Practice guide

Transfer pricing of intangibles

Speed read

Intangible assets play a fundamental part of how most businesses create value. As a result, the transfer pricing treatment of intangibles has been at the centre of the OECD's BEPS project and updated Transfer Pricing Guidelines. These consider both what assets and activities constitute an intangible, its pricing, and what businesses should do where the intangible is hard to value. Businesses must understand and address all of these aspects, and document them clearly, if their transfer pricing of intangible property is to be robust.

Malcolm Joy
BDO
Malcolm Joy is a transfer pricing partner at BDO LLP. He advises businesses on designing, documenting and defending robust transfer pricing policies for their global activities. Email: malcolm.joy@bdo.co.uk; tel: 020 7893 3718.

Duncan Nott
BDO
Duncan Nott is a transfer pricing director at BDO LLP. He specialises in supporting businesses to understand their value chain and set, support and document their transfer pricing policies. Email: duncan.nott@bdo.co.uk; tel: 020 7893 3389.

Tax authorities consider intangible assets to be at the heart of businesses' value creation. The OECD's updates to its Transfer Pricing Guidelines in 2017 reflect this, with a clear requirement that an arm's length price should be driven by the economic substance of the intangible assets – its key attributes and management roles – not just ownership of legal title.

The updated guidelines set out a framework for analysing intangibles transactions and expand the disclosure requirements for intangible assets in both the master file and local file elements of transfer pricing documentation.

Businesses will need to have a clear understanding of what their intangible assets are, where their value comes from, and how consistent their pricing policy is with the assets' performance, as well as comparable data, for their transfer pricing policy in this area to be considered robust.

The 2017 edition of the OECD guidelines, which were updated following their work on base erosion and profit shifting, contains a substantially revised Chapter VI on special considerations for intangibles. This article looks at the expectations which the guidelines now set, considering:

- what makes an intangible asset for transfer pricing purposes and how to identify one;
- the value intangibles create and where it comes from;
- the OECD's framework for analysing intangibles transactions;
- the nature of intangibles provided to connected parties;
- how to set and support a transfer pricing policy for intangibles and their constituent value drivers;
- what are hard to value intangibles and how best to address them; and
- best practice for documentation and support for the pricing of intangible assets.

Defining intangibles

The first step is to understand what an intangible asset is for transfer pricing purposes. This allows the assets to be specifically identified in the business. It may seem basic, but this comes with difficulties as intangibles, by their nature, can be hard to pin down.

The key part of the OECD's definition of intangible assets is 'something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances' (Guidelines, para 6.6).

This might reasonably (if unscientifically) be boiled down to assets which are not otherwise classified by the business. If that casts the net widely, the OECD goes on to explain that this is its intention:

'Intangibles that are important to consider for transfer pricing purposes are not always recognised as intangible assets for accounting purposes. For example, costs associated with developing intangibles internally through expenditures such as research and development and advertising are sometimes expensed rather than capitalised for accounting purposes and the intangibles resulting from such expenditures therefore are not always reflected on the balance sheet. Such intangibles may nevertheless be used to generate significant economic value and may need to be considered for transfer pricing purposes' (Guidelines, para 6.7).

As well as not being limited by accounting definitions, in para 6.13 the OECD also specifically differentiates its transfer pricing definition of intangibles from what is set out in the definition of royalties in the commentary on article 12 of its Model Tax Convention.

Identifying intangible assets

Each intangible asset should be identified specifically on its own merits through detailed functional analysis (discussed in more detail below). However, the OECD provides guidance around classification, together with examples to help frame discussions. It acknowledges that two commonly used headings are marketing intangibles and trade intangibles (Guidelines, para 6.16):

Common types of intangible

Marketing intangibles	Trade intangibles
• trademarks; • trade names • customer lists and proprietary data; and • customer relationships.	Everything not in marketing intangibles, e.g. • patents; • know-how and trade secrets; • product designs; and • software.

Licences and similar rights to parts of intangibles can fall within the definition, although group synergies or particular market conditions do not, as they are not capable of being controlled by the business. The OECD does not consider that a description as goodwill is enough on its own to reach a conclusion, but does not rule out a charge if that goodwill generates value.

Case study 1

A manufacturing business is headquartered in the UK with plants in France and Italy. On review, it identifies the following intangibles:

- trademark and related brand intangibles (UK);
- customer lists and relationships (UK, France and Italy);
- a UK patent (UK);
- know-how (UK, France and Italy); and
- internally developed software (UK and France).

At this stage, it is also not necessary for the intellectual property in question to be protectable or necessarily unique. Instead, these factors will influence the value of that intangible when reward is considered at a later step.

This means that businesses should consider their value drivers carefully, including not only those intangibles which are on the balance sheet or formally protected, but also assets which provide wider contributions.

Once identified, business should be able to describe these intangible assets clearly. Only then should they look at how and where value is created by these assets and what that value is.

Where does the value come from?

In a standalone company, the legal ownership and key management roles that relate to an intangible asset are co-located, and so the asset can be seen as an indivisible whole. However, both of these aspects are important.

In practice, an intangible's value rarely comes from its legal ownership alone. While it may be true for brief periods (for example, when a software asset is acquired by a business and can be used 'out of the box' as it stands), work will usually be needed to access and retain that value. Pace must be kept with the market, decisions will need to be made, and the right investment identified and delivered. The asset, in its abstract form, cannot do this; it is the responsibility of the business management, supported by the financial investment that it is willing and able to make.

To help identify these management roles, the OECD has set out key 'DEMPE' activities which can drive the value of intangible assets:

- Development: creating and adding to the asset;
- Enhancement: improving the way the asset operates;
- Maintenance: keeping the asset in working order;
- Protection: preventing and addressing infringement; and
- Exploitation: optimising the use of the asset in the business.

The relative importance of these activities must be considered. In our example, a newly acquired asset may need little immediate development, enhancement or maintenance; and the focus will be on protection and exploitation. An asset which has been in the business for some years may instead require greater emphasis on enhancement and maintenance.

The management roles related to each of these activities should be identified. As with any consideration of substance, those responsible for control of the activity and its associated risks are key and should be differentiated from those who are simply consulted or informed of decisions, or who are tasked with the performance of the strategy and delivery of instructions provided by the management team. The purse strings should also be considered, as the entity with the capability to bear the financial risk of these decisions will likewise need to be identified.

The increasingly interconnected nature of multinational enterprises means that these management roles can be dispersed between entities and locations. These can be different entities from the legal owner of the intangible asset. Mapping these roles and their contribution to the value chain is an important part of the functional analysis. This will be critical to determine the arm's length reward for each of the activities involved.

The OECD framework

The OECD now sets out a framework for the analysis of transactions involving intangibles (para 6.34). This compares the legal ownership of the intangible with the economic substance of these key activity types. If any differences arise, the arm's length policy will follow this economic substance; and tax authorities may adjust pricing on that basis.

The steps set out by the OECD can be summarised:

- Identify the intangibles used or transferred with specificity.
- Identify the full contractual arrangements, with emphasis on legal ownership.
- Identify the parties performing relevant functions, using assets and managing risks.
- Confirm the consistency between the terms of the relevant contractual arrangements and the conduct of the parties.
- Delineate the actual controlled transactions related to the DEMPE functions in light of legal ownership and other contractual arrangements.
- Determine arm's length prices consistent with each party's contributions of functions, assets and risks.

Intangibles provided to connected parties

Having identified the asset itself and the value it provides to the business, the next step is to determine the value provided between connected parties. For example, has the whole asset been transferred, or just rights to that asset?

Following the OECD's framework, any contractual arrangements will be the starting point, but the economic substance should drive the transfer pricing policy.

This economic substance will include how the asset is provided. The Guidelines provide examples of key terms in paras 6.118 to 6.127, such as:

- exclusivity: will the licensee be the only one in the territory, potentially making the licence more valuable?;
- extent and duration of legal protection: what time and space is available before competition is allowed?;
- geographic scope;
- useful life;
- stage of development: how much further work will the licensee be required to do?;
- rights to enhancements, revisions and updates: what can the licensee do with the asset, and can any of this be retained?; and
- expectation of future benefit: realistically, how much is the asset or the rights to use it worth?

The stage of development of the asset is a critical factor. The entity responsible for managing the risk of taking the asset to market will need to be identified, together with the nature of that risk and the level of uncertainty involved.

Roles on both sides of the transaction will be important here. The OECD gives an example of a distributor licensing a group's brand for its local market. Where this distributor's marketing cost is reimbursed by the group licensor, then the distributor's activity is likely to remain consistent with a routine sales agent. If this distributor instead markets the trademark on its own account, meeting costs and taking the associated risk itself, then any local aspect of the marketing intangible that it can develop would be expected to remain with the distributor.

The financial benefit expected from the provision of an asset should be estimated as accurately as possible. The OECD acknowledges that intangibles may be hard to value generally; special considerations for hard to value intangibles are discussed below.

Pricing and supporting intangible assets

Having identified the asset, its role in the business and how it is provided to connected parties, an arm's length price must be determined. This should encompass all of the aspects described above, including the terms of the licence or transfer, the risk involved and the expected financial benefit.

The OECD is clear that the standard approach to comparability provided in Chapter 1 of the Guidelines should be followed:

'[A] rule of thumb cannot be used to evidence that a price or apportionment of income is arm's length, including in particular an apportionment of income between a licensor and a licensee of intangibles' (Guidelines, para 6.144).

Of the generally accepted transfer pricing methods, the OECD pays particular attention to a comparable uncontrolled price (CUP), profit split, and valuation.

Comparable uncontrolled price

In cases where the business licenses intangibles to third parties, or where comparables benchmarking yields a comparable uncontrolled transaction, the CUP method may be applied. Typically, this will be a royalty set at a percentage of relevant sales. If the asset has been acquired recently, the price paid can also provide 'a useful comparable for determining the arm's length price' (Guidelines, para 6.147).

In both cases, it is important to look closely at potential comparables to ensure that the key terms of the arrangements, together with the asset itself, are consistent with the tested transaction. Some adjustment may be made (for example, if only a portion of an acquired asset is transferred), but these adjustments must remain reasonable and be capable of being clearly explained.

Profit split

Again, the expectation is that the application of a profit split with respect to intangibles will reflect the wider use of this method.

Using a profit split can be an alternative if a CUP cannot be identified. It may also be the best method where both/all parties have a significant amount of risk involved in taking the asset to market, and so it may be most appropriate where intangibles are partially developed.

However, the OECD sounds a note of caution, as it is important to ensure that the value of the ultimate outcome, the risk and the cost involved are treated in a way that is consistent with the facts and circumstances of the transaction. There can be significant potential for volatile results.

Similarly, uncertainty over financial projections can create practical difficulties to operating a profit split. These projections should be clear and realistic, and also be retained as part of the group's transfer pricing documentation.

Valuation

Valuation techniques are offered by the OECD where suitable comparables cannot be found:

'In particular, the application of income based valuation techniques, especially valuation techniques premised on the discounted value or projected future income streams or cash flows derived from the exploitation of the intangible being valued, may be particularly useful when properly applied' (Guidelines, para 6.153).

Again, proper application is key. It will still be necessary to identify and reflect the economically relevant characteristics of the asset. The assumptions made (for example, around the useful life of the asset), and the financials used in the calculation will need to be supported robustly.

Whichever method is applied, modelling of potential outcomes is recommended. This will allow the business to test and confirm that one party is neither over-rewarded nor underpaying. It will also allow the scenario analysis to understand the volatility of results under the proposed pricing policy.

Rewarding the value drivers

As discussed, much of an intangible asset's value can be driven by its related DEMPE functions and the associated management personnel. These roles may not all sit within a single entity in the group.

Once the intangible asset has been rewarded, the business should then ensure that each of its value drivers receives an appropriate share of that reward for the value that they contribute. This may be paid by the licensor, or by the parties to the profit split.

This may also require the remuneration of routine functions; for example, contract research and development teams working under management instruction on a cost plus basis. The balance after these obligations have been met should then be split between the providers of the DEMPE functions, finance and legal ownership of the intangible.

The split will be determined by the functional analysis and should be transparent and robust. As the business develops, this allocation should be reviewed at least annually to ensure that it remains appropriate.

Case study 2

A business produces software which allows customers to specify and order products, and which is licensed to the group's distributors. This software is legally owned in the UK. Its development is managed by a technical team split between the UK and France, and overseen by management that sit in the UK and the US. There is an R&D team working on the code in Bulgaria, under the direction of the technical team.

A licence fee is set for the software based on third party comparable data. This is structured as a royalty based on relevant turnover paid by the distributors to the UK.

From this income, the UK rewards the Bulgarian R&D team on a cost plus basis. A return has also been identified which the UK retains to compensate its legal ownership of the asset.

The balance remaining is split between the value driving activities. An allocation is used which identifies the members of the technical and management teams, and weights these to reflect the relative influence of each of these teams. The reward is paid out accordingly.

Hard to value intangibles

The OECD specifically identifies intangibles whose value is highly uncertain at the time of the transaction. It defines these as:

'Intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises: (i) no reliable comparables exist; and (ii) at the time the transaction was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer' (Guidelines, para 6.189).

It states that an asset is hard to value if it is:

- only partially developed at the time of transfer;
- not expected to be exploited commercially for several years;
- integral to an intangible that itself would be hard to value;
- expected to be exploited in a way that is novel with no track record on which to base projections;

- transferred under a lump sum payment; and
- developed under a cost contribution arrangement or similar (Guidelines, para 6.190).

These hard to value intangibles (HTVI) are assets that third parties would price in such a way to mitigate this uncertainty; for example by:

- adopting shorter-term agreements;
- including price adjustment clauses;
- adopting a payment structure involving contingent payments; and
- prospectively renegotiating all or part of the agreement to their mutual benefit (Guidelines, paras 6.183 and 6.184).

The concerns of tax authorities, reflected by the OECD, are that valuations can be materially different from the outturn; and that they do not consider themselves well placed to identify whether this is due to market conditions or the use of forecasts which unduly favour a party to the transaction when the transfer pricing policy is set.

To address this, the revised Guidelines allow tax authorities to use the outturn 'as presumptive evidence of the ex ante pricing arrangements' (Guidelines, para 6.192). They could then use this to inform their determination of the arm's length pricing arrangements at the time of the transaction. This could lead to the tax authorities taking a multi-year approach to the pricing arrangements, or potentially recharacterising aspects of the transaction and adjusting the transfer pricing policy accordingly.

Businesses can take steps to exempt themselves from this treatment by:

- providing details of projections made at the time of the transfer, with consideration of the risks involved, reasonably foreseeable events and their likelihood, and reliable evidence that differences between projections and actual results were unforeseeable or within reasonable (and reasonably foreseen) probabilities;
- a bilateral or multilateral advance pricing agreement;
- providing evidence that the difference between projections and actual results are below 20% of the compensation set at the time of the transaction; and
- ensuring that a five year commercialisation period has passed where third party income generated from the intangible and differences based on projections remains below 20%.

This will require the business to consider the facts and circumstances, and its associated transfer pricing policy, carefully at the time of the transaction. This consideration should be concluded in such a way that it can be included in the group's transfer pricing documentation as supporting evidence. The performance of the intangible must also be monitored over subsequent periods to identify the potential transfer pricing risk which could arise from the difference between projections and the outturn.

Documenting intangibles

As this shows, effective documentation of a group's intangibles and the supporting rationale for its transfer pricing policy is a critical part of achieving a robust filing position. Businesses will need to address the OECD's updated requirements, which place intangibles squarely at the centre of a group's transfer pricing documentation.

The master file should include a description of the important drivers of business profit and the principal contribution to value creation by individual entities within the group. Intangible assets are likely to feature strongly in these sections.

Over and above this, a specific section on intangibles is required covering:

- a general description of the multinational enterprise's overall strategy for the development, ownership and exploitation of intangibles, including the location of principal R&D facilities and R&D management;
- a list of intangibles that are important for transfer pricing purposes and which entities legally own them;
- a list of important agreements among associated enterprises related to intangibles;
- a general description of the group's transfer pricing policies relating to R&D and intangibles; and
- a general description of any important transfers of interests in intangibles between associated enterprises during the year, including the entities, countries and compensation involved (Guidelines, Annex I to Chapter V).

The local file must also specifically include a detailed description and explanation of any intangible transfers in the current or immediately prior year, along with their impact. Alongside this, a description of, and support for, the controlled transaction will be required.

This support must clearly explain both the asset and the value it creates, the nature and management of the DEMPE functions, and the risk associated with the asset. The assumptions and projections used in setting the pricing policy should be included and explained, together with appropriate supporting evidence which can be referred to in future periods if intangibles are considered hard to value.

The transfer pricing documentation should be able to explicitly address the OECD's framework for assessing intangibles. Where appropriate, the issues raised more widely by the 2017 Guidelines regarding the accurate delineation of risk should also be addressed, in particular when explaining the DEMPE functions.

Conclusion

To ensure that their transfer pricing policy covering intangible assets is robust, businesses should:

- clearly understand what intangible assets they have and the functions and risks which create and drive them. This should be achieved by functional analysis and kept under regular review;
- map the results of this onto the legal ownership of the intangible(s) and the way it is provided between connected parties;
- confirm that the pricing policy used matches this substance and appropriately rewards all of the roles involved;
- ensure that comparable data remains robust;
- regularly review financial outturns against the assumptions used when setting the intangibles pricing policy: can differences be explained and evidenced, and does any risk arise where this asset is a HTVI?; and
- review their transfer pricing documentation to make sure that their explanation and support for intangibles is transparent and meets the OECD's latest documentation requirements.

As well as substance, this will need the finance team to be in regular contact with the commercial management of the business to pick up developments at an early stage and be able to understand and demonstrate the commercial impacts on the pricing of intangible assets. ■

For related reading visit www.taxjournal.com

- Intra-group services and transfer pricing (Paul Daly & Duncan Nott, 2.11.17)
- The substance of transfer pricing (Paul Daly, Duncan Nott, 27.7.17)
- Value chain analysis (Paul Daly & Malcolm Joy, 11.5.17)