



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



TRANSFER PRICING AND INTANGIBLES: SCOPE OF THE OECD PROJECT

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CENTRE FOR TAX POLICY AND ADMINISTRATION

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A. Background

1. The OECD completed in 2010 a major revision of the Transfer Pricing Guidelines (hereafter “TPG”), including a revision of its guidance on comparability and profit methods (Chapters I-III) and the development of new guidance on the transfer pricing aspects of business restructuring (Chapter IX). In the process that led to the 2010 revision of the TPG, transfer pricing issues pertaining to intangibles were identified as a key area of concern to governments and taxpayers, due to insufficient international guidance in particular on the definition, identification and valuation of intangibles for transfer pricing purposes.

2. Chapter VI of the TPG contains special considerations for intangible property and Chapter VIII contains guidance on cost contribution arrangements. These two chapters date back to 1995-1997 and are in need of updating to address all the transfer pricing issues encountered in today’s business transactions and transfer pricing practices.

3. Many of the issues addressed in the 2010 revision of the TPG are relevant to intangible transactions. In particular, Chapter II provides guidance on the selection of the most appropriate transfer pricing method to the circumstances of the case (paragraphs 2.1-2.11) and expanded guidance on the application of a profit split method where both parties to a transaction contribute unique and valuable intangibles (paragraphs 2.108-2.145). Chapter IX provides new guidance on risks (paragraphs 9.10-9.47) and intangible transfers (paragraphs 9.80-9.92). Further relevant guidance is found in Chapter II in relation to the application of the transactional net margin method, in Chapter III in relation to comparability analyses, and in Chapter IX on business restructurings.

4. A number of issues specific to intangible transactions were however left aside in the 2010 revision of the TPG. There is currently significant difficulty, for taxpayers and governments, about the treatment of intangibles for transfer pricing purposes. This difficulty leads to many complex and monetarily-significant transfer pricing disputes and to risks of double or less-than-single taxation. The OECD believes that the development of clearer and consensus-based international guidance on the transfer pricing aspects of intangibles could help limiting this uncertainty and those risks. The Committee on Fiscal Affairs has decided to start in 2011 a new project on the transfer pricing aspects of intangibles. It is expected that this work will lead to an update of Chapter VI of the TPG, and possibly of Chapter VIII as need may be.

B. Process

5. This work will be carried out by Working Party No. 6 of the Committee on Fiscal Affairs on the Taxation of Multinational Enterprises, through a Special Session on the Transfer Pricing Aspects of Intangibles (“WP6 TPI”) set up for this purpose. The WP6 TPI is open to all interested member countries and Observers.¹ In addition, Brazil, Indonesia, Malaysia and Singapore will be invited to participate. Early and substantial involvement from the business community will be important.

¹ In January 2011, the OECD has 34 member countries, see http://www.oecd.org/document/25/0,3343,en_36734052_36761800_36999961_1_1_1_1,00.html. Observer countries to the Committee on Fiscal Affairs are Argentina, China, India, the Russian Federation and South Africa.

6. Public comments were invited in July 2010 on what interested parties saw as real issues in practice and shortfalls in the existing guidance, on the areas in which they believed that the OECD could usefully do some further work, and on what they believed the format of the final output should be. Fifty written contributions were received in response to this invitation to comment and a consultation was held with commentators in November 2010 (see www.oecd.org/ctp/tp/intangibles). This paper reflects the outcome of this scoping exercise.

7. The WP6 TPI will invite selected business representatives to attend part of its meetings on an ad hoc basis, depending on the substantive issues that will be discussed. The intention is to release a discussion draft for public comment if possible by the end of 2013. Depending on the nature and extent of the comments that will be received on the discussion draft, it is likely that at least one consultation meeting with the commentators on the discussion draft will be needed.

C. General comments on the scope of the project

8. The intention with the new project on the transfer pricing aspects of intangibles is not to re-open issues that were resolved in the 2010 revision of the TPG. Rather, it is to develop guidance on issues specific to intangibles that need to be updated.

9. This project relates to the examination of the transfer pricing aspects of transactions involving intangibles between associated enterprises, *i.e.* in the context of Article 9 of the OECD Model Tax Convention (“MTC”). It does not include a discussion of intangible dealings or of the attribution of the economic ownership of intangibles to a permanent establishment in an Article 7 context, as these are addressed in the July 2008 and July 2010 Reports on the Attribution of Profits to Permanent Establishments (“the PE Reports”). Issues that were resolved in the 2008 and 2010 PE Reports will not be reopened. Furthermore, the guidance that will be provided under Article 9 will be developed independently from the Authorised OECD Approach (“AOA”) that was developed for Article 7 (see paragraph 9.7 of the TPG).

10. The OECD is aware of and will keep in mind in the development of its new guidance the need for the compliance burdens imposed on taxpayers to be reasonable and proportionate to the significance and complexity of the transaction.

D. Specific areas identified for further work

D.1 Framework for analysis of intangible-related transfer pricing issues

11. Consideration will be given to the possibility of describing in Chapter VI of the TPG or in an Annex an overall framework or process for analysing intangible-related transfer pricing issues. Such a framework may be similar to the multi-step framework for conducting a comparability analysis developed at paragraph 3.4 of the TPG, *i.e.* a typical, non-compulsory process the use of which would be regarded as an accepted good practice.

D.2 Definitional aspects

12. The project will address certain definitional issues related to the scope of Chapters VI and VIII of the TPG. The TPG currently do not contain a definition of “intangibles” for transfer pricing purposes. Paragraph 6.2 of the TPG contains an illustrative list of some typical intangibles. The specific approach to be followed in addressing relevant definitional issues has not been finally determined. Based on the current thinking of the WP6 TPI, however, a number of issues are likely to be considered and addressed. These include the following:

- The meaning and usefulness of the language in Chapter IX related to payment for transfers of “something of value” in the context of transactions involving intangibles.
- The relevance and usefulness in describing the scope of Chapters VI and VIII of the TPG of definitions of intangibles drawn from accounting, financial valuation, and legal literature and other similar sources.
- Relevant factors that should be considered in determining whether or not an intangible is used or transferred and if so how it should be remunerated at arm’s length. Factors to be discussed include, among others, the ability to produce future economic benefits to a business activity, the availability of legal protection and whether a specific intangible can carry value if it cannot be transferred in isolation.
- The relevance and analytic usefulness of efforts to categorise intangibles contained in the current TPG or commonly referred to in transfer pricing analyses. Such terms of categorisation include, among others, the use of the terms marketing and trade intangibles, the use of the terms routine and non-routine intangibles, and other similar terms of categorisation.

13. Adequate and consistent terminology should be used throughout the TPG and definitions will be added to the glossary of the TPG where needed.

D.3 Specific categories of intangibles

(i) Research and development activities (“R&D”)

14. Examples of contract research activities are currently found at paragraphs 2.55, 7.41 and 9.26 of the TPG. In these examples, questions arise about the selection and application of the most appropriate transfer pricing method (paragraphs 2.55 and 7.41) or about whether the allocation of risks was arm’s length (paragraph 9.26). The WP6 TPI will review these examples to determine whether any further guidance on R&D activities is needed.

(ii) Differentiation between intangible transfers and services

15. The WP6 TPI intends to discuss the relevance of differentiating between services provided using intangibles and intangibles transfers for transfer pricing purposes. There is often an observed tendency in practice to use a cost plus method for services while a profit split would be considered for intangibles transfers, perhaps implying an assumption that services involving intangibles are inherently less valuable than transfers of intangibles. However, there are services which are unique and carry high added value, for which a cost plus may not be appropriate. There are also intangibles transfers which are not unique or not highly valuable, for which a profit split would not be appropriate.

16. Furthermore, while a full revision of Chapter VII is not in the scope of this project, the WP6 TPI will undertake a consistency check of Chapter VII towards the end of this project, in order to ensure that the terminology and concepts used in Chapters VI-VIII are consistent.

17. Finally, this project also provides a good opportunity to clarify what the similarities and differences are between the concept of intangibles for transfer pricing purposes and the definition of royalties for Article 12 of the Model Tax Convention.

(iii) *Marketing intangibles*

18. Many business commentators have expressed concerns about the broadening of the notion of marketing intangibles. The WP6 TPI believes that the correct identification and valuation as well as the determination of the rights to share in the profits of marketing intangibles will be derived from the application of the general guidance that will be developed for intangibles.

(iv) *Other intangibles and business attributes*

19. Business commentators have listed a variety of business attributes or notions for which they find that there is uncertainty as to whether they should be regarded as compensable intangibles for transfer pricing purposes. The list includes workforce in place, a commitment to undertake research and contribute to the development of future intangibles, goodwill, going concern, profit potential, business opportunities, value drivers, first mover advantage, and many others. The WP6 TPI intends to discuss the relevance of such notions for transfer pricing purposes and in particular their possible effect on the characterisation of a compensable transaction and on its valuation.

D.4 *Intangible transfers*

(i) *Identifying an intangible transfer and its form*

20. The WP6 TPI intends to develop guidance on how to determine whether an intangible has been transferred. This could include a consideration of the factors to be considered to determine whether all intangible property rights or partial intangible property rights have been transferred, or whether the value of intangibles has been transferred through the provision of services; consideration of factors informing whether intangible property has been transferred in isolation or in conjunction with tangible assets, business operations, other intangible assets, services, etc.; and consideration of the form of the transfer.

(ii) *Recharacterisation issues*

21. It is not in the scope of this project to reopen the existing guidance on recognition of transactions at paragraphs 1.64-1.69 of the TPG. However, the application to intangible transactions of that guidance might possibly be illustrated in the context of the revision of Chapters VI-VIII, as has been the case in the context of the new Chapter IX.

22. Some business commentators have suggested that the new guidance should apply differently depending on whether a transaction takes place with an associated enterprise in a high tax or low tax country. The view of the OECD is that the arm's length principle does not apply differently depending on the tax rate of the associated enterprise. The tax rate of the associated enterprise could be considered as part of the risk assessment made by tax administrations when deciding which cases to audit, but not as an element that induces a different application of the principle.

D.5 *Right of an enterprise to share in the return from an intangible that it does not own*

23. For transactions between associated enterprises, it is generally possible to identify which of the associated enterprises is the legal owner of a legally protected asset (e.g. a patent or a trademark). However, it may be that an enterprise that is not the legal owner of an intangible should nevertheless be entitled, at arm's length, to share in any additional return attributable to the development or exploitation of that intangible, e.g. because it has incurred significant risk and expenses related to the development of an intangible or the enhancement of its value. An example is found at paragraphs 6.36-6.39 of the TPG dealing with marketing activities undertaken by enterprises not owning trademarks or trade names.

24. In such cases, Article 9 of the MTC and the TPG do not generally suggest disregarding the legal ownership of the intangible,² but rather ensuring that each associated enterprise obtains an arm's length share in the benefits derived from the intangible, based on what independent parties would have agreed to in comparable circumstances.

25. The question of the attribution of the economic benefits derived from the development or exploitation of an intangible, by contrast to its legal ownership, is sometimes referred to as "economic ownership". In an Article 9 context, this is a slightly different notion from the one of "economic ownership" developed under Article 7, although the same phrase is often used for both. This can lead to some confusion between the two notions. In addition, other phrases such as "beneficial ownership" and "functional ownership" are sometimes used and were raised by some commentators. There is a need for clarification of this notion and consistent use of the terminology in the context of the TPG.

26. This project will consider whether clearer guidance can be developed in the TPG on these notions under Article 9.

D.6 Cost Contribution Arrangements

27. OECD guidance on Cost Contribution Arrangements ("CCAs") is found in Chapter VIII of the TPG. CCAs are sometimes used by MNEs to organise the development and ownership of valuable intangibles. In practice, controversies have arisen regarding the existing OECD guidance on CCAs, including issues related to the characterisation of intangibles transfers made at the inception of a CCA and issues related to the valuation of the contributions made by the participants in a CCA.

28. The WP6 TPI considers that its project on the transfer pricing aspects of intangibles should also encompass some review of the existing guidance in Chapter VIII of the TPG on CCAs, to the extent it relates to the sharing of the costs and risks of developing, producing or obtaining intangibles (rather than services). In practice, the work will focus in priority on revising Chapter VI of the TPG. Once sufficient progress is made with Chapter VI, the Working Party will revisit Chapter VIII and determine the extent of the work needed to bring this Chapter up-to-date with the guidance developed in the revised Chapter VI and in Chapter IX, as well as any further work that might be needed.

D.7 Valuation

29. The project will consider whether further guidance regarding the valuation of intangibles should be provided in the TPG.

(i) *General guidance on the selection of the most appropriate transfer pricing method, on the application of the five OECD-recognised methods and on comparability*

30. Chapter VI of the TPG confirms to a large extent that all five OECD recognised methods may in theory apply to intangibles, depending on the facts and circumstances of the case, while at the same time pointing repeatedly to the difficulties that arise in their application, due in particular to comparability issues where valuable unique intangibles are involved. It also insists on the need to consider "the expected benefits from the intangible property (*possibly determined through a net present value calculation [emphasis added]*)" (paragraph 6.20 of the TPG).

31. Since the publication of Chapter VI of the TPG, considerable work was done by the OECD in the 2010 revision of Chapters I-III to provide more specific guidance on the selection of the most appropriate

² Notwithstanding the exceptional circumstances discussed at TPG 1.64-1.69.

method to the circumstances of the case, on how to apply transactional profit methods (TNMM and profit split) and on how to do a comparability analysis in practice. This newly developed guidance is largely relevant to transactions involving intangibles and may be an adequate response to some of the difficulties identified in Chapter VI with respect to the practical application of these methods to situations involving intangibles. The WP6 TPI does not intend to do further work on the selection and application of the five OECD-recognised methods as part of the intangibles project. The guidance in Chapters I and III on comparability is expected to be broadly adequate and sufficient for intangibles transactions; it will nevertheless be checked to verify whether any specific point is missing in relation to comparability for intangibles.

(ii) *Financial valuation methods*

32. Methods that are commonly used for financial valuation purposes include methods relying on a cash flow analysis, replacement costs, premium profit approach, weighted average return, etc. While paragraph 6.20 of the TPG includes a reference to a net present value calculation, it does so as a comparability factor rather than as a pricing method. The WP6 TPI will consider the extent to which financial valuation methods and in particular the Discounted Cash Flow method (“DCF”) should be given greater recognition in the TPG.

33. Furthermore, some guidance could be developed on how to assess the reasonableness of the parameters used and assumptions made in the application of such valuation methods and on how the five comparability factors apply specifically in the context of intangibles.

(iii) *Aggregation of intangibles for valuation purposes*

34. The WP6 TPI will consider whether the guidance in the existing TPG related to aggregation of intangibles for valuation purposes is adequate or whether that guidance should be clarified in any way.

(iv) *Highly uncertain valuations*

35. The TPG contain guidance on intangibles transferred at a point in time when valuation is highly uncertain (see paragraphs 6.28-6.35 and Annex to Chapter VI). Working Party No. 6 is currently conducting, as part of its monitoring procedures, a review of the use of post-transaction and post-filing information and of the extent to which it constitutes hindsight. This existing guidance and ongoing work are relevant to the discussion of valuation issues in the context of this project.

(v) *Other aspects*

36. As the WP6 TPI will develop guidance on the valuation of intangibles for transfer pricing purposes, a number of questions are likely to arise, including the question how to take into account the perspectives of both parties and whether a valuation gap may exist between the two (paragraph 6.14 of the TPG); and the question of whether or not valuation should be based on the “highest and most productive use” of the transferred intangible (paragraph 6.15 of the TPG).