ACTION ITEM 8:
CHANGES TO THE TRANSFER PRICING RULES IN RELATION TO INTANGIBLES – PHASE I

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Tags
B.E.P.S.
Comparable Market Method
Cost Method
Excess Profits Method
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Relief of Royalty Method
Transfer Pricing

INTRODUCTION

Unlike some of the other B.E.P.S Action Items, Action Item 8 has a basis in existing O.E.C.D. rules. In this regard, the O.E.C.D. Transfer Pricing Guidelines[41] have established the operating rules for transfer pricing. It is understandable that Action Item 8 merely presents a series of amendments to Chapters I, II, and VI of the *O.E.C.D. Guidelines.*

Action Item 8 states that it seeks to:

- Clarify the definition of I.P.,
- Provide guidance on identifying transactions involving I.P., and
- Provide supplemental guidance for determining arm's length conditions for transactions involving I.P.

Action Item 8 also considers the treatment of local market features and corporate synergies.

Action Item 8's recommendations intend to accomplish these three goals by:

- Adopting a broad and clearly delineated definition of I.P.,
- Ensuring that profits associated with the transfer and use of I.P. are appropriately allocated in accordance with (rather than divorced from) value creation,
- Developing transfer pricing rules or special measures for transfers of hard-to-value I.P.,
- Updating the guidance on cost contribution arrangements, and

[41] O.E.C.D Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("the O.E.C.D. Guidelines").

- Adopting transfer pricing rules or special measures to ensure inappropriate returns will not accrue to an entity solely because it contractually assumed risks or provided capital.

THRESHOLD ISSUES

Definition of Intangible Property

Intangible property ("I.P.") for both O.E.C.D. and U.S. tax purposes is broadly defined. It includes

- Patents, inventions, formulae, designs, patterns, or know-how;
- Copyrights, such as for literary, musical, or artistic compositions;
- Trademarks, trade names, or brand names;
- Franchises, licenses, or contracts;
- Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
- Items similar to these listed.[42]

Further guidance regarding the definition of I.P. is found in the U.S. tax law provisions regarding the amortization of I.P. acquired as part of a trade or business.[43] Intangible assets include:

- Workforce in place;
- Business books and records;
- Patents, copyrights, formulae, etc.;
- Customer-based I.P.;
- Supplier-based I.P.; and
- Any similar items.

Goodwill is recognized under these U.S. tax law principles as an item of I.P. and is defined as the value of a business attributable to the continued expectancy of customer patronage, due to name reputation or any other factor.[44] Note that

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42 Code §936(h)(3)(B). These items are considered separately identifiable intangible property where they have substantial value independent of the services of any individual.

43 Code §197(d)(1)(C); Treas. Reg. §1.197-2(b) provides detailed descriptions of the Section 197 intangible property.

44 Treas. Reg. §1.197-2(b)(1).

goodwill for this purpose is not accounting goodwill or the goodwill embedded in another item of I.P. such as trademarks. Rather, it must be a standalone item of property.[45]

Valuation of I.P.

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The purpose of the valuation controls the choice of method used to value I.P. These purposes include:

- Transaction Strategy**:** Consideration of buying, selling, or transferring the I.P. in a licensing arrangement or acquisition;
- Financial Reporting**:** Valuing prescribed intangible assets for reporting on public financial statements;
- Litigation Strategy: Computation of damage awards in infringement suits; and
- Bankruptcy: Valuing assets to properly repay creditors or to reorganize the company.

Various methods may be used to value I.P. From a transfer pricing perspective, the most important methods are:

- Relief of royalty,
- Excess profits,
- Net present cash flow,
- Comparable market, and
- Cost.

The relief from royalty method assumes that if a business loses ownership of a particular I.P., it would be forced to pay a royalty to the owners of the I.P. for the right to use the property. This royalty rate can be based on a number of variables, but is most often based on revenues. The percentage rate for the royalty will differ depending on the characteristics of the asset considered and the industry in which that asset is deployed. The value of the I.P. under this method is the capitalized value of the after-tax royalties that the company is relieved from paying because it is the owner of the asset. Determining the appropriate royalty rate is the key consideration. Ideally it is calculated by reference to standard industry values and practices or comparable transactions.

The excess profits method is used primarily to determine the value of a brand to a business and involves determining a fair market value of the net tangible assets used in producing the branded product. A rate of return is then used to estimate

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[45] *International Multifoods Corp. v. Commr.*, 108 TC 25, supplemental op., 108 TC 579 (1997).

the profits required to promote investment in those assets. Any return in excess of this amount represents the maximum royalty payable. That amount is capitalized to compute the value of total intangible assets. This approach is a variation of the method in which the business is valued as a whole. The current market value of the business's net tangible assets is subtracted from that overall value. It assumes that the entire excess return can be attributed to the presence of the brand name alone. It ignores the possibility that other intangible factors, such as an established distribution network or statutory protection from competition, may influence the return.

Under the net present cash flow value method, the value of the I.P. comprises the present value of cash flows generated by the asset over its useful life. The useful life of an asset depends on its economic life. Critical factors include life cycle, rate of technological change, and barriers to entry. This method has been considered to have the strongest theoretical foundation because it is based on the economic measure of cash flow, including a focus on the future risks associated with the assets, and the duration of the economic life of the assets. The key is to readily identify the net cash flows that are directly associated with the I.P. These include cash flows attributable to a library of film, music, or program copyrights or royalty income from licensing a brand name.

The comparable market methodology values the I.P. by referring to prices obtained for comparable assets in recent similar transactions and licensing arrangements.[46] The method is credible, objective, and relevant in the context of market-based valuation exercises. Major requirements are:

- An active market,
- An exchange of comparable assets,
- Access to price information at which assets are exchanged, and
- Transactions that reflect market values.

There may be difficulties in valuing I.P. using this methodology even when information is available because particular transactions may be affected by non-value related factors. These factors include:

- Different levels of relevant knowledge,
- Different negotiating skills between the parties, and
- Fundamental differences between the assets used in the comparable analysis and the asset that is valued in the subject transaction, which may have the effect of over-pricing or underpricing the value of the I.P.

The cost-based approach seeks to measure future benefits of owning I.P. by quantifying the amount spent on developing an I.P. asset to its present form or the

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[46] The residential real estate market is a market where these conditions are usually present, albeit for real property.

amount required to replace the future service capability of that asset. The issue here is whether or not it is correct to assume that the value of the I.P.'s development costs, usually incurred over a lengthy period of time, reflects its ability to derive future economic benefit.

HISTORICAL PERSPECTIVE

The O.E.C.D. has had a long-standing project to revise Chapter VI of the 2010 O.E.C.D. Guidelines relating to I.P. Discussion drafts were released in June and September 2012. Almost simultaneous with the release of the B.E.P.S. Action Plans in 2013, the O.E.C.D. issued the "Revised Discussion Draft" on Transfer Pricing Aspects of Intangibles. The revised draft was consistent with the 2012 discussion drafts. The groundwork provided by the discussion drafts has enabled Action Item 8 to move at an accelerated pace, focusing the deliverable on the revision of Chapter VI of the O.E.C.D. Guidelines.

The 2013 Revised Discussion Draft discussed the definition of I.P., location savings, synergies, and pricing methods. The public debate focused on the allocation of income from the exploitation of I.P. among the members of a related party group. This contrasted with the prior discussion drafts, which placed more emphasis on functions performed and control over risk and less emphasis on I.P. ownership, funding, and contractual terms. For example, in the 2013 Revised Discussion Draft, emphasis was placed on certain important functions such as control over research and marketing programs, budgets, or strategic decision-making. These were key factors in valuation and were given special significance.

The 2013 Revised Discussion Draft diminished the role of capital by proposing to restrict the return that a related party should expect from bearing a funding risk. These risks typically appear in calculations supporting a cost sharing or contract R&D arrangement. In that regard, it provided,

> Bearing a funding risk, without the assumption of any further risk, and without any control over the use of the contributed funds or the conduct of the funded activity, generally would entitle the funder to a risk-adjusted rate of anticipated return on its capital invested but not more.

What this return should be is left open, but the implication is that it should be modest.

By the end of May, it was reported that Working Party 6 completed a revised text for Chapters I, II and VI to the Transfer Pricing Guidelines.

ACTION ITEM 8 AND THE THRESHOLD ISSUES

Action Item 8 addresses these threshold issues in its amendments to the O.E.C.D. Guidelines, Chapters I and II and VI, and is supplemented by a number of examples.

> *"Both positive and negative effects of organizational synergies should be considered, a point often overlooked by taxation authorities when dealing with multinational corporations."*

Chapters I and II Key Points

- Location savings, assembled workforce, and group synergies are to be taken into account to determine comparability of functions and risks in benchmarking the controlled transaction at issue to the appropriate set of comparables. The existence and relevance of each of these factors to transfer pricing is to be determined by a robust functional and comparative analysis.

- Location savings (*i.e.*, cost reductions from operating in a given market having comparatively cheap labor) may or may not be passed on to the customer. If not passed on to the customer, it is assumed that the members of the multinational group will share in the location savings based on their relative contributions to the benefits derived from the location savings.

- Assembled workforces with unique skills may differentiate the multinational group's controlled transaction from potential comparables. Where these workforces can be transferred from one entity/location to another, the associated cost savings to the recipient entity (time and expense of recruiting) would most likely represent an adjustment that would need to be made in determining the group's transfer pricing for purposes of the comparables' benchmarking.

- Both positive and negative effects of organizational synergies should be considered, a point often overlooked by taxation authorities when dealing with multinational corporations. Positive synergies might include the ability to purchase raw materials at a bulk discount or other indicia of economies of scale. Negative synergies might include bureaucratic hurdles to necessary business decisions or outdated company standards in comparison to the competition.

- The functional and comparable analysis to identify the existence and relevance of location savings, assembled workforce, and organizational synergies should identify any I.P. developed or used by the multinational group in the transaction. For example, location savings may be attributable to a license to conduct business within a given jurisdiction or market, which would be in and of itself I.P., depending on whether that license represents a barrier to entry of the market for other competitors. Transfer of an assembled workforce might include transfer of I.P. in the form of the business know-how resident in the workforce. Group synergies may result from concerted efforts by the multinational organization to achieve structural advantages over the competition. These efforts will necessitate a determination of, (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (iii) how that benefit or detriment should be divided among members of the group. Thus, the implication is that I.P. can be developed as a result of internal corporate organizational initiatives.

Chapter VI

Action Item 8 has amended Chapter VI in its entirety, replacing the old with the new. The new Chapter VI focuses on special situations in transfer pricing due to

the nature of I.P. and emphasizes that the procedures set forth in the earlier chapters regarding robust functional analyses and determination of comparable transactions especially applies to I.P. The functional and comparability analyses must consider:

- The identification of specific I.P.;
- The legal ownership of I.P.;
- The contributions of multinational group members to their development, enhancement, maintenance, protection and exploitation; and
- The nature of the controlled transactions involving I.P., including the manner in which such transactions contribute to the creation of value.

On these four threshold points, Chapter VI provides the following guidance:

- Chapter VI identifies I.P. as including anything that can be owned or controlled by parties in a commercial setting and whose use or transfer would be compensated for by independent parties in comparable circumstances. That certainly includes the items noted above and most likely others, as Chapter VI points out that the definition of I.P. for transfer pricing purposes should not be limited to accounting definitions or to items for which R&D expenses have been incurred and expensed rather than booked to a balance sheet account. Note that separate transferability is not necessary for something to be considered an intangible item. Chapter VI notes that I.P. can be transferred along with non-I.P. and that they are not tied to contractual rights but can exist separately.

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- Action Item 8's Working Group 6 was concerned with the issue of whether legal ownership of an intangible determined share of anticipated income from the intangible. In sum, Chapter VI provides that legal ownership will entitle the owner to such income if the legal owner of an intangible, in substance:
  - Performs and controls all of the functions (including the important functions described in paragraph 6.56) related to the development, enhancement, maintenance, protection and exploitation of the intangible;
  - Provides all assets, including funding, necessary to the development, enhancement, maintenance, protection, and exploitation of the I.P.; and
  - Bears and controls all of the risks related to the development, enhancement, maintenance, protection, and exploitation of the intangible.
- Determination of group members' assumption of functions and risks related to the development and exploitation of an intangible will be based on a function and risk analysis performed pursuant to the principles laid out in the earlier chapters. To the extent use of the I.P. or performance of these activities are carried out by other members of the multinational group, those members would be entitled to share in the anticipated returns from the I.P.

in the form of arm's length consideration for their efforts. Chapter VI notes that this compensation may constitute all or a substantial part of the anticipated return from the I.P., depending on the facts and circumstances. Chapter VI notes that entitlement to profit or loss relating to unanticipated events will depend on the terms and conditions of relevant contracts and on the functions performed, assets used and risks assumed by each member.

- Chapter VI sets out the basis for identifying and analyzing the transactions involving I.P. The required steps are:
  - Identifying the legal owner of I.P. based on the terms and conditions of legal arrangements, including relevant registrations, license agreements, other relevant contracts, and other indicia of legal ownership;
  - Identifying the parties performing functions using assets, and assuming risks related to developing, enhancing, maintaining, protecting, and exploiting the I.P. by means of the functional analysis;
  - Confirming the consistency between the conduct of the parties and the terms of the relevant legal arrangements regarding intangible ownership through a detailed functional analysis; and
  - Identifying the controlled transactions related to the development, enhancement, maintenance, protection, and exploitation of I.P. in light of the legal ownership of the I.P. under relevant registrations and contracts, and the conduct of the parties, including their relevant contributions of functions, assets, risks and other factors contributing to the creation of value.

  In principle, an accurate determination of an arm's length price reflecting each party's contribution will result when the foregoing steps are followed.

Chapter VI has certain transactions in mind that require this type of analysis, including:

- Development and enhancement of marketing I.P.;
- Research, development, and process improvement;
- Use of the company name;
- Transfers of I.P. or rights to I.P.;
- Transfers of combinations of I.P.;
- Transfers of I.P. or rights to I.P. in combination with other transactions, such as services or tangible property.

Chapter VI provides supplemental guidance for transactions most likely to reflect incorrect application of the transfer pricing guidelines. Points to be checked include:

- The quality of the intangible transfer – such as the exclusivity, geographic scope, useful life, and stage of development – for purposes of checking comparability of I.P. transactions;

- Inherent risks regarding the likelihood of future benefits from the exploitation of the I.P.; and

- Obsolescence of the intangible or infringement.

I.P. Valuation

Valuation of I.P. is integral to the determination of income attributable to the intangible, particularly where no third party comparable transactions can be identified. In this regard, Chapter VI reflects the general O.E.C.D. direction of recommending close scrutiny of the value of the intangible transferred out of a highly taxed jurisdiction to a low tax jurisdiction. Here again, Chapter VI gravitates away from reliance on accounting concepts, noting that accounting assumptions may be too conservative in order to avoid overstating the balance sheet. Chapter VI instead relies on realistic alternatives that take into account the perspective of the parties and attribution of risk. Income valuation methods such as discounted cash flow are considered particularly useful when properly applied. Chapter VI anticipates that valuation methods will also be used within the context of proper application of the approved O.E.C.D. transfer pricing methods related to I.P. as those methods have been outlined in Chapter II.

NEXT STEPS & OPEN ISSUES

Work remains on related Action Items, such as Action Item 9 on Risks and Capital, and Action Item 10 on Other High Risk Transactions. Work on these two Action Items anticipates a December 2014 discussion draft. Developments on Action Items dealing with permanent establishments, deductibility of interest, the C.F.C rules, and the digital economy are also anticipated to have an effect on I.P. In 2015, work is anticipated on special measures related to:

- Providing tax administrations with authority in appropriate instances to apply rules based on actual results to price transfers of hard-to-value I.P. and potentially other assets;

- Limiting the return to entities whose activities are limited to providing funding for the development of I.P., and potentially other activities, for example, by treating such entities as lenders rather than equity investors under some circumstances;

- Requiring contingent payment terms or the application of profit split methods for certain transfers of hard-to-value I.P.; and

- Requiring application of rules analogous to those applied under Article 7 of the O.E.C.D. Model Tax Convention and the Authorized O.E.C.D. Approach to certain situations involving excessive capitalization of low function entities.

As far as open issues are concerned, one query is whether further work needs to be done on the definition of I.P. Chapter VI seemed to conclude that I.P. should be limited to assets that are proprietary in nature, meaning that rights related to the I.P. are protected by law or contract. Chapter VI defined goodwill as I.P. for most I.P. transactions. An over-emphasis on the discounted cash flow valuation method could be detrimental in situations where other valuation methods are more appropriate.

From the U.S. perspective, it seems that the core U.S.-centric concern remains in issue. That concern is whether the favored methodologies in Chapter VI yield the most accurate arm's length result. If Action Item 8 is nothing more than an emphasis on functions and risks and a de-emphasis on capital investment, then the U.S. concern has not been addressed. Chapter VI's approach to I.P. transfer pricing may become overly political as each jurisdiction applies different methodologies based on factors that favor its position.

From the multinational group perspective, the author's advice has consistently reflected the following approach:

- Align transfer pricing strategy for tax purposes with the enterprise's business model. Do this in the context of a function and risk analysis.

- Monitor written intercompany agreements and procedures and amend them if necessary to reflect changes in the business. Do this in the context of affirmatively identifying the intangible and the intangible transaction.

- The quality of a transfer pricing analysis depends on the quality of the comparables. Note the increased focus on identifying proper comparables for use in benchmarking the I.P. transaction being valued.

- Know the comparables. Identify why a given comparable company has been selected and how that company's functions and risk allocations relate to the tested party's functions and risks. The I.R.S. analysis of comparables is often based on brief excerpts of 10-K reports that do not shed light on the ways in which the comparable companies conducted business.

- When push comes to shove, substance trumps writing. In this regard, stay faithful to your agreements as noted above.

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