

Dissecting revised OECD TP Guidelines - Special Considerations for Intangibles in focus

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Backdrop

Intangibles provides competitive advantage and are key profit drivers in most MNEs. It is therefore necessary to give careful consideration to intangibles when conducting a transfer pricing analysis, especially when MNEs develop, acquire, exploit or transfer intangibles. Transfer pricing aspects pertaining to intangibles is an evolving subject, creating challenges for both taxpayers and tax authorities across the globe.

Considering the complexity surrounding this issue, the OECD had commissioned a project on transfer pricing aspects of intangibles in July 2010. Then in 2015, Base Erosion and Profit Shifting (BEPS) introduced major transformation in the lives of taxpayers riddled with TP issues and tax authorities alike when the final reports on Actions 8-10 (Aligning transfer pricing outcomes with value creation) and Action 13 (Country-by-Country reporting) was released.

Recently, the OECD released the 2017 edition (revising the 2010 edition) of OECD Transfer Pricing (TP) Guidelines for Multinational Enterprises and Tax Administrations which mainly reflects a consolidation of the changes emanating from the OECD/G20 BEPS Project (hereinafter referred as the Guidelines). The Guidelines incorporates substantial revisions introduced by the 2015 BEPS Reports on Actions 8-10 and Action 13. The OECD Council also advised that both the OECD member countries and non-member countries follow the guidance set out in the Actions 8-10 and the Action 13.

Key considerations from Chapter VI of OECD TP guidelines

Chapter VI of the OECD TP guidelines on intangibles provides clarity on the approach to be followed for identification of intangibles, their ownership (legal or economic), approach for the comparability and selection of transfer pricing method for determination of the arm's length price. The guidance in other chapters relating to determination of ALP, application of most appropriate TP method and comparability analysis apply to the transactions pertaining to intangibles as well. Following sections are covered in the revised guidance:

Section A: Identifying Intangibles

OECD has laid emphasis on the importance to identify the relevant intangibles and various illustrations have been provided in respect of different categories of intangibles. The Guidelines also provide detailed meaning of intangibles i.e. something which is not a physical asset or a financial asset, 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.

Indian TP regulations provide for an inclusive definition of intangible property, which apart from the clearly defined intangibles such as marketing, technology, artistic, etc. related intangible assets (examples also provided), also includes any other similar item that derives its value from its intellectual content rather than its physical attributes. It is interesting to note that this detailed definition was introduced only around ten years after the introduction of TP regime in India. In essence, this definition differs than what is mentioned in the OECD guidelines (for instance, OECD considers human capital and market specific characteristics/ location factors as comparability factors and not as intangibles themselves).

Section B: Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles

This section provides guiding principles on identifying which entities within MNEs are entitled to the returns from exploiting (including their transfer and use) intangibles. The emphasis is on looking beyond legal ownership of intangibles and contractual arrangements; and instead focussing on allocation of the economic return, costs and economic burdens associated with intangibles to the entities that factually perform and control the important value-creating functions of developing, enhancing, maintaining, protecting and exploiting the intangibles (the DEMPE functions).

Furthermore, there is a need to accurately delineate a transaction and to ensure that the actual conduct of parties is reflected in contractual arrangements. A framework has been provided for analyzing transactions involving intangibles, which is in line with the guidance on identifying the commercial or financial relations between associated enterprises contained in Chapter I of the OECD TP guidelines.

In respect of risks analysis, the guidelines also explain the requirement of enterprises warranting compensation for risks undertaken, being able to exercise control over these risks coupled with financial capacity to assume such risks. In such cases, the funding entities which do not perform significant activities would be entitled only to risk-free returns to the extent of their capital contributions if they do not control the underlying risks.

This section also contains guidance on applying the aforesaid principles to specific factual situations involving intangibles (i.e. marketing intangibles, research and development and process improvement arrangements, payments for use of the company name).

Section C: Transactions involving the use or transfer of intangibles

This section sets out two general types of transaction where identifying the intangibles concerned and accurately delineating the transaction undertaken will be necessary for TP purposes. These are (i) transactions involving transfers of intangibles or rights in intangibles; and (ii) transactions involving the use of intangibles in connection with the sale of goods or the provision of services.

Section D: Supplemental guidance for determining arm's length conditions in cases involving intangibles

Section D contains guidance on applying the principles set out in Chapters I-III of the OECD TP guidelines to determine the arm's length pricing considerations for transactions involving intangibles including specific guidance on the methods appropriate for benchmarking, use of financial valuation techniques, comparability factors and hard-to-value intangibles (HTVIs).

In May 2017, OECD had released a discussion draft providing guidance on implementation of approach to pricing transfers of HTVI and invited comments from interested parties. OECD has recently released compilation of public comments on the said discussion draft.

Chapter VI of OECD Guidelines vs guidance in UN TP Manual

Basis the extensive guidance on the issue of intangibles available from the reports of the BEPS Actions 8-10, the United Nations Practical Manual on Transfer Pricing for Developing Countries (UN TP Manual) was also updated to include an additional chapter on intangibles. This update is broadly in line with the concepts and frameworks for transfer pricing assessment of intangibles as provided by the OECD. The Country Practices chapter in the context of India has also been updated in the new UN TP Manual to highlight significance of the DEMPE functions and conducting FAR analyses in cases involving intangibles in line with OECD BEPS report.

India's position on OECD

India does not formally subscribe to the OECD TP Guidelines. However, being an active participant of the BEPS project, India has already incorporated a few of the recommendations of the BEPS action plans like introducing country-by-country and master file reporting requirement for large companies, signing of the Multilateral Convention, introducing the concept of low-value adding intra group services along with a safe harbour in line with the BEPS recommended mark-up and so on. More action is expected on other issues in the near future.

Also, courts in India^[1] have placed reliance on the guidance available on various issues in the OECD TP guidelines and the UN TP Manual. The tax department internal guidance to Transfer Pricing Officers on marketing intangible adjustment (2016) also relies extensively on the BEPS guidance. Needless to say, in case of any conflict on a position adopted in the aforementioned literature and the Indian tax regulations, the latter shall prevail.

Concluding thoughts

MNEs should analyze the Guidelines in detail and accordingly align their transfer pricing policy. Furthermore, they should establish whether their policy correctly reflects comparability factors like market specific characteristics, DEMPE functions and so on. It would be pertinent to ensure that the profits are aligned to the value-creating functions. MNEs that have separated the DEMPE functions that contribute to value creation from the entities that are legal owners of intangibles need to realign the profits considering the relevant contributions of each entity.

In a nutshell, group entities of MNEs which contribute to the DEMPE functions of intangibles which may be legally owned by another member of the group must receive arm's length compensation for the functions they perform, the risks they assume, and the assets they use thus stressing importance of a thorough FAR analysis for MNEs based on actual conduct rather than contractual arrangements.

Aforementioned would be of more significance especially considering that a lot of information would be now available to tax authorities owing to the country by country reporting and master file documentation requirements and also through direct means of exchange of information arrangements between countries.

The revised Guidelines providing clarifications on various aspects on Intangibles and further final guidance awaited for profit split method; both together would go a long way in finding solution to the complex transfer pricing issues in the arena of Intangibles. Nonetheless, taxpayers grappling with issues on intangibles or facing litigation may need to look beyond the normal litigation process for dispute resolution like considering MAP and APAs.

The views and opinions expressed above are the personal views of the authors.

^[1] Refer the Delhi High Court Case of Sony Ericsson Mobile Communications India Pvt Ltd & Ors [TS-96-HC-2015(DEL)-TP]