arm's length conditions for transactions involving the use or transfer of intangibles.

The main goal of the above guidance that arose post the BEPS Project is to adopt a proper definition for intangibles, ensure that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation, and develop transfer pricing rules or special measures for the transfer of hard-to-value intangibles (HTVI).

1 This phenomenon is known as knowledge-based capital (KBC); more on the impact of it on today's economy can be found in the OECD Report *Supporting Investment in Knowledge Capital, Growth and Innovation*, 2013, Paris.

2 Anuschka Bakker, Stefaan De Baets, Marco Maria Mazio and Paulina Szotek, Chapter 1 Increasing Importance of IP Rights, in (Isabel Verlinden and Anuschka Bakker eds.) *Mastering the IP Life Cycle from a Legal, Tax and Accounting Perspective: Grasping the Intangible* (Amsterdam: IBFD, 2018), pp. 3–11.

3 OECD, 2nd Annual Centre for Tax Policy and Administration Roundtable: Business Restructuring, January 26–27, 2006.

4 OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10 – 2015 Final Reports*.

5 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017.

What has to be underlined when talking about the changes to the treatment of intangibles that has been introduced by the OECD is that the new rules mark a significant change when determining the entitlement of particular entities in an MNE to intangibles and their returns. Before the BEPS Project, many countries had merely accepted legal ownership as the main determinant of intangible-related returns. Instead, the OECD moves on to analyzing actual functions performed, assets used, and risks assumed by the group companies in relation to intangibles at stake. This change can be seen in the introduction of new concepts to the guidance (i.e., DEMPE functions)⁶ as well as through a significant modification of the existing guidance for the structuring (i.e., Cost Contribution Arrangements [CCA]).

The introduction part to this book provides a general overview of the changes introduced by the OECD in the 2017 TP Guidelines that relate to transfer pricing treatment of intangibles and refers to the main topics dealt with in the following chapters in more detail. Additionally, it links to the topics with practical case studies presented and discussed during the symposium.

2. Defining intangibles

2.1. General considerations regarding the meaning of intangibles

Transfer pricing approaches to intangibles start with a definition of what shall be understood as an intangible in the transfer pricing context. This is certainly not an easy task and, as was pointed out by the OECD in the TP Guidelines, potentially abusive situations might occur if the definition of intangibles happens to be either too narrow or too broad.⁷ In the first case, it may be argued by either tax authorities or by taxpayers that a specific item that would normally be treated as an intangible under the specific conditions of the transaction falls out of the scope of the definition. Hence, it can be transferred or used without a proper remuneration that would be due if the item was considered as an intangible. When the definition happens to be too broad, on the other hand, it may be argued that the transfer or use of an intangible by related parties requires separate compensation, although this would not be the case in comparable situations between independent parties.

In line with the definition authorized by the OECD,⁸ intangibles can describe anything that is not a physical or financial asset, but can be owned or controlled for the use in commercial activities.⁹ Another condition is that the use or transfer

6 P. Ludovici, *Transfer Pricing and Intangibles*, in: *Transfer Pricing Fundamentals: A Practical Guide*, M. Lang, G. Cottani, R. Petrucci, A. Storck (eds.), 2019, Kluwer Law International B.V.

7 Para. 6.5 of the 2017 OECD Guidelines.

8 Para. 6.6 of the 2017 OECD Guidelines.

9 J. Scott Wilkie, *Transfer Pricing Aspects of Intangibles: The License Model*, in: *Transfer Pricing in a Post-BEPS World*, M. Lang, A. Storck, R. Petrucci (eds.), p. 78, 2016, Kluwer Law International B.V.

of such an item would be compensated, had it been performed between independent parties in a situation that can be deemed as comparable to the one being subject to analysis. In general, also in the context of intangibles, the focus of a transfer pricing analysis is on the determination of the conditions in comparable transactions between unrelated parties.

2.2. Accounting and tax context

Another issue to which the OECD draws attention in its TP Guidelines is the fact that intangibles that are relevant from the transfer pricing perspective may not be recognized as such for accounting purposes and vice versa.¹⁰ In many cases, intangibles that are not reflected on the balance sheet (and were developed internally) will be used within the company and might generate significant profits and thus have to be considered for transfer pricing purposes. The same also applies to the enhancements of the value of intangibles during their exploitation. From the point of view of transfer pricing, accounting rules and their classification of certain items might have informative character, but those rules are not the only factor in determining whether a specific item can be treated as an intangible. In addition, the characterization of certain items for general tax purposes (including tax treaty law) will not necessarily be binding also for transfer pricing purposes. It is fair to say that transfer pricing has established a system of its own when it comes to the classification of intangibles.

In its revised TP Guidelines, the OECD also touches upon the issue of protection of intangibles and its different forms (legal, contractual, and others). The protection is not a decisive factor for the definition; however, it might be a factor affecting the value of intangibles. The same applies to the way in which intangibles are structured as some of them might be identified and transferred separately, while others are tied with other business assets.¹¹ Hence, separate transferability does not constitute an indispensable element of an intangible and does not have to be treated as decisive when determining whether an item is an intangible from the perspective of transfer pricing. This issue was underlined by the OECD after a wide debate on the nature of goodwill.

Intangibles, as such, do not always require a particular remuneration that is separate from the regular payment for goods and services, and not all of them entitle obtaining premium returns.¹² The analysis of whether an intangible requires either a separate compensation or a premium has to be performed taking into account the specific circumstances of the case. In this context, it also has to be taken into account whether or when an intangible exists and whether it really has

10 Para. 6.7 of the 2017 OECD Guidelines.

11 Para. 6.8 of the 2017 OECD Guidelines.

12 Para. 6.10 of the 2017 OECD Guidelines.

been used or transferred. This shall be analyzed in particular with reference to R&D activities and marketing activities that do not always lead to the creation or improvement of an intangible.¹³

Besides, the analysis of transfer pricing cases involving intangibles should provide results as specific as possible through identifying the intangibles at stake, the way in which the intangibles contribute to the value creation in the reviewed case, the important functions and specific risks assumed in connection with the DEMPE functions, and the interactions between analyzed intangibles and other intangibles, tangible assets, and value-adding activities.

2.3. Classifications of intangibles

When it comes to the various categories of intangibles, in practice, there are many ongoing discussions on how to actually classify intangibles. Mainly, differentiations between hard and soft intangibles as well as routine and non-routine intangibles are used, but the catalogue of possible classifications is much longer.¹⁴ The OECD, in its TP Guidelines, decides not to follow any of those classifications but rather to present an exemplary catalogue of items commonly considered in a transfer pricing analysis of cases involving intangibles. The catalogue created by the OECD entails eight diverse items out of which only five, however, can be treated purely as intangibles. In addition, the OECD also comes up with definitions of marketing and trade intangibles as those two types are perhaps the most commonly referred to intangibles in ongoing international discussions.

The above-mentioned catalogue designed by the OECD is not exhaustive in its character and entails items such as patents; know-how and trade secrets; trademarks, trade names and brands; rights under contracts and government licenses and similar limited rights in intangibles; goodwill and ongoing concern value; group synergies and market specific characteristics.¹⁵ Within this catalogue, the status of the last three items (starting from goodwill) is not certain. Admittedly, in certain situations, they can affect the determination of an arm's length price and, hence, they should be taken into account in a comparability analysis. However, they cannot be owned or transferred and thus they do not fall within the scope of the general definition of an intangible envisaged in the TP Guidelines. This was decided by the OECD in the BEPS context with controversies, as certain countries, in particular China, were in favor of considering market advantages, location savings, and the size of a market as well as the access to certain market-specific features as intangibles. Besides, the US added goodwill, going concern value,

13 Para. 6.11 of the 2017 OECD Guidelines.

14 Paras. 6.15–6.17 of the 2017 OECD Guidelines.

15 Para. 6.18 of the 2017 OECD Guidelines.

and workforce in place to the list of intangibles in the 2017 tax reform.¹⁶ The OECD, however, puts an emphasis on the ability to be owned or controlled by an associated enterprise and the items that do not fulfill this specific criterion do not fall within the catalogue of intangibles.

2.4. Goodwill and ongoing concern value

With regard to the catalogue of intangibles, some special comments shall be given on the topic of goodwill and ongoing concern value that is a recurring matter of controversy between tax administrations and taxpayers.¹⁷ The meaning of the term goodwill is very wide and also depends on the area in which it is applied. This ranges from the difference between the aggregate value of an operating business and the sum of the values of all of the separately identifiable tangible and intangible assets to the representation of future economic benefits associated with business assets that are not individually identified and separately recognized. However, based on current guidance, it is not necessary to come up with an exact definition of goodwill for transfer pricing purposes or to determine when goodwill or ongoing concern value can be treated as an intangible.¹⁸ Instead, both taxpayers and tax administrations shall make sure that their description of relevant intangibles that are analyzed for transfer pricing purposes is specific enough and that all of the contributions in a certain transaction are compensated at arm's length with no consideration to their classification.¹⁹

2.5. Practical impact

A proper definition of intangibles is of invaluable relevance for enterprises managing an IP portfolio or simply owning an intangible and performing different transactions, in particular granting usage or transferring the intangibles between associated enterprises. Chapter I of this book deals with a case of an MNE in which two related companies concluded service and manufacturing agreements, which then ceased during a subsequent restructuring (conversion). The main questions at stake are whether a transfer of “something of value” can be considered as a transfer of a certain intangible asset and whether a gradual formation of a global team is considered as a transfer of intangible asset.

16 Treas. Reg. 1.482-4(b), in effect before the 2017 US Tax Reform; Section 14221 of P.L. 115-97, Dec. 22, 2017.

17 S. Rasch, R. Schmidtke, *OECD Guidelines on Business Restructuring and German Transfer of Function Regulations: Do Both Jeopardize the Existing Arm's Length Principle?*, International Transfer Pricing, 1 (2011), Journals IBFD.

18 Para. 6.28 of the 2017 OECD Guidelines.

19 P. Ludovici, *Transfer Pricing and Intangibles*, in: *Transfer Pricing Fundamentals: A Practical Guide*, M. Lang, G. Cottani, R. Petrucci, A. Storck (eds.), p. 423, 2019, Kluwer Law International B.V.