



## OECD issues Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles

### Executive summary

On 30 July 2013, the Organisation for Economic Cooperation and Development (OECD) issued a Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles (Revised Discussion Draft).<sup>1</sup> This Revised Discussion Draft updates the initial discussion draft issued on 6 June 2012 (Discussion Draft) and has been amended in the light of comments received during the public consultation process held in November 2012.

Key changes in the Revised Discussion Draft are:

- ▶ New guidance on the transfer pricing treatment of local market features, location savings, assembled workforce and group synergies;
- ▶ An amendment to the proposed definition of “intangible” for transfer pricing purposes;
- ▶ Amendments to the proposed guidance on identifying entities entitled to intangible-related returns, while maintaining the approach that intangible related returns should be aligned to the functions, assets and risks associated with intangible development and exploitation;
- ▶ Guidance on how the funding of intangible development should be remunerated at arm's length;
- ▶ New guidance on payments between related parties for the use of the company or group name; and
- ▶ A reorganization of the proposed guidance on the practical application of transfer pricing methods to intangible transactions.



The OECD has requested interested parties to provide written comments on the Revised Discussion Draft on or before 1 October 2013. The OECD intends to hold a further public consultation on the Revised Discussion Draft and other topics on 12 - 13 November 2013 in Paris, France.

The detailed discussion provides:

- ▶ The context in which the Revised Discussion Draft has been issued, and its role as part of the OECD's Action Plan<sup>2</sup> on Base Erosion and Profit Shifting (BEPS) as released on 19 July 2013; and
- ▶ An overview in greater detail of some of the key areas of proposed new guidance and changes to the prior Discussion Draft.

## Detailed discussion

### Context

The issue of transfer pricing for intangibles has proven to be one of the most challenging topics in the transfer pricing area, both from a theoretical perspective and because of the number and size of the disputes that have arisen in relation to intangibles. Therefore, the OECD announced the commencement of a project on transfer pricing aspects of intangibles in July 2010, to be carried out by OECD Working Party No. 6.

After a number of public consultations with interested commentators, the OECD published its initial draft proposal for revised guidance on the transfer pricing of intangibles (the Discussion Draft) on 6 June 2012.<sup>3</sup> Following the release of the Discussion Draft,

the OECD received comments from interested parties including businesses, academia and the professions, and a public consultation was held on 12-14 November 2012. On the basis of these comments and reflecting other developments, Working Party No. 6 has now published a Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles.

The OECD's work on intangibles is a specific action area listed in the OECD's BEPS Action Plan and is closely related to other action areas on transfer pricing, including work on allocation of risks and capital for transfer pricing purposes, work on re-characterization of transactions that might not occur between unrelated parties, and work on transfer pricing methods including profit splits in the context of the global value chains of multinational enterprises. Some of the text and examples contained in the Revised Discussion Draft raise issues that the OECD expects to address further through the various actions contained in the Action Plan. Accordingly, the Revised Discussion Draft is viewed by the OECD as a work in process and portions of it are likely to be further revised during the course of the work on BEPS.

### Key areas of new guidance and updates

#### *Features of the local market, location savings, assembled workforce and group synergies*

The Revised Discussion Draft sets out the OECD's thinking on how comparability factors such as local market features including location

savings; assembled workforce; and group synergy benefits should be treated for transfer pricing purposes. The revised draft proposes a new section to be appended to part D of Chapter I of the OECD Guidelines, including five new examples.

The thrust of the guidance in the Revised Discussion Draft here is that these are all comparability factors that should be taken into account in transfer pricing analysis, but are not in themselves intangible assets. However, in certain situations, these features can involve intangible assets. For example, where a regulatory license is required to operate in a specific market, this may constitute an intangible that would entitle the license holder to a greater share of the benefits of operating in that market. In addition, in the context of "assembled workforce," the transfer or secondment of employees may result in the transfer of valuable know-how from one associated enterprise to another. In each case, the question of arm's length compensation for these intangibles will depend on the facts and circumstances.

In the case of group synergies, the Revised Discussion Draft focuses on how structural advantages or synergy benefits enjoyed by an MNE (such as scale economies, integrated management, elimination of duplication, etc.) would be shared at arm's length. Where group synergy benefits accrue to an associated enterprise simply by being part of the MNE group, the revised draft guidance

suggests that these benefits should not be reallocated or shared with other group members. An example is given of credit enhancement that may be enjoyed by an affiliated enterprise on the strength of the parent company's balance sheet, in the absence of a guarantee. In contrast, where the MNE group takes active steps to activate group synergy benefits (for instance, by organizing central purchasing), then the principle is that synergy benefits should be shared in proportion to contribution.

#### ***Changes to the proposed definition of intangibles for transfer pricing purposes***

The original Discussion Draft included a proposed definition of an intangible asset for transfer pricing purposes as *something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities*. To this definition, the Revised Discussion Draft adds the words *and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances*. This clarifies that the thrust of the proposed guidance is to determine the conditions that would apply between parties acting at arm's length.

The Revised Discussion Draft also proposes a wider definition of the term "marketing intangible" than is currently provided in the Glossary to the TP Guidelines: *an intangible (within the meaning of paragraph [40]) used in business operations that are customer facing. Depending on the context,*

*marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data used in marketing and selling goods or services to customers.*<sup>4</sup> However, the Revised Discussion Draft emphasises that the use of a particular term (e.g., "marketing intangibles" or "trade intangibles") does not eliminate the obligation to identify intangibles with specificity, nor does it suggest that a particular approach should be applied in determining arm's length conditions for transactions involving those intangibles.

Finally, the Revised Discussion Draft proposes a definition of "unique and valuable" intangibles, as *those intangibles (i) that are not comparable to intangibles used by or available to parties to potentially comparable transactions, and (ii) whose use in business operations (e.g. manufacturing, provision of services, marketing, sales or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible*.

#### ***Revised guidance on which entities are entitled to the return from exploiting intangibles***

Section B of the Revised Discussion Draft provides proposed guidance on which of the entities in an MNE group should be entitled to retain the economic profits from exploitation of intangibles. Section B has been revised from the original Discussion Draft to adopt a more transactional approach, while continuing to reflect a clear focus

on the importance of functions performed, assets used and risks assumed in the development, enhancement, maintenance and protection of intangibles.

The Revised Discussion Draft now states explicitly that the legal ownership of an intangible by itself does not confer any right to retain the return from exploiting an intangible, even where this return may initially accrue to the legal owner as a result of its legal or contractual rights. Instead, the return ultimately retained by the legal owner depends on the contributions it makes to the anticipated value in the intangibles, relative to the contributions made by other group members, through functions performed, assets used, and risks assumed that contribute to the value of the intangible.

In order for the legal owner of an intangible to be entitled to any of the return attributable to the intangible, under the Revised Discussion Draft it must therefore make some contribution to the development, enhancement, maintenance or protection of the intangible, either by performing these functions itself, or by having such functions performed under its control by independent or associated enterprises. Whereas the original Discussion Draft stated that an entity with the right to intangible related returns should physically perform these functions through its own employees, the Revised Discussion Draft clarifies that these functions can be outsourced by the entity retaining the right to the intangible related return, so long

as the entity controls the party performing these functions. In assessing whether a group member in fact controls the performance of the relevant functions, principles analogous to those included in paragraphs 9.23 through 9.28 of the OECD Guidelines would apply.<sup>5</sup>

A further change to the proposed guidance is around determining an appropriate return for entities that fund intangible development. The Revised Discussion Draft states that an entity that provides funding but does not control the risks or perform the functions associated with intangible development would generally, at arm's length, not receive a return equivalent to the return earned by a similarly-situated investor who also controls the risks and/or performs the functions associated with the development of value in the intangibles.

#### *Transfer pricing aspects of the use of company names*

The final part of section B of the Revised Discussion Draft is now devoted to providing guidance on applying the principles of section B to different circumstances, including consideration of situations

where a payment should be made for the use of the group name. The guidance follows the principles developed elsewhere, that the quantum of any payment for the use of a company name should depend on the amount of the financial benefit received from using the name, and the relative contribution made by the owner and user of the name, as assessed through an analysis of functions, assets and risks.

One observation here is that where one existing successful business is acquired by another and rebranded to use the name or trademark of the acquirer, there should be no automatic assumption that payment should be made by the acquired business. A second observation is that in those circumstances, it may be the case that the acquirer is using the market position of the acquired business to promote its own brand name, in which case the acquirer might need to compensate the acquired business additionally for the functions, risks and assets (including market share) deployed by the acquired business to promote the acquirer's name.

#### *Reorganization of Section D on the application of transfer pricing methods to intangible transactions*

In the Revised Discussion Draft, the material contained in Section D of the original Discussion Draft has been reorganized into sections that are intended to fit together more logically than in the previous draft. However, there has not been any significant substantive change. The Revised Discussion Draft acknowledges explicitly that application of a valuation technique, either as part of one of the five approved OECD methods or as a useful tool, may prove more reliable than any other transfer pricing method.

The guidance on arm's length pricing when valuation is highly uncertain at the time of the transaction of the previous discussion draft has been removed and has been replaced with wording identical to that in the existing TP Guidelines. It is noted in the Revised Discussion Draft that much future BEPS work is likely to involve reviewing the transfer pricing treatment of hard to value intangibles, and therefore this section is likely to change in future.

## Endnotes

1. See <http://www.oecd.org/ctp/transfer-pricing/intangibles-discussion-draft.htm> (the announcement) and <http://www.oecd.org/ctp/transfer-pricing/revised-discussion-draft-intangibles.pdf> (the Revised Discussion Draft).
2. See <http://www.oecd.org/tax/closing-tax-gaps-oecd-launches-action-plan-on-base-erosion-and-profit-shifting.htm> (press release) and <http://www.oecd.org/ctp/BEPSActionPlan.pdf> (the Action Plan). For further information, see also EY's Global Tax Alert: <http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--OECD-issues-Action-Plan-on-Base-Erosion-and-Profit-Shifting--BEPS->.
3. "Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions," available at <http://www.oecd.org/tax/transfer-pricing/50526258.pdf>. For a more detailed explanation of the OECD Intangibles Discussion Draft, please refer to International Tax Alert, *OECD publishes revised draft of guidance on transfer pricing of intangibles*, dated 7 June 2012.
4. Currently, the term marketing intangible is defined as: "An intangible that is concerned with marketing activities, which aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned."
5. These paragraphs elaborate on the meaning of "control" in view of the notion that in arm's length transactions it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control and note that control does not require day to day monitoring of a risk, but rather, refers to the capacity to make decisions to take on the risk and the ability to assess the performance of the entity that does perform the day to day monitoring.

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EYG No. CM3691

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