OECD Project On Intangibles: Public Comments Released

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On October 22, 2013 the Organization for Economic Cooperation and Development (OECD) published comments received from the public on its Revised Discussion Draft on Transfer Pricing Aspects of Intangibles. The OECD Committee on Fiscal Affairs Working Party 6 held a public consultation on the comments received in Paris on November 12-13.

Background

Although the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines) include extensive guidance on the cross-border transfer of intangible property among members of a controlled group, the OECD has recognized that new issues have emerged in recent years which were not foreseen or fully addressed when the OECD Guidelines were released.[1]

In order to address these issues, in 2010 the OECD announced a new Project on the Transfer Pricing Aspects of Intangibles and established Working Party 6 to develop the content of a discussion draft on the topic. After preparing a project scoping paper and soliciting public feedback and consultation, the Working Party decided to focus the initial draft on three primary topics: the definition, identification and valuation of intangibles.

According to the original timeline established for the project it was estimated that an initial discussion draft would be released by the OECD at the end of 2013. However, at a business consultation meeting held in November 2011, representatives of the business community suggested that it would be helpful if the OECD were to release interim drafts of its work as it progresses for further detailed public comment. In response to this request, in June 2012 the OECD issued an initial interim draft titled Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions.

In conjunction with the publication of its initial draft, the OECD solicited comments from the public and subsequently incorporated the feedback received into a Revised Discussion Draft, which was released on July 30, 2013. The Revised Discussion Draft modifies some of the content of the original document and also introduces a number of new concepts that were not contemplated in the original draft.[2]

The principal additions and modifications include the following:

- A discussion of how factors such as the local market, location savings, synergies, and assembled workforces apply to the valuation of intangibles and the allocation of profits among the relevant controlled entities;
- Explanatory changes to the definitions of intangibles;
- Additional guidance on applicable transfer pricing methods, comparable data, and comparability analyses; and
- Changes to Section B of the draft which suggests adopting a more transactional approach while maintaining the importance of functions performed, risks assumed, and assets employed.

In October 2013, the OECD received comments on the Revised Discussion Draft from a number of transfer pricing consulting firms, multinational corporations and non-profit organizations. The comments range from minor wording changes and requests for further clarification to broad conceptual criticism of the document on the basis that it may lead to outcomes contradictory to the arm's length principle.

The remainder of this article provides an overview of some of the key conceptual comments submitted by the business community and a discussion of the next steps.

Overview Of Comments

Influence Of The OECD Action Plan On Base Erosion And Profit Shifting

The concept of base erosion and profit shifting (BEPS) was formally addressed by the OECD in February 2013 and followed up by an Action Plan for BEPS in July 2013. The Action Plan proposes 15 action points for dealing with deficiencies in existing international tax and transfer pricing rules, and the issue of intangible property is a major focus area. Specifically, Action Item 8 suggests developing rules to prevent BEPS via transfer of intangibles among group members by (i) adopting a broad and clear definition of intangibles, (ii) ensuring that profits related to transfers and use of intangibles are appropriately allocated in accordance with value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.

Comments from Ernst & Young and the Tax Executives Institute, Inc. have noted that the BEPS project appears to have had an influence on the Revised Discussion Draft, such that BEPS may have introduced an "anti-abuse" bias. Specifically, E&Y commented that:

> "(Working Party 6) should recognize that it must balance two apparently different objectives for this report: on the one hand, providing practical advice on the arm's length principle with the aim of avoiding instances of double taxation, and on the other hand, arming tax authorities with guidance that in many jurisdictions will become *de facto* anti-avoidance rules."[3]

In essence, the concern on the part of some members of the business community is that by attempting to address so many highly controversial issues at once and in a way that represents a material departure from internationally recognized standards, the OECD Project on the Transfer Pricing Aspects of Intangibles may simultaneously serve to *reduce* instances of less-than-single taxation and *increase* instances of double taxation.

"Important Functions" And "Legal Ownership"

The Revised Discussion Draft also introduces "important functions" and "legal ownership" as new concepts in establishing a framework for setting transfer prices for intangible assets. Specifically, §80 of the draft states the following:

> "An entity claiming the right ultimately to retain all or material parts of the return attributable to a given intangible on the basis of legal ownership will generally perform, through its own employees, the more important functions related to the development, enhancement, maintenance and protection of that intangible that are described in paragraph (79)… Because it may be difficult to find comparable transactions involving the outsourcing of such important functions, it may be necessary to utilize transfer pricing methods not directly based on comparables, including profit split methods and valuation techniques, to appropriately reward the performance of those important functions… In some such circumstances it may also be determined that the outsourcing of such important functions would not have been undertaken by independent enterprises behaving in a commercially rational manner and that the actual structure adopted impedes the determination of an appropriate transfer price, thereby necessitating the disregarding of the actual structure adopted…."[4]

While the Revised Discussion Draft appropriately stresses the importance of conducting a thorough analysis of the functions performed, assets employed and risks assumed by each of the relevant parties with regard to an intangible property transaction, KPMG has expressed concern that the concept of "important functions" is overly restrictive, poorly defined and lacks reference to the arm's length principle.[5]

Likewise, PwC suggested that the OECD take a more deliberate approach in its discussion on "important functions" and "legal ownership" and specify that these terms (i) have been introduced for the purpose of providing additional clarity on the components of a functional and risk analysis; and (ii) should not be misconstrued as an attempt by the OECD to place more importance on the physical location of individuals performing functions than the entity that legally owns the intangible and assumes the resulting risks, per an executed contractual agreement.[6]

Lack Of Guidance On Use Of Market Evidence And Third Party Data To Analyze Intangibles

A basic principle contained in the OECD Guidelines for determining the arm's-length nature of intercompany dealings relates to how independent entities would conduct business and agree to a fair market price for a given transaction. However, comments submitted on this topic in the Revised Discussion Draft suggest that the draft fails to properly address the process of identifying uncontrolled transactions to benchmark the arm's length nature of transactions involving intangible property. Specifically, the Revised Discussion Draft seems to summarily dismiss benchmarking approaches on the basis that unique circumstances commonly exist in transactions involving intangibles, thus making it difficult to obtain a reliable set of comparables.

Moreover, the Revised Discussion Draft proposes the use of profit split methods and valuation techniques without providing guidance on how to reliably search for and identify supporting market observations. In his comments, David Jarczyk of ktMINE notes that failing to perform proper due diligence to identify empirical market data in favor of a subjective approach that is not linked to the actual behavior observed between uncontrolled parties can compromise the reliability and legitimacy of the economic analysis of intangible property.[7]

The potential advantage of using third party market data is clear, yet the issue of whether the Revised Discussion Draft sufficiently emphasizes this point and provides proper guidance has been the subject of additional scrutiny. In particular, KPMG calls into question the Revised Discussion Draft's focus on market evidence and other departures from certain basic principles of transfer pricing, noting that:

> "…a basic building block of transfer pricing is comparability analyses. If comparable transactions exist then those provide evidence of arm's-length pricing. Despite the revisions to its section B, the Revised Discussion Draft seems to overlook this basic principle in its discussion of which entity deserves the returns from an intangible. Instead, it dictates 'arm's-length' conduct by assumption rather than by reference to the observed behavior of third parties."

Conclusion

Based on the critical nature of much of the feedback received from the business community, it is evident that the Revised Discussion Draft does not represent a consensus view on the proper treatment of intangibles. However, it bears noting that the interim draft does not represent the OECD's final position on the topic.

Following the November 12-13 public consultation, which was broadcast on the OECD website, the members of Working Party 6 are expected to make additional revisions to the interim draft. Based on the iterative and interactive nature of the OECD Project on the Transfer Pricing Aspects of Intangibles, it is likely that the existing draft will continue to evolve substantially before it is finalized.

Endnotes

1 *Transfer Pricing Aspects of Intangibles*. (n.d.). Retrieved October 29, 2013, from the OECD website: http://www.oecd.org/ctp/transfer-pricing/transferpricingaspectsofintangibles.htm

[2] For a detailed discussion of the Revised Discussion Draft refer to pages 36-41 of Global Tax Weekly Issue 40 (August 15, 2013).

[3] *OECD revised discussion draft on intangibles*. Ernst & Young Belastingadviseurs LLP. October 2, 2013. Retrieved October 29, 2013 from the OECD website: http://www.oecd.org/ctp/transfer-pricing/ey-intangibles.pdf

[4] *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*, July 30, 2013. Paragraph 80.

[5] *OECD Invitation to Comment on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles.* KPMG's Global Transfer Pricing Services Professionals. September 28, 2013. Retrieved October 29, 2013 from the OECD website: http://www.oecd.org/ctp/transfer-pricing/kpmg-intangibles.pdf

[6] *Comments provided by PwC in its capacity as a professional organization.* PricewaterhouseCoopers LLP. (n.d.). Retrieved October 29, 2013 from the OECD website: http://www.oecd.org/ctp/transfer-pricing/rricewaterhousecoopers-global.pdf

[7] *Comment on Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles*. David R. Jarczyk, President and CEO of ktMINE. (n.d.). Retrieved October 29, 2013 from the OECD website: http://www.oecd.org/ctp/transfer-pricing/ktmine.pdf