

Sharing insights

News Alert
14 June, 2012



OECD releases discussion draft for revision of Chapter VI (Intangibles) of OECD TP Guidelines

In brief

In mid 2010, the Organisation for Economic Co-operation and Development (OECD) announced the launch of a new project focusing on transfer pricing issues involving intangible property which is expected to be completed in 2013. In this regard, on 6 June 2012, the OECD published the first public discussion draft¹ on the “Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines” (the discussion draft). The discussion draft contains proposed revisions to Chapter VI of the OECD Transfer Pricing Guidelines (OECD Guidelines or the Guidelines). The final publication would be

made after considering public comments², and would replace the existing Chapter VI of the OECD Guidelines.

The purpose of the proposed Chapter VI is to provide guidance on determination of arm’s length conditions/prices for transactions involving use of or transfer of intangibles. The discussion draft has been broadly divided into following four sections:

¹ http://www.oecd.org/document/41/0,3746,en_2649_33753_50509929_1_1_1_1.00.html

² OECD has requested written comments on the discussion draft by 14 September, 2012.

Part A - Identification of specific intangibles

*Part B - Identification of parties entitled to retain the return derived from use
or transfer of intangibles*

*Part C - Nature of the controlled transactions and whether they involve the use of
intangibles and/or lead to the transfer of intangibles and*

*Part D - Remuneration that would be paid between independent parties for the
use or transfer of such intangibles.*

The highlights of the discussion draft along with our initial comments are provided below:

Part A - Identification of intangibles

The discussion draft specifies that an “intangible” is something which is “*not a physical asset or financial asset*” and which is “*capable of being owned or controlled for use in commercial activities*”. The discussion draft stresses that the corner stone of a transfer pricing analysis involving intangibles should be based on how independent third parties would behave in comparable situations, rather than on accounting or legal definitions or those used for general tax purposes. Further, the existence of legal, contractual, or other forms of protection are not a necessary condition for an item to be characterised as an intangible (for example know-how and trade secrets are intangibles but are not protected as are patents or trademarks). Also, considering the fact that some intangibles may not be separately transferrable and could be viewed only in combination with other

business assets, separate transferability is also not a necessary condition for an item to be an intangible.

The discussion draft does not differentiate between trade and marketing intangibles, soft and hard intangibles, routine and non-routine intangibles. However, a clear differentiation has been made between intangibles and items which are not capable of being owned, controlled or transferred but “*contribute to the creation of value*” such as market specific characteristics (including local markets and competitive positions) and group synergies. As per the discussion draft, such items should be taken into account when undertaking a comparability analysis (including making comparability adjustments thereof, if required).

The discussion draft treats goodwill and ongoing concern value as an intangible and recognises that these terms are often used to describe an important and monetarily significant part of the compensation paid between independent enterprises when transferring some or all assets of a business. However, the discussion draft cautions that in most cases, accounting and business valuation measures of goodwill and ongoing concern are not relevant for transfer pricing purposes.

In relation to human capital or “workforce”, the discussion draft provides that a long term contract to provide uniquely qualified employees may constitute an intangible as against secondment of isolated employees, unless their transfer results in transfer of valuable know-how or trade secrets. Further, though not explicitly recognised as an intangible, transfer of an “existing assembled workforce” has been acknowledged as a factor which may affect compensation for a transaction.

Throughout, the discussion draft places thrust on a functional analysis for identification of intangibles, and mentions that guidance for characterisation of an item as intangible is specific for transfer pricing purposes and has no relevance for any other tax purpose.

Part B – Identification of parties entitled to intangible related returns

At the outset, the discussion draft clarifies that not all intangibles deserve a separate compensation or give rise to premium returns, and that an examination of facts and circumstances would be required to make such a determination. For example, know-how is an intangible, but a non-unique know-how (under certain facts and circumstances) may not fetch a premium return over and above the normal return for functions performed. ***This is an important matter raised by the OECD, though not followed up with any detailed guidance. However, it can be assumed that the “intangible related returns” being referred to in the discussion draft presumably arise from those intangibles which deserve a separate compensation or give rise to premium returns.***

As per the discussion draft, legal registrations and contractual arrangements are the starting point for determining entitlement to intangible related returns. As a first step it is essential to examine the specific terms of the agreement. Thereafter, the focus shifts on the conduct of the parties to the agreement, which remains the key test when determining entitlement to intangible related returns.

The discussion draft highlights that it is important to examine whether or not the conduct of the parties to the agreement is aligned with the legal registrations and agreements. For this, an examination of the “*functions, risks and costs related to*

the development, enhancement, maintenance and protection of the intangibles is necessary”. Here, the discussion draft takes guidance from Chapter IX “Business Restructurings” of the OECD Guidelines to stress the importance of notions such as “control over functions (and risks)”. Entitlement to intangible related returns needs to stem from the performance (including having the requisite capability and capacity) and control (and when outsourced to affiliates or third parties, the oversight and management responsibility) of the important functions related to development, enhancement, maintenance and protection of the intangible (and bearing the necessary costs and risks thereof). ***This is a critical aspect emanating from the discussion draft, and as per this principle, economic ownership is a critical factor for consideration in any intangible related analysis.***

The discussion draft specifies that when undertaking a functional analysis, the functions relating to research and development (R&D), and sales and marketing, which lead to the development and enhancement of intangibles, will be especially important. When functions are in alignment with the legal form and contractual terms, the entity entitled to intangible related returns will perform key people functions relating to development, enhancement, maintenance, and protection of the intangibles, including, functions such as design and control of research and marketing program, control over strategic decisions, control of budgets, quality control measures, and decisions relating to protection of intangibles. If some of the important functions related to development of intangibles are “performed” by a group entity (say Company A), it would be important that the performance of functions is under the “control” of the entity entitled to beneficial returns associated with the intangibles, who will then also provide arm’s length compensation to Company A for the functions performed by it. Further, the risks in relation to the development, enhancement, maintenance, and protection of

intangibles should also be borne by the same entity. The discussion draft provides that if the party to which the intangible related return is allocated fails to perform and control the important functions and does not bear the relevant risks, even though it passively bears the cost, the ownership as well as the associated return should be reallocated to an entity which performs and controls such functions.

Part C - Identifying transactions involving the use of/ transfer of intangibles

The discussion draft provides guidance on factors to be considered for identification and proper characterisation of the specific controlled transactions involving intangibles. It recognises following two general types of transactions where identification and examination of intangibles will be relevant for transfer pricing purposes:

a) Transactions involving the use of intangibles in connection with sales of goods and services

b) Transactions involving transfer of intangibles or rights in intangibles

In the first kind of transactions, intangibles may be used by one or both parties to a controlled transaction in connection with manufacture of goods, provision of services or distribution of goods, while there is no transfer of intangibles *per se*. Once identified, such intangibles should be taken into account in the comparability analysis.

The second type of transaction entails situations where the intangibles or right in intangibles (including limited rights) are transferred as part of controlled transactions. Herein, it is recognised that the intangibles or rights in intangibles

may be transferred individually or in combination with other intangibles. The discussion draft provides that in such cases, all intangibles transferred should be identified and the nature and economic consequences of interactions between different intangibles should be considered.

The discussion draft further acknowledges that in some situations, intangibles may also be transferred in combination with tangible business assets or services. It recognises that in certain circumstances (e.g. where services and intangibles made available under an arrangement are sufficiently unique that reliable comparables cannot be identified for the entire service/intangible package), it may be possible and appropriate to separate tangible transactions from intangible transactions for a transfer pricing analysis. While, in other situations, the provision of a service and the transfer of one or more intangibles may be so closely intertwined that it is difficult to separate the transactions for a transfer pricing analysis, and therefore, determining arm's length prices on an aggregate basis may be necessary.

The discussion draft emphasises that the characterisation of the transaction does not necessarily dictate the use of a particular transfer pricing method. It provides that the facts of each specific situation, and the results of the functional analysis, will guide the manner in which transactions are combined, characterised and analysed for transfer pricing purposes, as well as the selection of the most appropriate transfer pricing method.

Part D - Determining arm's length conditions/ pricing for use or transfer of intangibles

The discussion draft re-emphasises that for wholly legitimate business reasons, due to the relationship between them, associated enterprises (AEs) might

sometimes structure a transaction involving intangibles in a manner that independent enterprises would not contemplate.

When undertaking a comparability analysis for a transaction involving the use or transfer of intangibles, considerable attention has been given by the OECD to the concept of “options realistically available to the parties”, wherein the perspective of each of the parties should be considered (a two-sided approach). The discussion draft also places considerable reliance on the recommended nine step process contained in Chapter III (“Comparability”) in para 3.4 of the OECD Guidelines.

As per the discussion draft, in transactions involving the use of intangibles, in many cases where only the non-tested party uses intangibles, an arm’s length price or level of profit for the tested party can be determined without the need to value the intangibles used in connection with the transaction. However, if the tested party uses intangibles and/or the potentially comparable uncontrolled transactions also entail the use of intangibles, then “intangibles” itself become a comparability factor in a transfer pricing analysis. The discussion draft suggests that in case of incomparable intangibles, potentially comparable transactions should be disregarded. On the other hand, when comparing intangibles and rights in intangibles, the discussion draft highlights several factors which may affect comparability, for example, exclusivity, extent and duration of legal protection, stage of development, expectation of future benefits, etc.

The discussion draft stresses the importance of comparability adjustments. The discussion draft emphasises that caution should be exercised when using data for comparability purposes which is drawn from the public domain, as the data should be such that it is sufficiently detailed to permit an evaluation of the specific features of the intangibles. ***It appears that comparability parameters have***

been made stringent, although there is limited practical guidance on comparability adjustments. The discussion draft acknowledges that difficult factual questions can arise in quantifying reliable comparability adjustments.

The discussion draft then discusses the selection of transfer pricing methodologies for different transactions involving the use or transfer of intangibles in situations where comparables exist and where they do not. The discussion draft acknowledges that experience has shown that the Comparable Uncontrolled Price method and the transactional profit split method prove useful in transactions involving transfer of intangibles or rights in intangibles.

The discussion draft cautions against the adoption of a transfer pricing methodology that *“too readily assumes that all residual profit from transactions after routine functional returns should necessarily be allocated to the party entitled to intangible related returns”*. Instead, the discussion draft calls for a thorough functional analysis of the group (group’s value-chain) including an understanding of global business processes and the interaction between intangibles and the other functions, assets and risks of the global business. The discussion draft further places importance on the recognition of *“other factors”* (other than intangibles) which *“contribute to value creation”*. ***This is a significant take-away of the discussion draft, where the contribution of “other factors”, other than intangibles, to residual profits has been recognised.***

The discussion draft also discusses in detail the use of valuation techniques. The discussion draft provides that while valuation techniques drawn from financial valuation practice may have application for transfer pricing analysis, caution should be used in accepting valuations performed for accounting purposes, as

necessarily reflecting arm's length prices for transfer pricing purposes, without a thorough examination of the underlying assumptions. The discussion draft specifically provides that valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes. Further, the discussion draft also discourages the application of "rules of thumb" as well as use of cost based approaches (i.e., cost of intangible development) for measuring the value of partially/fully developed intangibles.

The discussion draft has considerable discussion on the use of valuation techniques which make use of discounted cash flows, and highlights several specific areas of concern in this regard.

In this context, while the discussion draft observes that financial projections prepared for non-tax business planning purposes are usually more reliable than projections prepared exclusively for tax purposes, it expresses concern about the use of financial projections that are extended beyond the point where a business enterprise can reasonably forecast. It also questions the reliability of constant growth assumptions (linear growth rates) which are not in line with experience of the company or industry as a whole.

Other concerns raised in the discussion draft relate to discount rates and useful lives. As per the discussion draft, discount rates used in the valuation analysis must be tailored to reflect the risk associated with discounted cash flows. In this regard, the use of company's Weighted Average Cost of Capital (WACC) as default rate has been discouraged. As for useful lives of intangibles, the discussion draft recognises that some intangibles may have indeterminate useful lives at the time of valuation, but that does not mean that they are expected to earn non-routine returns indefinitely.

The discussion draft encourages taxpayers to undertake and present a sensitivity analysis which reflects the consequential changes in intangible values, as are produced when alternative assumptions and parameters are adopted.

Finally, as for assumptions regarding tax rates, on the one hand, the discussion draft emphasises that "*prices for transfer pricing purposes under a discounted cash flow analysis must typically be determined on a pre-tax basis*". However, on the other hand, the discussion draft acknowledges that "*it is important to take into account the perspectives of both parties to the transaction...and to consider how unrelated parties might account for the relative tax advantages or disadvantages faced by the transferee*" and also proceeds to give example which values intangible on after-tax basis. ***The discussion draft, therefore, appears to struggle with the reconciliation of pre and post-tax cash flows.***

The discussion draft winds up with a discussion on a specific situation, viz., "*when valuation is highly uncertain at the time of the transaction*". In this regard, the discussion draft discusses various steps that independent enterprises might undertake such as adoption of shorter term agreements, incorporation of price adjustment clause or even undertaking of prospective renegotiation by mutual agreement.

Examples

The discussion draft has included 22 examples to provide practical guidance on various aspects in applying some of the principles mentioned therein. Such examples may go a long way in reducing disputes between taxpayers and tax administrations when applying the said principles.

PwC observations

Multinational enterprises are continuously evolving and their operations continue to grow in complexity. Needless to say, increased complexities emanate from and impact intangible related matters as well. The current dynamics, therefore, do not support application of traditional principles of transfer pricing. The tenets of transfer pricing have to be aligned with business fundamentals and operational realities. Notably, in this regard, a key message which runs through the discussion draft is the relevance of a functional analysis of not only the tested party but of the group as a whole. A thorough understanding and analysis of the group corporate value chain (including interactions between the various elements of the value chain) have been considered pivotal while identifying intangibles, ascertaining which entities would be entitled to intangible related returns, and to what extent.

Entitlement to intangible related returns must go to the entity which exercises “control” over performance of functions, assumption of risks and bearing of costs related to “development, enhancement, maintenance and protection” of intangibles. Therefore, while contractual agreements and legal restrictions continue to be an important starting point, there is a clear emphasis on actual conduct of the parties and the substance of the transaction. This is an extremely critical principle articulated by the OECD which must be borne in mind by both taxpayers and tax authorities while determining entitlement to intangible related returns. Typical intangibles related disputes faced in India, such as those relating to alleged creation of marketing intangibles, remuneration for provision of R&D services, etc., may be largely eased off if the above ground rules are followed.

An interesting distinction has been made in the discussion draft between “intangibles” and “other factors contributing to creation of value”. The primary

differentiation being that the former is capable of being owned, controlled and transferred, while the latter is not. Further, the discussion draft dissuades the use of accounting or legal definitions of intangibles or those used for general tax purposes. Owing to the expanded list of intangibles introduced in the Indian transfer pricing regulations vide Finance Act, 2012, the guidance provided by OECD on identifying intangibles may prove particularly helpful.

The discussion draft has been referred to as an “interim draft” by the OECD, i.e., it is not a complete draft as it does not provide the necessary modifications to other chapters in the OECD Guidelines which may be required as a consequence of the re-write of Chapter VI. It is therefore, somewhat premature to predict the exact and final outcome of the OECD’s intangibles project. Nonetheless, it is evident from the discussion draft that traditional fundamentals are up for change, and given India’s increasing reliance on OECD Guidelines, taxpayers and revenue authorities would need to gear up for the change.

Our Offices

For private circulation only

Ahmedabad President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000	Bangalore 6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000	Bhubaneswar IDCOL House, Sardar Patel Bhawan Block III, Ground Floor, Unit 2 Bhubaneswar 751009 Phone +91-674 253 2279 / 2296	Chennai PwC Center, 2nd Floor 32, Khader Nawaz Khan Road Nungambakkam Chennai 600 006 Phone +91-44 4228 5000	Hyderabad #8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600
Kolkata South City Pinnacle, 4th Floor, Plot – XI/1, Block EP, Sector V Salt Lake Electronic Complex Bidhan Nagar Kolkata 700 091 Phone +91-33 4404 6000 / 44048225	Mumbai PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000	Gurgaon Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000	Pune GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444	For more information contact us at, pwctrs.knowledgemanagement@in.pwc.com

The above information is a summary of recent developments and is not intended to be advice on any particular matter. PricewaterhouseCoopers expressly disclaims liability to any person in respect of anything done in reliance of the contents of these publications. Professional advice should be sought before taking action on any of the information contained in it. Without prior permission of PricewaterhouseCoopers, this Alert may not be quoted in whole or in part or otherwise referred to in any documents

©2012 PricewaterhouseCoopers. All rights reserved. "PwC", a registered trademark, refers to PricewaterhouseCoopers Private Limited (a limited company in India) or, as the context requires, other member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.