Insights: Transfer Pricing

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OECD project on the transfer pricing aspects of the intangibles: status and challenges

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This article provides an overview of the status of the OECD project on the transfer pricing aspects of intangibles, highlights the likely challenges, and discusses how such challenges could be anticipated and addressed.

Timeline

In July 2010, the OECD launched the project with an invitation to comment on the scoping of work to be undertaken on intangibles. Approximately 50 contributions were sent to the OECD by companies, advisors, and other business organizations. In November 2010, a one-day "public consultation" meeting was held by the OECD's Working Party 6[1], a group of country representatives working with the OECD Secretariat on issues in the taxation of multinational enterprises. On that day, the Working Party met with commentators from the private sector to discuss selected topics about the scope of the project. In January 2011, the OECD Committee on Fiscal Affairs approved the scope of the project. In March 2011, a three-day long public consultation was held during which Working Party 6 met with private sector representatives on valuation issues. In November 2011, another three-day long public consultation was held during which Working Party 6 met with private sector representatives on definitional and ownership issues.

The end of 2013 is the target date for the release of a discussion draft for public comment. This is likely to take the form of a new draft version of Chapter VI of the *OECD Transfer Pricing Guidelines* and possibly of Chapter VIII or parts of it.

All documents published by the OECD on the project and the presentations given at the meetings can be found **here**.

The public consultation process

Remarkably, three public consultation meetings have been held in approximately one year. During these meetings, the OECD Secretariat and the country delegates met with selected private sector representatives. These meetings have proven to be extremely valuable as they provided the opportunity to discuss topics that are particularly difficult or controversial. However, the discussions were rarely conclusive and they can only be viewed as a step forward in supporting the development

[1] Working Party 6 is one of the groups of country representatives working together with the OECD Secretariat and carrying out the projects of the Committee on Fiscal Affairs. Working Party 6 is dedicated to the taxation of multinational enterprises.

of a document. The frequency of the meetings with private sector representatives within this project is, in any case, a very positive aspect and clearly shows the effort of the OECD Secretariat to develop a balanced project grounded in fact.

Scope

During the November 2011 meeting, the OECD Secretariat confirmed that the key elements to be covered by the project remained unchanged. Those elements are:

1. The development of a framework for analysis of intangible-related transfer pricing issues;
2. Definitional aspects;
3. Specific categories of transactions involving intangibles, such as research and development activities; differentiation between intangible transfers and services; marketing intangibles; and other intangibles and business attributes;
4. How to identify and characterize an intangible transfer;
5. Situations where an enterprise would at arm's length have a right to share in the return from an intangible that it does not own; and
6. Valuation issues.

Items #6, #2, and (partially) #5 have been addressed in the 2011 meetings with the private sector representatives and are commented on later in this article. Item #1 refers to the possibility of developing a process framework to guide the analysis of intangibles, probably similar to the framework for comparability analysis included in Chapter 3 of the 2010 update of the *OECD Transfer Pricing Guidelines*.

In relation to the other items, the preliminary observations made in the scoping paper have raised concerns about the possible broadening of the definition of intangibles to include controversial items and increasing uncertainty for topics that were relatively uncontroversial until now—for example, contract research and development.

Valuation issues

At the March 2011 meeting, several private sector representatives made technical presentations on valuation methods, techniques, standards, parameters, models, and examples.

The critical challenge in this topic was summarized well by Chris Lenon, Chair of the Business and Industry Advisory Committee (BIAC)[2] Tax Committee, in his closing remarks: income-based methods are based on a series of assumptions and their application is not an exact science. Michelle Levac, the Chair of the Working Party 6 intangibles project, also acknowledged in her closing remarks the message from the business representatives that the guidance in this area should not be too prescriptive as valuation involves professional judgement and depends on the facts and circumstances of each case.

Definitional and ownership issues

At the November 2011 meeting, the presentations made by private sector representatives focused on definitional and ownership issues related to transfer pricing for intangibles. The presentations

[2] BIAC is an independent international business association devoted to advising government policymakers. Since its founding in 1962, it has been recognized by the OECD as being representative of the OECD business community.

covered general definitional aspects, the difference between value drivers and intangibles, goodwill and going concern, brands and brand value, synergies, and ownership issues.

Among the main concerns expressed by commentators were the risk of confusion between value drivers and intangibles, the risk of double taxation (or even more than double taxation) of the same income that could result both from the use of income methods without a proper identification of the associated intangibles and also from double-counting effects (for example in connection with the difficult concept of goodwill), and the need for consensus between countries on the definition and role of economic ownership.

The business community's concerns were summarized as the need for certainty as well as the need for a set of rules that will help in eliminating double taxation. The importance of agreement on a set of consistently applied definitions was stressed as a key element in achieving these objectives.

On the other hand, several country representatives seemed to reject the idea of a definition of intangibles that is too precise and limited as this would limit their ability to identify, value, and tax certain intangibles.

With reference to the ownership issue, the OECD Secretariat indicated that this is another critical issue for the project that can be captured in three simple questions:

- what did the inter-company contracts say;
- who paid the money; and
- who did what and with what level of autonomy?

It is also interesting to note which country representatives were more active in asking questions and in the overall discussions at the November meeting. Beyond the traditionally very active countries (USA, UK, Canada, Australia, and the Netherlands), the representatives of Japan and Israel were also particularly active and, quite surprisingly, the Chinese observers, too.

The challenge

While it is still too early to anticipate the conclusions of the project and it is not even clear whether it will focus more on definitional aspects or valuation or the simple definition of a framework, taxpayers should anticipate possible challenges from tax authorities linked to the project.

The expectation is that tax authorities will increasingly focus transfer pricing audits on intangibles. This is already happening within business restructuring audits and certain tax authorities already use valuation methods aggressively—for example, to size the value of intangibles transferred or allegedly transferred to another jurisdiction within a business restructuring.

On the one hand the focus on intangibles is not surprising, considering the importance of intangibles in the global economy; on the other hand, there is growing concern, in particular, about the analysis of "soft" intangibles whose nature, definition, valuation and ownership can be very debatable. This can create a lot of uncertainty for taxpayers, which may increase over the next two to three years in the absence of a finalized OECD position on the subject.

How to prepare for the challenge

A "wait and see" approach is proving to be more and more dangerous. Whatever the evolution of the OECD's project will be, there are areas that are in any case predictably at risk of being aggressively challenged by tax authorities in transfer pricing audits:

- business restructuring in all its forms;
- marketing intangibles, i.e., all cases where marketing and business development activities exist, especially in a local entity performing a limited distribution or sales support functions, which could be viewed as not purely routine activities;
- high value-adding services;
- contract research and development activities, in cases where the entrepreneurial entity has limited functions; and
- cross-national management structures where it is difficult to associate specific high value-adding functions with specific countries.

A tax department could significantly increase its chances of successfully defending its transfer prices in tax audits by establishing an organized process of monitoring developments in the business and by ensuring that appropriate defence strategies are developed. Such measures do not need to be prohibitively time-consuming or expensive. In reality, there is usually a pragmatic solution based on a structured and timely approach that does not aim simply to develop extensive documentation but rather focuses on the quality of the analysis and appropriately targets it.

Example steps in an efficient process include:

1. Analysis of the key facts and circumstances;
2. Identification of defense arguments;
3. Broad definition of defense strategies;
4. Identification and filing of key supporting documents; and
5. Development of a brief roadmap summarizing the above points to be used as the starting point in case of actual challenge.

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