

OECD Intangibles Discussion Draft

November 1, 2012

On June 6, 2012, the Organisation for Economic Co-operation and Development (OECD) released a discussion draft on potentially updating the provisions of Article 6 of the OECD Transfer Pricing Guidelines (Guidelines). The draft was released by Working Party No. 6 for purposes of comment, and does not reflect a consensus of the member countries.

The draft contains two principal elements: (1) a proposed revision of Chapter 6 of the Guidelines and (2) a proposed revision of examples in the Annex to Chapter 6.

A summary of the content of the 2012 draft follows.

Definition of “Intangibles”

The term “intangible” is intended to address something that is not a physical asset or a financial asset, and that is capable of being owned or controlled for use in commercial activities. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing (TP) analysis should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.

Intangibles that are important to consider for TP purposes are not always recognized as such for accounting purposes (for example, due to expensing rather capitalizing costs). In addition, the enhancement to value that may arise from the complementary nature of a collection of intangibles when exploited together is not always reflected on the balance sheet. Accordingly, characterization for accounting purposes is not determinative for transfer pricing purposes.

Similarly, the availability and extent of legal, contractual or other forms of protection may affect the value of an item and the returns that should be attributed to it, but this does not drive characterization for transfer pricing purposes.

Identification of an item as an intangible is distinct from the determination of the value of the item or the return attributable to the item.

Labels used to describe trade or marketing intangibles, “soft” or “hard” intangibles, routine or non-routine intangibles, and other such categories are not determinative for TP purposes. The discussion draft notes a variety of types of items that could be considered as constituting intangibles. Of particular interest are goodwill and going concern value (deemed to be intangibles), as well as group synergies and market specific circumstances (deemed not to be intangibles, as not owned or controlled).

Parties Entitled to Intangibles-Related Returns

The outcome of specific cases should reflect the functions performed, assets used and risks assumed by the parties. Thus, legal ownership or the bearing of costs related to intangible development, standing alone, should not entitle an entity within a multinational enterprise (MNE) group to an intangibles returns without more. Rather, returns should follow relative contributions.

Entitlement to intangible-related returns should be determined on the basis of the relevant facts and circumstances of each case.

The intangible-related return is the economic return from business operations involving use of that intangible after deducting:

- Costs and expenses related to the relevant business operations
- Returns to business functions, assets other than the particular intangible in question, and risks, taking into account appropriate comparability adjustments

Registration and contractual arrangements are the starting point for analysis. For such items to have importance, there must be alignment with the functions, risks and costs relating to the intangibles in question.

Arm's Length Compensation for Functions Performed

In determining whether a specific party is entitled to an intangible return for the functions it performs, it must be determined whether it performs “control functions.”

DISREGARD OF TRANSACTIONS, REGISTRATIONS AND CONTRACTS

In extraordinary circumstances, contractual allocations of entitlement to intangible-related returns may be disregarded by tax authorities “notwithstanding the fact that the registrations and contractual entitlements are fully in alignment with the functions, risks and costs related to the development, enhancement, maintenance and protection of the intangibles.” This “disregard” element rings of “general anti-avoidance” concepts.

TP ADJUSTMENTS

To be entitled to intangible-related returns, a party should in substance, and with “alignment”:

- Perform and control important functions related to the development, enhancement, maintenance and protection of the intangibles, including functions performed by unrelated parties
- Bear and control the risks and costs related to the function
- Bear and control risks and costs associated with maintaining and protecting its entitlement to intangible-related returns

Transactions Involving the Use or Transfer of Intangibles

There must be an identification and proper characterization of the specific controlled transactions involving intangibles. There are two general types of transactions.

USE OF INTANGIBLES

Intangibles may be used in connection with controlled transactions where there is no transfer of the intangible or of rights in the intangible (such as in the manufacture or marketing of goods, performance of services, and so on).

TRANSFER OF INTANGIBLES

Rights in intangibles may be transferred in controlled transactions, including all or limited rights. There can also be a transfer of a combination of intangibles.

Determining Arm's Length Conditions (comparability)

The general principles of the Guidelines are to be used to identify the pertinent conditions relating to the use in question. In this regard, attention is to be given to the “options realistically available to each of the parties to the transaction.” For this purpose, the perspectives of each of the parties to the transaction must be considered. A one-sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving the use or transfer of intangibles:

It will often be the case that a price for a transaction can be identified that is consistent with the realistically available options of each of the parties. The existence of such prices is consistent with the assumption that MNE groups seek to optimise resource allocations, at least on an after tax basis. If situations arise in which the minimum price acceptable to the transferor, based on its realistically available options, exceeds the maximum price acceptable to the transferee, based on its realistically available options, it may be necessary to consider whether the actual transaction should be disregarded

This “options realistically available” criteria, again, feels like an after-the-fact, subjective, General Anti-Avoidance Rule (GAAR)-type criteria. It is a rather obvious open-ended inquiry that raises the question of how an MNE is to prepare documentation on this issue?

The discussion draft contains detailed comments about comparability and potential adjustments with uncontrolled transactions.

TP Method

The general provisions of the Guidelines are generally to be applied. Caution should be exercised to not too readily assume that “all residual profit from transactions after routine functional returns should necessarily be allocated to the party entitled to intangible related returns.”

Financial valuation techniques may have application in some contexts.

USED IN CONNECTION WITH SALES OF GOODS OR SERVICES

Where reliable comparables do not exist, a variety of normal elements will need to be addressed to select an appropriate method.

TRANSFER OF INTANGIBLES

Where reliable comparables do not exist, the discussion draft gives detailed consideration to the use of profit-split methodologies and valuation techniques (such as discounted cash flow and net present value, discount rates, terminal values and tax rates).

When valuation is highly uncertain, there are additional steps that can be taken into account to determine the arm’s length pricing.

Examples

The discussion draft contains an extensive set of 22 examples, which provide sound context for the principles enunciated.

Timing

In a separate discussion draft, Working Party No. 6 addressed whether transfer pricing analysis of intangibles transactions should be undertaken on an ex ante basis, relying on information available at the time of the transaction, or an ex post basis, using information available at the time the tax return is filed.

There are variety of potential issues to be considered in this regard, as to which comments were solicited.

Way Forward

The 2012 discussion draft undertakes to update the intangibles provisions of the Guidelines. As with any such updating, there are inevitably a variety of issues that will need to be addressed in subsequent analysis by the OECD. MNEs will need to evaluate their own TP policies and effective tax rate (ETR) plans to take these factors into account.

The issues include the following:

- **Intangibles definition:** Further analysis of so-called soft intangibles (such as goodwill, going concern, value, synergies, and so on). When are such items simply elements of being a member of a MNE group?
- **Disregarding transactions:** How can transactions that actually occurred be disregarded? Adjusting the TP is one thing, purporting to disregard the transaction feels like substance versus form of GAAR principles.
- **“Alignment”:** The concept needs elaboration and explanation. Otherwise, it becomes another level of TP analysis without guidance.

- **“Realistically available options”**: This appears to be a circular concept. It is an open invitation to examination teams to invoke, in essence, substance versus Form, or GAAR arguments.
- **Financial valuation techniques**: There is a tremendous overlap between financial valuation, financial accounting and transfer pricing. It would be helpful for the OECD to spell out how this can be handled, as it occurs in every acquisition.
- **Profit splits**: The discussion draft cautions that tax administrations and MNEs not go too quickly to residual profits splits when comps are not readily available. On the other hand, the favorable view of profit-split methodologies in this area seems to be more positive in the discussion draft than in the existing Guidelines. A brief comment reconciling these items may be appropriate.
- **Timing**: One element that could be helpful to the OECD deliberation with respect to timing is the U.S. experience in its “commensurate with income” provision (Section 367(d) of the U.S. Internal Revenue Code) enacted in 1986. The United States has struggled with how to apply these provisions, even after almost 30 years on the books.
- **Annual documentation**: With all of these newly defined concepts, including concepts of disregarding actual transactions or deeming there to be “realistic alternatives,” it would be helpful if the OECD provided guidance as to how MNEs can prepare transfer pricing documentation in a manner to satisfy these requirements without having to essentially document the negatives (i.e., the transactions are not to be “disregarded” or there are no “realistic alternatives.”) One approach would simply be to make a laundry list of the issues and opine that the chosen methodology is the most appropriate methodology.
- **MNE planning considerations**: Existing advance pricing agreements; ETRs; acceptance of TP policies and ETR strategies in BRICS and other source countries; the ability to absorb foreign country adjustments (bilateral, foreign tax credit or otherwise); difference between financial valuation, financial accounting and TP policies, etc. *Ommy non eum volobortis nit dolore con ullaorpercing exero consequ ipisist et, corer sum quisim zzrit verit luptat, veliquat ecte conulput ver adit num zzriustisit niamet niat, quat. Na facipsusci erostis nim adipit, quat, quatuer si te modo conulputate cons accum zzriusto dunt lam nonse tismolorerit vullan ute molore verciduisi.*

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