SPEED READ The OECD issues new draft guidance on the transfer pricing of intangibles including: consideration of the identification of intangibles, identification of parties entitled to intangibles income and methods for pricing intangibles. In addition, a new annex contains detailed examples to help both taxpayers and tax authorities in applying transfer pricing to intangibles. The OECD reconsiders the use of safe harbours for certain low-risk transactions, particularly when agreed bilaterally. The OECD seeks input from businesses on the practical consequences of ‘timing issues’ and considers when information is available for use in transfer pricing analyses.

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The OECD has published three discussion drafts on transfer pricing matters, inviting comments by 14 September 2012. These cover (1) the pricing of intangibles, (2) the use of safe harbours for certain low-risk transactions, and propose updates to the OECD’s existing Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD guidelines). The discussion draft on intangibles is the longest and most significant, the latest step in an important ongoing project.

The UK’s legislation incorporates the OECD model: UK transfer pricing rules have to be read in such a way as to be consistent with the OECD guidelines, and there is a mechanism for UK law to be updated for new versions.

Special considerations for intangibles
The discussion draft proposes a rewritten version of Chapter VI ‘Special Considerations for Intangibles’, expanding the guidance considerably (from 39 to 180 paragraphs) as well as providing 22 detailed examples.

The draft sets out requirements for applying the arm’s length principle to transactions involving intangibles, acknowledging the significant complexities that this may entail. It covers the following:

Identification of intangibles, including categorisation. The draft considers whether various items are intangibles for the purposes of separate pricing, or instead factors that should be taken into account in finding arm’s length comparables for goods and services. Patents, know-how and trade secrets, trademarks, trade names and brands and licenses are acknowledged as intangibles whereas group synergies and market specific characteristics are not intangibles within the meaning given.

Goodwill is ‘treated as’ an intangible within the meaning given and factors are noted in relation to assembled workforce which could mean there is an intangible.

Identification of parties entitled to intangible-related returns. The draft notes that registrations and contractual arrangements should be used as the starting point. However, attention should be given as to whether the functions, risks and costs are aligned with the actual behaviour of the parties. This will include considering the compensation for other enterprises that perform functions related to the development, enhancement, maintenance or protection of the intangibles (perhaps as services).

Types of transactions involving the use or transfer of intangibles. This includes consideration of situations where there is no intra-group transfer of the intangible or rights in the intangible, such as may be the case with sales of goods or services even where one party might have used intangibles in respect of the goods or services. In other situations, it is the intangible itself, or rights in the intangible via for example a licence, that is transferred, and the draft discusses the factors to be taken into account in concluding on the exact nature of the transfer.

Determination of arm’s length circumstances in order to price intangibles. The draft refers to general principles set out in earlier chapters of the OECD Guidelines, but acknowledges the complexities that arise in applying these to intangibles transactions. In particular, the OECD stresses that in taking into account the options realistically available, the perspective of each party to the transaction must be considered. The draft covers a wide range of factors, including comparability, exclusivity, the extent and duration of legal protection, geographic scope, useful life, stage of development, rights to enhancements, revisions and updates, expectation of future benefits and comparisons of risk. The draft also discusses at length criteria for the selection of the most appropriate transfer pricing method for intangibles transactions – recognising the variety of forms that the transactions can take. For example, the OECD points out that the discounted value of projected future cash flows may, with certain caveats, be a useful valuation technique whereas those based on the cost of developing the intangibles are unlikely to be, and confirms that ‘rules of thumb’ cannot be substituted for complete analysis. The draft also covers the particular issues that arise when the transaction relates to an intangible with a highly uncertain value.

Why it matters: Transactions involving intangibles create complexity for businesses in complying with the arm’s length principle, and the likelihood of tax authority audits of such transactions also creates
uncertainty. Additional guidance and examples from the OECD are welcomed, and businesses now have the opportunity to shape further the details.

**Safe harbours**

A safe harbour is, broadly, a simplification offered by a tax authority so that transfer prices of certain transactions meeting prescribed requirements are automatically accepted. For example, the UK offers exemption to taxpayers who are small or medium-sized enterprises (provided that the counterparty to the transaction is in a country with a double tax treaty with the UK which has a non-discrimination clause), and such an exemption could be considered a safe harbour in the broadest sense.

The new OECD discussion draft looks again at safe harbours (already discussed in the existing OECD guidelines), as part of an on-going project to improve the administrative aspects of transfer pricing.

In terms of the setting of price targets or offering simplified transfer pricing approaches to categories of taxpayers or transactions, the OECD recognises that there are benefits and issues with the use of safe harbours. The potential benefits include, for the taxpayer, simplification of compliance and cost-saving allied with certainty that the tax authority will accept the prices used, and, for the tax authorities, an ability to direct their limited resources away from low-risk cases. The main issue is that the result may not be in accordance with the arm’s length principle, which underpins Article 9 (Associated Enterprises) of the OECD’s model tax treaty and approach to transfer pricing. The OECD is concerned that by departing from the arm’s length principle unilateral safe harbours can create unobservable double taxation or open avenues for inappropriate tax planning.

The discussion draft confirms that safe harbours are not appropriate for complex or high-risk transfer pricing matters, but concludes that the benefits of safe harbours may outweigh the issues for smaller taxpayers or less complex transactions, and proposes revisions to the existing OECD Guidelines accordingly. The OECD proposes that safe harbours should be elective so that the arm’s length principle is always an option for taxpayers, and that mutual agreement procedures under double tax treaties should be available to adjust profits that have been filed under a safe harbour. The most significant new development, though, is that the OECD encourages, under appropriate circumstances, the use of bilateral (or multilateral) safe harbours to achieve the benefits without some of the potential double taxation or double non-taxation problems. Bilateral safe harbours would be agreed and published by the competent authorities of the countries involved. The OECD includes in the discussion draft three sample documents for competent authorities to use if they wish, setting out frameworks for safe harbours for low-risk manufacturing services, low-risk distribution services and, surprisingly, low-risk research and development services.

**Why it matters:** Compliance with the arm’s length principle can be costly, and without an advance pricing agreement a taxpayer has no certainty that their prices will not be audited by one or more tax authorities. To date the focus on unilateral safe harbours has meant that the potential issues of double taxation or unacceptable planning has led the OECD to discourage the use of safe harbours and they have been rejected by tax authorities. The recommendation for bilateral safe harbours provides an opportunity for simplification of transfer pricing compliance in appropriately targeted cases. Of course, to get this benefit, taxpayers will have to meet the requirements set out in the safe harbour agreement and, perhaps most significantly, will have to wait until competent authorities agree the terms of individual bilateral safe harbours.

**Timing differences**

As part of the OECD's project on intangibles 'timing issues' have been identified as an area of concern, and the OECD has issued a third (short) discussion draft to seek the input of businesses on the matters raised. The OECD is concerned here that different approaches taken to the timing of information used to determine compliance with the arm’s length principle can cause issues, including double taxation.

The OECD considers two possible approaches adopted by taxpayers and tax authorities: firstly, an arm’s length price setting approach, based on information available at the time the transaction is undertaken; and, secondly, an arm’s length outcome testing approach, looking at the actual outcome at the end of the relevant year or at the time the tax return is filed. The issues identified by the OECD are:

- the nature of the information that may be relied on, and the time at which it must be available;
- year-end adjustments by taxpayers, and whether they are respected by tax authorities in all countries;
- consideration of post-transaction date developments in assessing the reasonableness of adjustments or financial projections; and
- specific issues with highly uncertain valuations of intangibles, and a tax authority’s ability to assume a risk-sharing mechanism between seller and purchaser.

The OECD is requesting input from businesses, as part of the consultation, on the practical problems that arise from these issues, including compliance difficulties and examples of double taxation, together with suggestions of practical steps that could be taken to ameliorate them.

**Why it matters:** Of particular relevance are year-end adjustments which, in the UK for example, are accepted where they are used to ensure compliance with the arm’s length principle, but which are not respected by tax authorities in all countries. This can cause significant compliance problems if not double taxation. The use of hindsight is a potentially contentious issue, but if considered in light of what third parties would have agreed in contractual terms for the transaction in question (a facts and circumstances test) then it becomes clearer when, and if, post-event data should be used.

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The OECD stresses that in taking into account the options realistically available, the perspective of each party to the transaction must be considered.

All three OECD discussion drafts on transfer pricing matters are available via www.lexisue.com/LLCIC