UN-ATAF Workshop on Transfer Pricing
Administrative Aspects and Recent Developments
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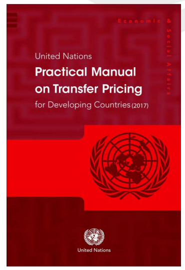
AFRICAN TAX ADMINISTRATION FORUM

TRANSFER PRICING FOR CASES INVOLVING INTANGIBLES

Wednesday, 6 December 2017
2.00pm – 4.00pm



Importance of Intangibles

- In an innovation based economy much corporate value is attributed to knowledge based intangibles
- Intangibles often provide competitive advantages
- Some types of intangibles permit rapid corporate growth and high profitability
- Because intangibles are easily moved within a corporate group, they can raise tax planning opportunities and transfer pricing challenges

TP Problems Related to Intangibles

- Unique nature of many intangibles
- Issues with comparability
- Potential high value
- Can attract high income streams over many years
- Difficult to value precisely
- Ownership can be and often is separated from both development activity and use in business operations
- Easily transferred without material business consequences

Intangible Issues in Developing Countries

- Failure to recognize local contributions to intangible value
- Attribution of excessive value (often so-called residual profit) to intangibles held by the MNE group outside the developing country
- Analytical confusion of intangibles with corporate synergies or features of local markets in which local associated enterprises participate

Basic TP Rules Apply to Intangibles Transactions

- Arm's length principle
- Accurately delineating the transaction
- Functional analysis
- Identification of comparables
- Comparability adjustments
- Approved transfer pricing methods

TP Guidance on Intangibles is Supplemental Guidance

- The guidance on intangibles in the UN TP Manual and the OECD Guidelines is <u>supplemental guidance.</u>
- That guidance builds on and adds to the basic principles that are contained in earlier chapters of the UN TP Manual and the OECD Guidelines. The intangibles guidance does not replace the basic principles

Importance of Definition of Intangibles

- The definition of intangibles in the guidance determines when the special supplemental rules apply
- The definition of intangibles is therefore the first item addressed in the supplemental guidance on intangibles
- It is important that the definition be neither too broad (sweeping in items better analyzed in another way) or too narrow (excluding items that taxpayers may then argue can be transferred without payment but that may attract substantial income in future years

Definition

An intangible is:

- Not a physical or financial asset
- Capable of being owned or controlled
- For use in commercial activities
- An item the use or transfer of which would be compensated if it occurred between unrelated parties.
- The fourth point is critical. Since the basic transfer pricing rules apply whether or not something is an intangible, the focus needs to be on whether the use or transfer of an item would be compensated if it occurred between unrelated parties

Intangibles and Comparability Factors

- Intangibles satisfy the definition on the previous slide
- Comparability factors do not (usually because unrelated parties would not generally pay for the transfer or use of the item).
- BUT comparability factors may affect the price of another transaction and thus need to be taken into account through comparability adjustments
  - Example: Sunshine in Tunisia – unrelated parties don't pay for sunshine, but the sunshine may affect the price paid for beach front property

Categories of Intangibles

Trade intangibles:
- Patents
- Product designs
- Manufacturing know-how
- Supplier relationships
- Etc

Categories of Intangibles

Marketing intangibles:
- Trademarks
- Trade names
- Customer Relationships
- Customer lists
- Copyrighted marketing materials
- Etc

Goodwill

The term goodwill can be used to describe different concepts:
- Excess of aggregate business value over the sum of the values of all identified assets
- Future economic benefits associated with a collection of assets
- Expectation of future trade from existing customers
- Possibly other concepts

- May or may not be an intangible – Careful factual analysis required to develop the correct analysis

Corporate Synergies

- Group synergies exist and can explain large elements of the success of an MNE group
- Synergistic benefits or cost savings generally do not constitute an intangible located in only one member of the group. Instead, all members contributing to the synergistic benefit should gain part of the value of that benefit
- Example: Group purchasing power yielding better supplier prices

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Other Value Adding Contributions

- The list of possible types of intangibles is very long
- The list of items which have some intangible characteristics but are not generally treated as separate intangible assets for transfer pricing purposes is also very long
- The important principle is that the transfer or use of intangibles or non-intangibles should be based on whether there is a transfer of value for which an independent party would receive or provide compensation. And the basic rules of transfer pricing analysis apply to both intangibles and non-intangibles.
- How such items fit with the definition of intangibles is not usually critical so long as the appropriate compensation is provided

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Workforce

- An entity should be compensated for the value produced by its workforce or by individual employees
- In many cases, salaries paid to the workforce will reflect the value provided by the workers – seconding arrangements
- Sometimes, when a workforce is transferred from one entity to another, the assembled workforce has a value greater than the cost of hiring a group of new employees, and compensation should take that value into account
- Transferred or seconded employees may transfer other intangibles through their work, which should be paid for
- The transfer pricing question to be resolved in every case is how much an independent entity would pay for services or transferred employees

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Key Elements of Supplemental Guidance on Intangibles

- Intangible ownership and its importance
- Rewards for contributions to intangible value
- Development and enhancement of marketing intangibles and company names
- Arrangements related to research, development and process improvement
- Combinations of intangible transfers with other transactions
- Options realistically available
- Perspectives of both parties to the transaction
- Transfer pricing methods and valuation techniques

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Intangible Ownership and Its Importance

- A critical question is which entity or entities within the group get the financial benefit of the group's intangibles
- Answering this question begins with an examination of which entity or entities own legal title to the intangibles under contractual arrangements
- However, the legal owner is obligated to compensate other group members for their contributions to intangible value
- Those contributions may take the form of contributions of functions, assets and the assumption of risk
- Functional analysis and accurate delineation of transactions is therefore critical to determining how income attributable to intangibles is ultimately allocated within the group

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Rewards for Contributions to Intangible Value

- The fact that an entity is the legal owner of an intangible does not necessarily imply that it is entitled to intangible related income. Entities in the group should be compensated for their contributions of functions, assets and assumption of risks
- Each entity performing functions related to the development, acquisition, enhancement, maintenance, protection and exploitation of intangibles should be compensated for those functions. The UN Manual calls these "DAEMPE" functions
- Not all functions receive equal rewards. Compensation for important control functions in the development process are especially important to consider

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Rewards for Contributions to Intangible Value

- Contributions of assets and assumption of risk should be similarly rewarded
- Often, an important asset contribution consists of the contribution of capital or funding for the cost of conducting research or acquiring intangibles
- The appropriate return to funding will turn in part on the nature and level of risk assumed by the entity providing funding. Importantly, analysis of such risks requires consideration of all of the aspects of assigning risk, including evaluating control over risk and financial capacity to bear risk, discussed in earlier sessions.
- Rewards to funding and risk are first determined on an ex ante (projected) basis. However, consideration also needs to be given to which entity bears the risk that actual outcomes may differ from expected outcomes.

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Example

- See Example 7 in OECD Guidelines Chapter VI Appendix.

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Development of Marketing Intangibles

- The development and exploitation of marketing intangibles is one example of how functions, assets and risks related to intangibles should be rewarded.
- A marketer or distributor may contribute functions, assets, and assume risks related to the development of the value of its supplier's trademark
- When this happens, the appropriate level of the marketer or distributor's compensation will depend on its right to receive future benefits for its trademark enhancement activities, and on whether its current compensation for such efforts is equivalent to similarly situated marketers or distributors. See Examples 8 to 13 in OECD Guidelines Chapter VI Appendix.

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Research, Development and Process Improvement

- Similar principles apply to determine the appropriate reward to an entity that performs functions, contributes assets, or assumes risk related to R&D and process improvement
- Cost plus remuneration will be appropriate in some but not all cases
- Appropriate compensation will depend on the functional analysis and the market position of the entity performing R&D functions, funding R&D, or assuming risks, and may range from modest service fees to large shares in the profit of the business depending on the facts

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Combining Intangible Transfers and Other Transactions

- Factual and functional analysis may identify situations where products and services are sold in combination with rights to intangibles
- Where combination transactions occur
  - The price for the services or products sold may be influenced by the value of intangibles used in providing the goods or services
  - It may be necessary to segregate combined transactions into individual components to find an arm's length price

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Options Realistically Available

"In applying the principles of the Guidelines related to the content and process of a comparability analysis to a transaction involving intangibles, a transfer pricing analysis must consider the options realistically available to each of the parties to the transaction."

2017 OECD TP Guidelines paragraph 6.111

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Perspectives of Both Parties

"In considering the options realistically available to the parties, the perspectives of each of the parties to the transaction must be considered. A comparability analysis focusing only on onen side of a transaction generally does not provide a sufficient basis for evaluating a transaction involving intangibles (including those situations for which a one-sided transfer pricing method is ultimately determined). While it is important to consider the perspectives of both parties to the transaction in conducting a comparability analysis, 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."

2017 OECD TP Guidelines paragraphs 6.112 & 6.113

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Intangibles and Residual Profits

"In matters involving the transfer of intangibles or rights in intangibles it is important not to simply assume that all residual profit, after a limited return to those providing functions, should necessarily be allocated to the owner of intangibles. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE's global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business…The transfer pricing method selected…should take into account all of the relevant factors materially contributing to the creation of value, not only intangibles and routine functions."

2017 OECD TP Guidelines paragraph 6.133

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Transfer Pricing Methods and Valuation Techniques

- Depending on the specific facts, any of the approved transfer pricing methods might constitute the most appropriate transfer pricing method
- "The transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method." OECD TP Guidelines paragraph 6.145
- Cost based methods and one sided methods like the RPM and TNMM are unlikely to be reliable for directly valuing intangibles. OECD TP Guidelineis paragraph 6.142
- Rules of thumb should not be used to determine prices for transferred intangibles or the amount of license fees.
- Valuation techniques based on anticipated future cash flows may be useful in evaluating the arm's length price for transferred intangibles

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Relevant Comparability Factors

- The following comparability factors are important in evaluating transactions involving intangibles
  - Exclusivity
  - Extent and duration of legal protection
  - Geographic scope
  - Useful life
  - Stage of development
  - Rights to enhancements, revisions and updates
  - Expectation of future benefits

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Cautions Regarding Valuation Techniques

- Valuation techniques based on discounted value of projected cash flows can be useful in pricing transferred intangibles. However:
  - Careful attention must be given to the accuracy of financial projections
  - Assumptions regarding growth rates should have a basis in fact
  - Discount rates utilized are critical elements of the analysis and must be based on accurate assessments of risk
  - Useful lives of intangibles and terminal values are critical elements of the analysis
  - Tax effects of future cash flows must be thoroughly considered

Hard to Value Intangibles

Intangibles or rights in intangibles transferred at a time when:

- No reliable comparables exist
- Projections of future cash flows or income expected to be derived from the intangible are highly uncertain
- For example
  - Partially developed intangibles
  - Not expected to be commercially exploited soon
  - Intangibles expected to be exploited in a novel manner
  - Intangibles transferred for lump sum payments
  - Intangibles developed under or used in connection with CCAs

Post Transfer Results and Hindsight

- For HTVI
  - Tax administration can rely on valuations based on ex post (post transfer) evidence
- But not if the taxpayer provides
  - Details of the projections it used in determining value
  - Information on how risks were evaluated and the appropriateness of that evaluation
  - Reliable evidence that differences between financial projections and actual results are due to unforeseeable developments or the playing out of foreseeable outcomes whose likelihood was reasonably estimated
  - Or if other specified exceptions apply (APAs, relatively accurate projections, etc.)