Understanding Intangibles –
Summary of OECD BEPS Action 8

This publication provides you with a summary and helpful interpretation of OECD BEPS Action 8 including the Final Draft of Chapter VI of the OECD Transfer Pricing Guidelines published by the OECD in September 2014.
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Summary of OECD BEPS Action 8/Chapter VI OECD Guidelines
The following summary of the current status of the draft OECD Transfer Pricing Guidelines Chapter VI was prepared by Dr Thomas Bittner, Dr Roman Dawid, Madlen Haupt, Dr Simon Renaud, Daniel Schwerdt and Dirk Wilcke, all members of PwC Germany’s IP Transfer Pricing (IP TP) focus group. The group was further supported by Dr Isabel Ruhmer-Krell.

With respect to Action 8 (Intangibles) of the OECD Action Plan on Base Erosion and Profit Shifting (BEPS), the OECD has published its final and interim revision regarding Chapters I, II and VI of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

The objectives of the revised OECD Guidelines are as follows:
1. Clarification of the definition of intangibles
2. Guidance on identifying transactions involving intangibles
3. Provision of supplemental guidance for determining arm’s length conditions for transactions involving intangibles
4. Guidance on the transfer pricing treatment of local market features and corporate synergies

Key elements of the work on intangibles are not yet finalised due to the fact that some of the transfer pricing issues related to intangibles are closely linked to the work related to Action 9 (Risks and Capital) and Action 10 (Other high-risk transactions) of the BEPS Action Plan that will be completed by the OECD in 2015. Thus, the revised OECD Guidelines as of September 2014 have to be viewed as a final draft.

In the following, the amendments to Chapters I, II and VI of the OECD Guidelines will be explained in more detail.
Amendments to Chapters I–II of the Transfer Pricing Guidelines

The amendments to Chapter I of the OECD Transfer Pricing Guidelines add additional paragraphs and examples at the end of Chapter I. These additional paragraphs relate to location savings, other local market features, assembled workforce and group synergies.

Location savings are defined as cost reductions that can be realised because companies operate in certain local markets. The Guidelines state that the guidance of Chapter IX related to location savings is also applicable in general and not only in the context of business restructurings.

To determine the appropriate allocation of location savings the following questions have to be analysed: Do location savings exist and what is the amount realised? To what extent are location savings retained by the group and not passed on to customers and suppliers? How would unrelated parties allocate the retained savings in comparable situations?

Local market comparables would constitute a reliable basis to determine an arm’s length allocation of location savings. If transfer prices with local entities are based on reliable local market comparables an adjustment for location savings should not be required. If no reliable local market comparables exist the allocation of location savings should be based on an analysis of the facts and circumstances, especially the functions, risks and assets used. This analysis should follow the guidance included in Chapter IX of the Guidelines related to location savings.

Other local market features that do not lead to location savings may have an impact on arm’s length transfer pricing as well and will have to be considered in the comparability and transfer pricing analysis. Examples are local market conditions, the competitive situation, local infrastructure, and educational level of the local workforce. Local market features have to be taken into account when conducting comparability analyses and determining whether adjustments are required. An appropriate reference point for the analysis of the impact of local market features can be found in reliable local comparables. Because such data should reflect local market conditions it should usually not be required to conduct adjustments for local market features. Where local comparables do not exist the questions addressed in the context of location savings above have to be analysed:

Do local market features exist and to what extent? How much is retained by group entities and how would unrelated parties allocate the respective advantages under similar circumstances?

Local market features do not constitute intangibles and have to be distinguished from intangibles like contractual rights, regulatory licences and the know-how required to enter a local market. Such intangibles may constitute barriers to entering the local market and can determine how unrelated parties would allocate the economic impact of local market features. However, not every regulation necessarily constitutes a large barrier to entering the local market. The facts and circumstances of the specific case have to be analysed.

An assembled workforce might give rise to economic advantages which should be reflected in the arm’s length prices for services or products or which lead to relatively low production costs for these services or products. These factors have to be considered in the comparability and transfer pricing analysis, if required through adjustment calculations.

In restructurings, where part of the workforce is transferred between related entities, cost savings can potentially be realised because no new workforce has to be built up. Such advantages might be taken into account in the prices of the assets transferred or other compensation in the course of
the restructuring. There might also be situations where the transfer of the workforce leads to disadvantages. This would be taken into account through the compensation paid in the context of the restructuring. However, the Guidelines do not require a compensation for the transfer of a workforce or the secondment of personnel per se. A secondment will often be appropriately compensated by an arm’s length service fee. If through the secondment intangible assets are transferred (e.g. product or manufacturing know-how for a new factory), this has to be analysed in accordance with the guidance in Chapter VI on the transfer of intangibles. A transferred intangible has then to be compensated through a respective arm’s length transfer price.

Multinational enterprise (MNE) groups and their affiliates might realise synergies from joint action within the group. Advantages can, for instance, result from pooling of purchasing power, joint IT and communications infrastructure, integrated management, avoidance of duplicative functions and pooled borrowing power. If such advantages are actually realised, the group benefits in total and the overall profit of the group might be increased. In other situations, negative synergies might be realised through bureaucratic inefficiencies or if group-wide IT or communications systems and standards do not allow for an efficient performance in all operational units of the group.

The OECD Guidelines distinguish whether an affiliate incidentally benefits from group synergies or whether the group conducts a “deliberate concerted action”. The distinction should not be based on the magnitude of the benefit. In the first case, no compensation for the benefits of group synergies would be required. A “deliberate concerted action” creates material, clearly identifiable structural advantages (or disadvantages) for the group entities. This has to be analysed through a thorough functional and risk analysis. As an example the OECD mentions the centralisation of the purchasing function, which leads to the realisation of advantages through pooled purchasing power.

With respect to advantages through a “deliberate concerted action” the questions addressed above have to be analysed: Do advantages/disadvantages exist and to what extent? How much is retained by group entities and how would unrelated parties allocate the respective advantages/disadvantages under similar circumstances?

The benefit of group synergies through a “deliberate concerted action” should be allocated among the members of the group in accordance with the contribution that each group member makes to the creation of the respective synergies. For example, the benefits of a purchasing pool which generates benefits through the bundling of purchasing volumes should be allocated in accordance with relative purchasing volumes, after an adequate compensation for the coordinator/negotiator of the pool. In addition, comparability adjustments might be appropriate in the case of group synergies.

**Examples 1 and 2: implicit support**

These examples look at external and intercompany financing and the advantages of a group rating which is better than the stand-alone rating: A parent has a rating of AAA and its subsidiary of Ba on stand-alone basis. If the subsidiary now borrows externally at A-rating conditions because it is member of the group, this constitutes a group synergy. However, as no “deliberate concerted action” has been conducted, no compensation to the parent would be required. In addition, external financing at A-rating conditions would provide an arm’s length interest rate, although the stand-alone rating is below the external rating, which already reflects the impact of the group. In a variation of the base case (Example 2) a parent grants an explicit guarantee to B to receive AAA-rating conditions. The respective enhancement from an A-rating to an AAA-rating interest rate is considered a “deliberate concerted action” and therefore an arm’s length guarantee payment from subsidiary to parent is considered appropriate.

**Examples 3 and 4: centralised group purchasing**

A purchasing entity of an MNE group can realise significant advantages with suppliers through the bundling of purchasing power. The purchasing entity buys the products from external suppliers and sells them on to affiliates. The purchasing entity should be compensated on a cost-plus-markup basis. The purchasing advantages are mostly passed on to affiliates through the transfer price reflecting that purchasing volume is the driver for the purchasing advantages and would thus be the most appropriate allocation
basis. In a variation of the base case (Example 4), the purchasing entity only negotiates rebates and does not buy the products, but affiliates buy directly from external suppliers. The lower risk of the purchasing entity should be reflected in a lower cost plus remuneration for the purchasing entity.

**Example 5: purchasing manager**

Several subsidiaries of a group buy from the same unrelated supplier which grants a significant rebate for high purchasing volumes. The purchasing manager bundles the demand for supply and negotiates a rebate for all products bought by group entities. The overall rebate of the group is taken into account in the external supplier’s invoices to one of the affiliates whereas the other affiliates buy at undiscounted prices. The country where the rebates are not reflected in the suppliers’ invoices can conduct a transfer pricing adjustment to appropriately reflect the rebate.

Changes to Chapter II of the OECD Guidelines first state that the current paragraph 2.9 related to other methods than those discussed in Chapter II (e.g. income-based valuation methods) has to be seen as preliminary and will be revised as a consequence of the BEPS Project. In contrast, the 2013 draft included a modified version of paragraph 2.9. In addition, paragraph 2.10 is added in the final revision which states that general rules of thumb do not constitute an appropriate transfer pricing method in accordance with Chapters I–III. Application of a rule of thumb does not provide evidence for an arm’s length allocation.

The current provisions of Chapter VI of the Transfer Pricing Guidelines will be deleted entirely and will be replaced by new paragraphs. The changes and amendments with respect to Chapter VI of the OECD Transfer Pricing Guidelines are structured into four sections:

- A. Identifying intangibles;
- B. Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles;
- C. Transactions involving the use or transfer of intangibles; and
- D. Supplemental guidance for determining arm’s length conditions in cases involving intangibles.

**Amendments to Chapter VI of the Transfer Pricing Guidelines**
A. Identifying intangibles

A1. In general
The Guidelines first highlight that there may be difficulties in transfer pricing analysis due to different (broader and narrower) definitions of the term intangible. Therefore, the term intangible in the Guidelines is defined as something

- which is not a physical or financial asset,
- which is capable of being owned or controlled for use in commercial activities, and
- whose use or transfer would be compensated in a transaction between third parties.

The focus in TP analysis is not on legal or accounting definitions of intangibles, but rather on what compensation would be agreed upon between third parties in comparable transactions.

The importance of intangibles for TP analysis may be different than for tax or accounting purposes (e.g. because valuable intangibles for TP purposes may have been created without being capitalised and reflected in the balance sheet).

The availability and extent of legal, contractual or other forms of protection may affect the value of an intangible; however, the existence of such protection is not a necessary condition for an item to be recognised as intangible for TP purposes.

Separate transferability (without other items) is not a necessary condition for being characterised as intangible.

Local market circumstances (e.g. high purchasing power or level of competitiveness) are not considered an intangible asset for purposes of Chapter VI as these cannot be owned or controlled.

The identification of an intangible is separate from determining the price for use and transfer of the item: It is emphasised that not all intangibles deserve a separate/additional compensation to the price of goods or services as not all intangibles give rise to premiums (e.g. non-unique know-how that other comparable providers have).

For TP analysis, it is important to identify intangibles with accuracy: The functional analysis should thoroughly identify the relevant intangibles, the manner in which they contribute value and how they interact with other intangibles, as well as tangible assets and business operations that create value.

A2. Relevance of this chapter for other tax purposes
The guidance in this chapter is for TP matters only and not intended to have relevance for other tax purposes (e.g. with the term royalty in the OECD commentary on model convention).

It is also not relevant for recognition of income, capitalisation of intangible development costs, amortisation or similar matters under local tax regulations.

A3. Categories of intangibles
The Guidelines do not seek to delineate precise classes or categories of intangibles, such as trade or marketing intangibles, soft or hard intangibles, routine or non-routine intangibles. Nevertheless, some definitions of intangibles are given (see definition of marketing and trade intangibles in the glossary). The existing definition of the term marketing intangible is replaced with the following language: “An intangible (within the meaning of paragraph 6.6) that relates to marketing activities, aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.”

Unique and valuable intangibles are defined as being not comparable to intangibles used by or available to other parties and whose use in business is expected to yield higher economic benefits than without the intangible.
A4. Illustrations

In the following the Guidelines provide illustrations of items often considered to be intangibles in TP analysis (list is not comprehensive and should not substitute a detailed analysis in the specific case).

- **Patents**: Legal instrument that grants an exclusive right to its owner to use a given invention for a limited period of time within a specific geography. The Guidelines discuss the potential value of patents (e.g. premium returns, cost advantages, significant commercial advantage) and different transactions involving patents (sale of products covered by patents, sale of patents, licensing of patents).

- **Know-how and trade secrets**: Proprietary information or knowledge that assists or improves commercial activity but that is not registered for protection like patents or trademarks. Value is often dependent on ability to preserve confidentiality. In some industries companies may decide not to disclose the necessary information to obtain patent protection to prevent competitors from developing similar solutions. Nevertheless, know-how and trade secrets may substantially contribute to value creation and companies' success.

- **Trademarks, trade names and brands**: A trademark is a unique name, symbol, logo or picture that the owner may use to distinguish its products and services. Proprietary rights in trademarks are often confirmed through registrations. Trade names may have the same force of market penetration and form of registration as a trademark. The term brand is sometimes used interchangeably with trademark and trade name. In other cases brand is considered a combination of intangibles including trademarks, trade names, customer relationships, reputation and goodwill, whereby it is sometimes difficult or impossible to separate the value of the various items contributing to brand value.

- **Rights under contracts and government licences**: May cover a wide range of business relationships; for example, a government grant to exploit specific natural resources or public goods or to carry on a specific business activity are considered intangibles within the meaning of this section. Company registrations that are required for doing business in a particular jurisdiction are not covered by the definition. Rights under contracts that are important for certain businesses (e.g. contracts with suppliers or key customers) are also intangibles in the meaning of this section.

- **Licences and similar limited rights in intangibles**: Commonly transferred by means of a licence or similar contract. Although limited in their scope of use, such limited rights are themselves considered intangibles.

- **Goodwill and ongoing concern value**: The Guidelines discuss different concepts of goodwill value and ongoing concern value without giving a precise definition. Neither item can be segregated or transferred separately from other business assets. Therefore, it is important to recognise that a significant part of the compensation paid between independent enterprises when some or all assets are transferred may be a compensation for goodwill or ongoing concern value. This should be taken into account when pricing intercompany transactions. The Guidelines make clear that measures of goodwill derived for accounting purposes are not necessarily appropriate for TP purposes but may serve as a starting point.

- **Group synergies**: May contribute to the level of income earned by MNEs (e.g. streamlined management, costs advantages, integrated systems, purchasing or borrowing power). Are not considered intangibles in the sense of this chapter but should be addressed as comparability factors when determining arm's length TPs.

- **Market-specific characteristics**: May affect arm's length conditions of transactions in a specific market (e.g. high purchasing power, low labour costs, proximity to markets, climate conditions). Are not considered intangibles in the sense of this chapter but should be addressed as comparability factors when determining arm's length TPs.

Changes to the previous draft in this section are minor.
B. Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles

Section B is titled “Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles” and is mainly an interim draft upon which country delegates have not yet fully agreed. The main reason for the preliminary status of the current version is that Section B deals with issues that will also be discussed under Action 8 of the BEPS initiative in 2015. In order to take in the expected results of future discussions, the finalisation of Section B was postponed to 2015.

Like the 2013 draft of Section B, the current version is structured into three main subsections. Subsection B.1. deals with the relevance of contractual terms in the transfer price analysis of intangibles. Subsection B.2. covers in four chapters the relationship between the allocation of profit to a related party and (a) the performance and control of functions, (b) the use of assets, (c) the assumption of risk and (d) unanticipated ex post return. Difficulties with identifying comparable uncontrolled transactions of intangibles are outlined in Subsection B.3., while B.4. applies the principles set out in Subsections B.2. and B.3. to the development and enhancement of marketing intangibles, the execution of R&D services and the use of the company name. In contrast to Subsections B.1 and B.2., Subsections B.3. and B.4 constitute a final version. The Annex to Chapter VI contains examples that illustrate the argumentation outlined in Section B. As relates to Subsections B.1 and B.3, the examples given in the Annex are preliminary.

The main point of the 2013 version and the current version of Section B is that the return related to an intangible shall be allocated to the members of a multinational group according to their functions, assets and risks. It is recognised that contractual agreements between transaction partners are a starting point for a transfer pricing analysis but ultimately the functions, assets and risk of the transaction partners are the decisive criteria for income allocation. Consequently, Subsection B.2. constitutes the largest subsection of Section B. Both versions contain in their general introduction a framework for the analysis of intangible transactions which starts with the identification of the legal owner of intangibles, assesses the consistency of the functions, risks and assets of the parties with the contractual agreement, and allows the recharacterisation of a transaction when the contractual agreement is not consistent with the economic substance of the transaction.

Despite this common thread, the current version sharpens its wording with respect to several aspects. Several sentences were inserted in Subsection B.1. that further qualify the importance of contractual agreements. For example, paragraph 67 of the 2013 draft states that when no written term exists, the contractual relationship of the parties must be inferred from their conduct and the economic principles that generally govern the relationships between independent enterprises. In contrast, sec. 6.36 of the current draft refers not only to cases where no written contract exists but also to cases where the contractual terms are ambiguous or incomplete. paragraph 67 of the 2013 draft was also amended by a sentence highlighting again that prices and other conditions contained in contracts may or may not be consistent with the arm's length principles.

Consistent with the relativisation of contractual agreement, a mere legal owner must not be entitled to the intangible-related return. The new draft highlights the decisive role of important functions (e.g. design of research of marketing programs, establishing of priorities, or management of budget) and gives the control function a more prominent rule than before. This is also reflected in the new title of subsection B.2(a). It has changed from “Functions performed” to “Performance of and control of functions.” Subsection B.2. states now more explicitly that a legal owner should compensate the members of a multinational group that control important functions and highlights now that the question of whether a particular entity has the capacity to exert control and perform control functions is an important part of the transfer pricing analysis (paragraph 6.53). If the legal owner does not control or assume important functions, the parties controlling these functions and bearing related risks should be entitled to the returns remaining after the legal owner is remunerated for its own functions, assets and risks. Hence, the current draft explains under which
conditions the legal owner is not entitled to a residual profit but parties performing and controlling important functions are (paragraph 6.57, 6.63). If an entity only assumes the funding risk, it would be entitled to a risk-adjusted rate of anticipated return. Holding entities are explicitly addressed in the new draft (paragraph 6.42) as an example of a legal owner of intangibles with limited functions.

The current draft clarifies (paragraph 6.44, 6.45) that parties involved in the intangible development must be compensated on an ex ante basis and addresses in a new chapter which party would be entitled to an unanticipated ex post return. Paragraph 6.67 highlights that tax payers might deliberately underestimate future earnings, so high ex post earnings might not be the result of unanticipated events. Paragraph 6.67 also underlines that the legal owner is not always entitled to an unanticipated return. Aspects like monitoring, control and management of functions and assets related to risk and the capacity to bear the consequences of unanticipated events have to be considered. Again, functions performed and risks assumed by the related parties are the crucial point of the analysis.

It is also noteworthy that paragraph 6.43 of the new draft introduces the concept of realistic alternatives into the transfer pricing analysis. Although it has been addressed in the context of business restructurings in Chapter IX (paragraph 9.59) it has only been applied in the context of intangibles with respect to royalty payments (paragraph 6.14 of the 2010 OECD Guidelines). Subsection B.4. has been marginally revised in the new draft. With respect to the creation of marketing intangibles it confirms that a distributor which owns a long-term distribution contract benefits from its marketing activities because the value of its distribution contract increases. If a distributor bears higher-than-average marketing costs that distributor might claim a separate compensation for the enhancement of the trademark from the owner of the trademark (paragraph 6.75).

Concerning the provision of research and development activities, Paragraph 6.76 states that reimbursement of the costs plus a modest mark-up might not be appropriate in all cases. Unfortunately, the section does not explain whether a modest mark-up might be insufficient or whether a compensation based on cost is not arm’s length, that is, whether a profit split might be the more appropriate transfer pricing method.

According to paragraph 6.79 a royalty can be charged for a group name if the group name provides a financial benefit for the user. This also applies to situations where a group is acquired by a second group and further onwards uses the group name of the acquiring group. If the acquiring group benefits from the expanded use of its group name it is possible that it pays the acquired group for the use of its name.

C. Transactions involving the use or transfer of intangibles

This chapter is intended to provide guidance on identifying transactions involving intangibles. Two general types of transactions are relevant for TP purposes:

- Transactions involving transfers of intangibles or rights in intangibles
- Transactions involving the use of intangibles in connection with the sale of goods or provision of services

C1. Transactions involving transfers of intangibles or rights in intangibles

This chapter makes clear that in transactions involving the transfer of intangibles or rights in intangibles it is essential to precisely identify the nature of the intangibles or rights in intangibles. In this context any limitations on the transferred rights (e.g. perpetual or limited time, exclusivity, geographic scope, right to use further developments) need to be reviewed in detail as they have a significant influence on the transfer pricing analysis and value of the rights transferred. Such limitations must be evaluated in light of both written agreements and actual conduct of the parties.

Some transactions involve the transfer of combinations of intangibles. In such a case the legal and economic interactions between the transferred intangibles need to be identified because in some cases the combination of
Intangibles may be much more valuable than the value of the intangibles considered in isolation. Furthermore, it should be ensured that all intangibles transferred in a transaction have been identified (e.g. in some cases one intangible cannot be transferred without another).

Situations in which the taxpayer or tax administration attempt to artificially separate intangibles which independent parties would not separate in comparable circumstances should be critically analysed.

When intangibles or rights in intangibles are transferred in combination with tangible business assets or services, it is important to identify and take into account all intangibles involved in the transaction. In some cases it may be possible to separate the analysis in tangible goods/service transactions and transactions involving IP. In other cases transactions may be so closely related that a separation is very difficult. Reliability of available comparables is an important factor in determining whether the transactions should be combined or segregated. Written agreements and actual conduct of the parties should also be examined when determining whether a separate analysis is possible. However, in any case it should be kept in mind that the interactions between intangibles and services may enhance value compared to an isolated view.

C2. Transactions involving the use of intangibles in connection with the sale of goods or performance of services

Intangibles may be used in controlled transactions where there is no transfer of the intangible or right in the intangible (e.g. intangible used in manufacture of goods). The nature of such a transaction and any relevant intangibles used by either party in the transaction should be identified and taken into account for the comparability analysis, selection of TP method and tested party.

Changes to the previous draft in this section are minor.

D. Supplemental guidance for determining arm’s length conditions in cases involving intangibles

This section provides additional guidance on determining arm’s length conditions for transactions involving intangibles.

It is first stated that the principles set out in Chapters I–III of the OECD Guidelines should be applied in determining arm's length conditions for transactions involving intangibles. In particular, the recommended nine-step process set out in paragraph 3.4 in Chapter III is asserted to be helpful in identifying arm's length conditions for transactions involving intangibles. However, it is acknowledged that the principles of Chapters I–III can sometimes be difficult to apply to controlled transactions involving intangibles, as intangibles may have special characteristics that complicate the search for comparables, and in some cases make pricing difficult to determine at the time of the transaction. Further, the OECD states that – for wholly legitimate business reasons and due to the relationship between them – associated enterprises might sometimes structure a transaction involving intangibles in a manner that independent enterprises would not contemplate.

Subsection D.1. provides general supplemental guidance related to all transactions involving intangibles. Subsection D.2. provides supplemental guidance specifically related to transactions involving the transfer of intangibles or rights in intangibles. Subsection D.3. provides supplemental guidance regarding transfers of intangibles or rights in intangibles whose value is highly uncertain at the time of the transfer. Subsection D.4. provides supplemental guidance applicable to transactions involving the use of intangibles in connection with the sale of goods or the provision of services in situations where there is no transfer of rights in the intangibles.
D.1. General principles applicable in transactions involving intangibles

In general it is proposed that the principles contained in paragraphs 1.33–1.63 and Chapter III should be considered in analysing controlled transactions involving intangibles.

The OECD notes that in applying the principles of the Guidelines related to the content and process of a comparability analysis to a transaction involving intangibles, a transfer pricing analysis must consider the options realistically available to each of the parties to the transaction. In considering the options realistically available to the parties, the perspectives of each of the parties to the transaction must be considered, as a comparability analysis focusing only on one side of a transaction generally does not provide a sufficient basis for evaluating a transaction involving intangibles.

For example, a transferor would not be expected to accept a price for the transfer of either all or part of its rights in an intangible that is less advantageous to the transferor than its other realistically available options (including making no transfer at all), merely because a particular associated-enterprise transferee lacks the resources to effectively exploit the transferred rights in the intangible.

The OECD further notes (this is of specific relevance in the context of German transfer of functions regulations) that if situations arise in which the minimum price acceptable to the transferor, based on its realistically available options, exceeds the maximum price acceptable to the transferee, based on its realistically available options, it may be necessary to consider whether the actual transaction should be disregarded under the second circumstance of paragraph 1.65, whether the principles of paragraphs 9.34–9.38 or 9.122 should be applied or whether the conditions of the transaction should otherwise be adjusted.

D.2. Supplemental guidance regarding transfers of intangibles or rights in intangibles

This section provides supplemental guidance regarding specific issues arising in connection with the transfer between associated enterprises of intangibles or rights in intangibles.

In applying the provisions of Chapters I–III to transactions involving the transfer of intangibles or rights in intangibles, it should be borne in mind that intangibles often have unique characteristics and as a result have the potential for generating returns and creating future benefits that could differ widely. In conducting a comparability analysis with regard to a transfer of intangibles, it is therefore essential to consider the unique features of the intangibles.

The OECD then sets out a description of some of the specific features of intangibles that may prove important in a comparability analysis involving transfers of intangibles or rights in intangibles, comprising of (a) exclusivity, (b) extent and duration of legal protection, (c) geographic scope, (d) useful life, (e) stage of development, (f) rights to enhancements, revisions and updates and (g) expectation of future benefit. Each of these items and its relevance for comparability analysis is further elaborated.

In conducting a comparability analysis involving the transfer of intangibles or rights in intangibles, the existence of risks related to the likelihood of obtaining future economic benefits from the transferred intangibles must also be considered, including the allocation of risk between the parties which should be analysed within the framework set out in Subsection B.2. of Part I of Chapter IX of the Guidelines. According to the OECD, the following types of risks, among others, should be considered in evaluating whether transfers of intangibles or combinations of intangibles are comparable, and in evaluating whether the intangibles themselves are comparable: (a) risks related to the future development of the intangibles, (b) risks related to product obsolescence and depreciation in the value of the intangibles, (c) risks related to infringement of the intangible rights, (d) product liability and similar risks related to the future use of the intangibles.

The OECD further states that the principles of paragraphs 3.47–3.54 relating to comparability adjustments apply with respect to transactions involving the transfer of intangibles or rights in intangibles. It is important to note that differences between intangibles can have significant economic consequences that may be difficult to adjust for in a reliable manner. Particularly in situations where amounts attributable to comparability adjustments represent a large percentage of the compensation for the intangibles.
intangible, there may be reason to believe, depending on the specific facts, that the computation of the adjustment is not reliable and that the intangibles being compared are in fact not sufficiently comparable to support a valid transfer pricing analysis.

Comparability, and the possibility of making comparability adjustments, is stated to be especially important in considering potentially comparable intangibles and related royalty rates drawn from commercial databases or proprietary compilations of publicly available licence or similar agreements.

It is noted that the principles of paragraphs 3.30–3.34 apply fully in assessing the usefulness of transactions drawn from such sources.

In selecting the most appropriate transfer pricing method in a matter involving the transfer of intangibles or rights in intangibles, the principles of the Guidelines related to the selection of the most appropriate transfer pricing method for the circumstances of the case described in paragraphs 2.1–2.12 are understood to apply fully to cases involving the transfer of intangibles or rights in intangibles. In selecting the most appropriate transfer pricing method in a case involving a transfer of intangibles or rights in intangibles, attention should be given to (a) the nature of the relevant intangibles, (b) the difficulty of identifying comparable uncontrolled transactions and intangibles in many, if not most, cases, and (c) the difficulty of applying certain of the transfer pricing methods described in Chapter II in cases involving the transfer of intangibles.

Depending on the specific facts, any of the five OECD transfer pricing methods described in Chapter II might constitute the most appropriate transfer pricing method to the circumstances of the case where the transaction involves a controlled transfer of one or more intangibles. The use of other alternatives may also be appropriate.

Where the comparability analysis identifies reliable information related to comparable uncontrolled transactions, the arm’s length prices for a transfer of intangibles or rights in intangibles can be determined on the basis of such comparables after making any comparability adjustments that may be appropriate and reliable. However, it will often be the case in matters involving transfers of intangibles or rights in intangibles that the comparability analysis (including the functional analysis) reveals that there are no reliable comparable uncontrolled transactions that can be used to determine the arm’s length price and other conditions. This can occur if the intangibles in question have unique characteristics or if they are of such critical importance that such intangibles are transferred only among associated enterprises. It may also result from a lack of available data regarding potentially comparable transactions or from other causes.

Notwithstanding the lack of reliable comparables, it is usually possible to determine the arm’s length price and other conditions for the controlled transaction, except in circumstances where paragraph 1.65 applies; that is, in circumstances in which it may, exceptionally, be appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. Where information regarding reliable comparable uncontrolled transactions cannot be identified, the arm’s length principle requires use of another method to determine the price that uncontrolled parties would have agreed under comparable circumstances. By using another method, it is important to consider the following:

- The functions, assets and risks of the respective parties to the transaction
- The business reasons for engaging in the transaction
- The perspectives of and options realistically available to each of the parties to the transaction
- The competitive advantages conferred by the intangibles, including especially the relative profitability of products and services or potential products and services related to the intangibles
- The expected future economic benefits from the transaction
- Other comparability factors such as features of local markets, location savings, assembled workforce and MNE group synergies

In identifying prices and other conditions that would have been agreed between independent enterprises under comparable circumstances, it is often essential to carefully identify idiosyncratic aspects of the controlled transaction that arise by virtue of the relationship between the parties. There is no requirement that associated enterprises structure their transactions in precisely the same manner as independent enterprises might have done. However, where transactional structures are utilised by
associated enterprises that are not typical of transactions between independent parties, the effect of those structures on prices and other conditions that would have been agreed between uncontrolled parties under comparable circumstances should be taken into account in evaluating the profits that would have accrued to each of the parties at arm's length.

The OECD discourages the use of transfer pricing methods that seek to estimate the value of intangibles based on the cost of intangible development, as there tends to be rarely any correlation between the cost of developing intangibles and their value or transfer price once developed. Hence, transfer pricing methods based on the cost of intangible development should usually be avoided. However, in some limited circumstances, transfer pricing methods based on the estimated cost of reproducing or replacing the intangible may be utilised. Such approaches may sometimes have valid application with regard to the development of intangibles used for internal business operations (e.g., internal software systems), particularly where the intangibles in question are not unique and valuable intangibles.

The OECD states that provisions of paragraph 2.10 related to the use of rules of thumb apply to determinations of a correct transfer price in any controlled transaction, including cases involving the use or transfer of intangibles. Accordingly, a rule of thumb cannot be used as 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.

The OECD concludes that where reliable comparable uncontrolled transactions can be identified, the CUP method can be applied to determine the arm's length conditions for a transfer of intangibles or rights in intangibles. The general principles contained in paragraphs 2.14–2.21 apply when the CUP method is used in connection with transactions involving the transfer of intangibles.

Where the CUP method is utilised in connection with the transfer of intangibles, particular consideration must be given to the comparability of the intangibles or rights in intangibles transferred in the controlled transaction and in the potential comparable uncontrolled transactions.

In some situations, intangibles acquired by an MNE group from independent enterprises are transferred to a member of the MNE group in a controlled transaction immediately following the acquisition. In such a case the price paid for the acquired intangibles will often (after any appropriate adjustments, including adjustments for acquired assets not re-transferred) represent a useful comparable for determining the arm's length price for the controlled transaction under a CUP method. Depending on the facts and circumstances, the third-party acquisition price in such situations will have relevance in determining arm's length prices and other conditions for the controlled transaction, even where the intangibles are acquired indirectly through an acquisition of shares or where the price paid to the third party for shares or assets exceeds the book value of the acquired assets.

In some circumstances, a transactional profit split method can be utilised to determine the arm's length conditions for a transfer of intangibles or rights in intangibles where it is not possible to identify reliable comparable uncontrolled transactions for such transfers. Paragraphs 2.109–2.146 contain guidance to be considered in applying transactional profit split methods. That guidance is fully applicable to matters involving the transfer of intangibles or rights in intangibles. In evaluating the reliability of profit split methods, however, the availability of reliable and adequate data regarding combined profits, appropriately allocable expenses and the reliability of factors used to divide combined income should be fully considered.

The next section considers the use of valuation techniques, especially with reference to the income methods (discounted income or cash flow methods), for cases where the other methods according to Chapter II cannot be applied
in a reliable manner. Special reference is made that these methods have to be consistent with the arm’s length principle especially with reference to
• options realistically available (paragraph 1.34),
• attribution of risk (paragraph 9.10–9.46) and
• aggregation of transactions (paragraph 3.9–3.12).

This especially refers to the use of income methods for other purposes, such as purchase price allocations, where the inherent conservatism used may not be consistent with the arm’s length principle. Additionally, the OECD emphasises a two-sided approach, namely that the arm’s length price will fall within the range of present values from the transferor’s and the transferee’s perspective. Changes compared with the previous draft are marginal.

The last section of this paragraph describes in more depth the most relevant areas when using valuation techniques, since the results may be very volatile, depending on the reliability of the assumptions. Assumptions should be consistent with non-tax valuations within the company (which may be more reliable than valuations made specifically for transfer pricing purposes) and a sensitivity analysis may be appropriate in the transfer pricing documentation. The following are specific relevant areas to consider for valuation techniques:
• Accuracy of financial projections, including consistency with non-tax management projections, useful life assumptions for projections and consistency of past performance and future projections, whereby past performance may not always be representative for the future, but may give a first indication
• Growth rates whereby an assumed steady growth pattern over a long period of time may not be consistent with actual financial performance
• Discount rates and the effect of risk in projections and the underlying intangible, whereby simply using the company’s weighted average cost of capital (WACC) may not always be appropriate since intangibles usually involve more risk than the taxpayer’s average business
• Useful life/terminal values depending on the nature of the intangible, since the lifetime has a significant impact on the value
• Taxes, which should be considered at the level of transferor and transferee
• Form of payment (present value of instalments or one-time payments).

Especially the discussion regarding useful life (paragraph 6.172 and 6.173) considers important aspects with large impacts on the value of the intangible. While legal protections and the technological change in the industry may have an impact, the discussion regarding “platform IP” will significantly impact the actual useful life. Platform IP refers to older IP (e.g. not subject to legal protection any more) that forms the basis for new IP. On the other hand, IP with an indeterminate useful life may not create returns above routine level either. The changes to this section compared with the earlier draft are moderate as well.

D.3 Arm’s length pricing when valuation is highly uncertain at the time of the transaction
Section D.3. of the new draft describes arm’s length pricing when the valuation is highly uncertain at the time of the transaction. It is marked as preliminary since it infers with the BEPS Action Plan regarding hard to value intangibles and therefore changes are to be expected.

The section essentially concludes that in cases of high uncertainly, the taxpayer and the tax administration should do what independent third parties would do in similar circumstances. Possibilities could be
• using anticipated benefits, that is, without the right to make future adjustments;
• using contractual arrangements with price adjustments clauses (e.g. lower licence rate in case the profits are lower than expected); and
• allowing third parties to renegotiate the pricing arrangement in case of major unforeseen developments (e.g. in case a licensee might otherwise stop producing a product).

Paragraph 6.182–6.185 specifically discuss in which cases the tax authorities may reassess the pricing of a company. Essentially, the OECD Guidelines again refer to third-party behaviour, e.g. the tax authorities may reassess the pricing in case third parties would do so as well (i.e., in cases 2 and 3 above). Changes to the previous draft are again small.
D.4 Supplemental guidance for transactions involving the use of intangibles in connection with the sale of goods or the provision of services

Subsection D.4. refers to supplemental guidance for cases where intangibles are used in connection with other transactions (goods, services). In the case that the tested party in the resale price method, the cost plus method or the transactional net margin method (TNMM) uses intangibles, then comparability adjustments or the use of another method may be appropriate. In case another party to the transaction uses intangibles, this should be irrelevant for the mentioned methods. Even if the tested party uses intangibles, the relevant impact deviates:

• In case the comparables use similar (non-unique) intangibles, the comparability for the methods used above should be high enough and the intangible should be sufficiently taken into account.
• In case the tested party and/or the comparable use(s) non-unique intangibles, comparability adjustments or the choice of another method is appropriate. But even in those cases, the identified transactions may be the best available indication. Otherwise, the use of the transactional profit split method may be more appropriate.

Changes to the previous draft in this section are minor.
Annex to Chapter VI of the Transfer Pricing Guidelines
### Action 8: 2014 Deliverables/Annex to Chapter VI – Examples

The provisions of the existing Annex to Chapter VI of the OECD Transfer Pricing Guidelines will be deleted in their entirety and replaced by 33 examples which illustrate the application of the principles outlined in the revised Chapter VI. Some of the examples (1–7, 16–18 and 31–33) are marked as preliminary and should be viewed as interim guidance. It is anticipated that they will be finalised and agreed upon in 2015 in connection with other work related to the OECD’s BEPS project.

#### Topic/Area | Example No. | Fact pattern described | Recommendations | Main references to | Changes compared with 2013 version |
--- | --- | --- | --- | --- | --- |
Legal ownership vs performance of IP-related functions | 1 | • Parent company P funds R&D, performs R&D functions; rights in patentable inventions are assigned to subsidiary S • S holds and maintains all patent registrations (global patent administration) • S employs only lawyers and does not perform any R&D functions, does not bear any R&D expenses, has no R&D personnel • P takes decisions regarding defence (advised by S) and licensing of patents to related/unrelated entities • Nominal payment by S to P at time of patent assignment (no arm’s length payment) and simultaneous exclusive, royalty-free licence provided to P with full rights to sublicense • P manufactures and sells products by using the patents; S makes no commercial use of the patents | • P performs all IP-related important functions except for patent administration services and substantially bears all risks related to the IP • P should be entitled to bulk of returns • Depending on the facts, it might be concluded that the set-up is “in substance” a patent administration service arrangement • Arm’s length price would need to be established for the patent administration services but P would retain all residual profits derived from the exploitation of the patents | Para. 6.43 | Additional emphasis on the functional contributions Notion that “in substance” tax authorities might qualify the arrangement as patent administration services |

#### Legal ownership and licensing income

2 | • Fact pattern as in Example 1 (italics) • Under control of P; S grants licences of patents to associated/independent companies against a royalty (assumed to be at arm’s length) | • Despite being the legal owner, S is only entitled to a remuneration in line with functions performed (registering patents and maintaining patent registrations) • S should not be entitled to retain income from licensing arrangements over arm’s length remuneration for patent administration services • True nature of arrangement is patent administration service contract • Ex ante compensation due to P for the patents should be equal to anticipated licensing revenue of S less return for functions performed by S • Ex post returns are not addressed | Para. 6.43 | Clarifications to the fact pattern |

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For paragraphs 6.43–6.67, please refer to Section B. Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles.
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<td>Legal ownership and sale of IP</td>
<td>3</td>
<td>Fact pattern as in Example 1 (italics) • After licensing of IP, S (acting under the control and direction of P) sells the IP to an independent enterprise • Price reflects appreciation of IP during the period in which S was the legal owner (throughout the period, S did not perform any functions other than patent registration functions)</td>
<td>Income of S should be the same as in Example 2: compensation for patent registration services but no participation in returns generated by the licensing of the IP or the disposal of the IP</td>
<td>Para. 6.43</td>
<td>Clarifications to fact pattern</td>
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<tr>
<td>Entitlement to returns upon sale of IP/Unanticipated external circumstances</td>
<td>4</td>
<td>Fact pattern as in Example 1 (italics) • Price paid by S to P was arm’s length price which reflected at the time of their assignment the anticipated returns from exploitation • Following IP assignment, S licenses patents to independent entities • S has employees taking all management decisions with regard to the patents; negotiations, monitoring of compliance is done by S • Due to unanticipated external circumstances, value of the patents increases and S sells the patents (decisions, negotiations, control by S)</td>
<td>S is entitled to retain the proceeds of the sale, including the amounts attributable to the increase in value due to the unanticipated external circumstances</td>
<td>Para. 6.43</td>
<td>New example</td>
</tr>
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<td>5</td>
<td>Fact pattern as in Example 4 • Instead of appreciating, value of the patents decreases during the time they are owned by S due to unanticipated external circumstances</td>
<td>S is entitled to retain proceeds of the sale (ie, will suffer a loss)</td>
<td>Para. 6.43</td>
<td>New example</td>
</tr>
<tr>
<td>Entitlement to returns upon exploitation of IP</td>
<td>6</td>
<td>Fact pattern as in Example 4 • Appreciation in value of patents results from efforts of P (launch, payment and management of marketing campaign in new markets) • Marketing campaign results in significant increase in royalties received by S</td>
<td>S must compensate P for contributions for enhanced value of patents</td>
<td>Para. 6.43</td>
<td>New example</td>
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| Segregation of funding and performance of R&D, entitlement to IP-related returns | 7           | • Group companies A and B agree to develop IP on the basis of existing IP of company B under development agreement  
  • Company B performs and controls all activities related to development, maintenance and exploitation of IP; company A provides funding and will become the legal owner of the IP  
  • As per development agreement, company B shall make contingent payments to company A for the right to use the IP based on comparable licences  
  • Functional analysis performed by tax authority in country of company B determines that company A's contribution to the development of the intangible is solely R&D funding assuming the inherent risk  | • Company A’s anticipated remuneration should be a risk-adjusted rate of anticipated return on its funding commitment  
  • Company B would be entitled to all remaining anticipated income after accounting for company A’s anticipated returns  
  • As per numerical example provided, company A would be entitled to 20% of anticipated profits and company B to 80%  
  • Contingent contractual arrangements (eg, licensing payments) should be determined accordingly  
  • Differences between actual and anticipated profits would be allocated to company A and/or to company B | Para. 6.43 and 6.58, 6.66/6.67  
New example |
| Bearing of IP-related risks/costs, marketing entity vs IP owner (Pharma)    | 8           | • P develops IP related to product X and registers patents around the world  
  • Wholly owned subsidiary S to distribute X through various territories on limited risk basis  
  • Distribution agreement foresees that P should bear product recall and liability risk and that P shall be entitled to all profit or loss from selling X; S to receive compensation for distribution functions  
  • S purchases X from P and resells X to customers  
  • During first three years, S earns returns from distribution functions consistent with limited risk characterisation  
  • Thereafter, X needs to be recalled due to serious side effects (removal from the market)  
  • S incurs substantial costs due to recall/product liability claims, costs are not being reimbursed by P  | • Inconsistency between entitlement to returns and failure to bear costs related to the risks  
  • Transfer pricing adjustment would be appropriate  
  • Need for analysis of risks borne by P and S, course of conduct, control over risks, capacity to bear risks and other facts  
  • Two options discussed: (1) true nature of relationship is limited risk distribution agreement – adjustment likely to be appropriate is allocation of recall/product liability costs from S to P; (2) true nature of relationship includes assumption of risks by S – increase in distribution margins of S may be appropriate if arm’s length price can be identified  
  • Clarification that option 2 may be unlikely as risks and functions related to control of risks should be aligned  | Para. 1.53 and 6.65  Clarification that risks and functions related to risks should be aligned |

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4 For paragraphs 6.43–6.67, please refer to Section B. Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles.  
5 Please refer to paragraph 1.53 (guidance on contractual terms) in the OECD Transfer Pricing Guidelines.
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| Marketing IP/compensation of distribution and marketing functions/marketing costs | 9 | • P owns trademarks/trade name and manufactures the product  
• Trade name has considerable economic value due to efforts of P but is unknown in country Y market  
• Subsidiary S to distribute products in country Y under long-term royalty-free marketing/ distribution agreement (exclusive, sole activity, option to renew)  
• S performs distribution activities for products and acts as marketing agent to assist in developing the market for the products  
• S consults with P in developing the marketing strategy; P develops overall marketing plan, approves budgets, takes various decisions, eg, product positioning  
• Assumption that prices paid for finished products are at arm’s length  
• In first years of agreement, S embarks on marketing strategy consistent with agreement with P and incurs marketing expenses (reimbursed by P with mark-up, compensation deemed arm’s length) | • P is entitled to retain income derived from exploiting the trademark and trade name in country Y market (in excess to compensation paid to S for its functions)  
• No transfer pricing adjustment warranted | Para. 6.73 et seq. | No changes |
| | 10 | • Facts as in Example 9 except: S is obliged to develop/execute marketing plan without the control of P; S bears the marketing-related costs and bears certain risks; S receives no reimbursement of the costs nor does the contract specify an amount of expenses S is expected to incur (S is expected to earn its return solely from the sale of the products); as result of the differences in the functional analysis, lower price is adapted for the products and S earns higher margins than in Example 9 due to higher risks  
• S has high operating expenses/slim margins during first years of distribution agreement | • P exercises lower level of control over marketing activities of S  
• Risks of S are greater than in Example 9  
• Where marketer/distributor bears the costs and associated risks of the marketing activities, question arises of to what extent the marketer/distributor can share potential benefits  
• Assumption that on the basis of a functional analysis, it was determined that the functions S performed are in line with the functions/ expenses that S would have incurred being independent from P  
• Information on comparable uncontrolled arrangements provides best measure of arm’s length return earned by S for the contribution to intangible value  
• No separate additional compensation needs to be provided to S | Para. 6.73 et seq. | Minor amendment: “anticipated” returns of S |

6 Please refer to Section B. Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles.
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|            | 11          | Same facts as in Example 10 but market development functions undertaken by S are more extensive | - S has a larger functional contribution to development of the marketing intangibles and assumed greater costs and risks than comparable independent enterprises  
- S has not been adequately compensated by the margins earned under resale of products  
- Transfer pricing adjustment in country of S is warranted and could take the following form: (1) reducing price of products by applying resale price method or transactional net margin method (TNMM); (2) applying residual profit split method; (3) directly compensating S for excess marketing expenditures, including appropriate profit element for the functions and risks reflected by those expenditures | Para. 6.73 et seq. | Minor clarification of fact pattern |
|            |             | • Assumption that the marketing expenses incurred by S by far exceed the level of marketing expenses incurred by comparable independent marketers and distributions; assumption that high level of expense of S reflects performance of additional functions  
• Profit margins of S are significantly lower than profit margins of identified comparable companies | | | |
|            | 12          | Same facts as in Example 10 but S enters into shorter-period royalty-free agreement with no option to renew (at end of the period, no new contract is concluded) | - Risks assumed by S are substantially higher; S has not been adequately compensated for those additional risks  
- Short-term nature of the contract makes it unreasonable to expect that S has the opportunity to obtain appropriate benefits under the contract during the limited term  
- S is entitled to compensation for its at risk contribution to the value of the trademark and trade name  
- Compensation could take form of direct compensation from P to S for anticipated value created through the marketing expenditures and functions (alternatively, compensation could take form of price reduction for products) | Para. 6.73 et seq. | No changes |
| Ibid., Marketing activities and royalty payments | 13          | Facts are same as in Example 10, with additions: by end of initial period, trademark/trade name has been successfully introduced into the market and P/S renegotiate the contract and enter into long-term licensing agreement (all other terms of agreement being the same except for royalty to be paid by S)  
• Anticipated sales of products in following years correspond to budgeted figures but margins of S decrease substantially due to royalty | • For transfer pricing purposes, it would not be expected that a royalty would be paid where a marketing and distribution entity obtains no rights in marketing IP other than the right to use such IP in distributing a branded product supplied by the entity entitled to the income derived from exploitation of such IP  
• Profit margins of S are lower than those of independent entities with comparable functions, assets and risks  
• Transfer pricing adjustment disallowing the royalties paid would be appropriate | Para. 6.73 et seq. | Minor clarification of fact pattern |
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| Ibid., market development functions | 14 | - Facts are same as in Example 11, with additions: P stops manufacturing products and contracts with independent entity to produce on its behalf; S imports unbranded products form the producer and undertakes secondary processing to apply trade name, logo and package products before sale to final customer  
- Renegotiation of contract and conclusion of long-term contract with option to prolong (S receives exclusive right to process, market and distribute products bearing the trademark in consideration for payment of royalty to P)  
- S receives no compensation from P for renegotiation of the original agreement  
- Tax audit and functional analysis establish that level of marketing expenses of S, and level and intensity of marketing activity has been higher than that of comparable entities (market development activities)  
- S has undertaken market development activities and incurred marketing expenditures beyond what comparable independent licensees with similar long-term licensing agreements undertake and incur for their own benefit | - S should be compensated with an additional return for market development functions  
- Possible bases for adjustment for initial years as descried in Example 11; for later years, bases for adjustment would be similar except that adjustment could reduce royalty payments rather than purchase price  
- Depending on facts and circumstances, compensation may be due to S for the renegotiation of the arrangement | Para. 6.73 et seq. | Minor clarification of fact pattern |
| Ownership of IP, R&D service provider | 15 | - Shuyona is a parent company and the group maintains two R&D centres (one operated by S, one by Shuyona)  
- Shuyona R&D Centre is responsible for: overall research programme of group, design of research programmes, development and control of budgets, decision taking as to where R&D is undertaken, and monitoring of progress on R&D projects; it controls R&D function for the group under strategic direction of group senior management  
- S R&D Centre operates on project-by-project basis assigned by Shuyona R&D Centre, reports on progress, requires approval if additional budgets required  
- Contracts between Shuyona Centre and S specify that Shuyona bear all risks and costs related to R&D undertaken by S, all IP is registered by Shuyona, Shuyona pays service fee to S | - Shuyona is legal owner of IP (controls and manages R&D)  
- Shuyona is entitled to returns from exploitation of the IP developed through R&D efforts of S  
- Compensation of S depends on relative skill and efficiency of the R&D personnel, nature of research being undertaken  
- If transfer pricing adjustments are required, they should relate to the year of the service being provided and not affect entitlement of Shuyona to future returns from exploiting IP | Para. 6.76 et seq. | Minor adjustments to wording |

\(^7\) Please refer to Section B. Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles.
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| Ownership of IP and entitlement to IP-related returns | 16          | • Modification of Example 15: Shuyona group sells two lines of products; Shuyona and S R&D Centre operate autonomously, each for one product line  
• S also functions as regional headquarters of group in North America and has global responsibilities for its product line  
• All patents developed by R&D Centres are registered by Shuyona; the latter makes no or only nominal payment to S in regard to R&D  
• S R&D Centre reports to product line management in S and does not report to Shuyona R&D Centre  
• Joint meetings of R&D teams are sometimes held to discuss common issues and research methods | • TP analysis would begin by recognising legal ownership of IP by Shuyona  
• Shuyona neither performs nor exercises control over R&D functions carried out by S, including important functions  
• Shuyona’s legal ownership would not entitle it to any returns related to product line IP developed by S  
• TP outcome could be that S should not make any royalty or other payment to Shuyona for right to use product line IP developed by S; future income from exploitation of IP would be allocated to S  
• If Shuyona exploits product line IP developed by S, appropriate compensation should be paid to S  
• Important functions performed by S make it unlikely appropriate that S should be tested party | Para. 6.76 et seq.                                                                                                                                  | Clarification that legal ownership does not entitle owner to IP returns; conclusion that important functions performed by S make it unlikely to be tested party |
| Integrated IP ownership/ supply chain          | 17          | • Shuyona operates exclusively in country X, group runs two R&D Centres with relationship as described in Example 16 (S operates in country Y)  
• Shuyona sells rights to IP to new subsidiary T organised in country Z, which establishes manufacturing facilities and produces products for other group members (assumption that compensation paid by T is at arm’s length)  
• At time of transfer, T enters into separate contract R&D agreements with Shuyona and S, pursuant to agreements T bears financial risks associated with failure of R&D and pays S and Shuyona service fee on cost-plus basis  
• T has no technical personnel capable of conducting or supervising R&D activities  
• Shuyona continues to develop R&D programme, establish R&D budgets and make other decisions related to R&D, and supervises/controls R&D activities of S | • TP analysis recognises legal ownership of IP of T  
• S, Shuyona and T should be compensated for functions, assets and risks related to the development of the IP and the production of products  
• It may be extremely difficult to identify comparable transactions with such structure  
• Use of profit split methods, valuation techniques or other methods may be necessary | Para. 6.76 et seq.                                                                                                                                  | No changes |
| Contract R&D                                   | 18          | • Pharmaceutical company A employs a third-party contract R&D provider  
• Company A transfers patents and related intangibles for product M to related party S for an arm’s length price  
• Company S funds all ongoing research for product M, but A continues to carry out R&D for product M as before  
• S agrees to pay for A’s services based on the same cost-plus margins as for the third-party contract R&D provider | • Given the important functions performed by A, the external contract R&D arrangement cannot be seen as comparable  
• Although S is the legal owner and bears financial risks, it lacks capability to control the research-related risks  
• A should be entitled to larger profit than contract R&D provider  
• Due to lack of appropriate comparables, profit split methods, valuation techniques or other methods would be needed | Para. 6.56, 6.76 et seq.                                                                                                                               | Minor clarification of fact pattern |
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| Licensing agreement vs actual conduct          | 19          | • Company X holds a patent for various countries and licenses the related patent and know-how rights for usage **only in country B** to related party Y  
• Company Y sells products not only in country B, but also to associated distribution entities in Asia and Africa  
• Company Y does not prevent these sales | • Actual conduct of X and Y suggest that I/C transaction is the licensing of patents and know-how rights to Y for country B, Asia and Africa  
TP analysis should extend to Asia and Africa and royalty should be recalculated based on total projected sales for country B, Asia and Africa | Para. 6.88³ | Minor clarification of fact pattern; remark on recalculation of royalty was added |
| Identification of transactions involving the transfer of intangibles | 20          | • Retailing company A developed a special and unique marketing concept for the operation of department stores  
• A new subsidiary of A created in another country opens department stores and achieves substantially higher margins than comparable retailers in this country | • A functional analysis proves that the new subsidiary uses A’s marketing concept  
• Conduct of parties reveals a transfer of rights to use the marketing concept  
• Independent companies would have concluded a licensing agreement; thus tax authorities can do TP adjustment imputing a royalty payment | Para. 6.83³ | New example |
| Transfer of combination of intangibles          | 21          | • Company A holds patents, trademarks and marketing intangibles related to a product that it sells via subsidiary B in countries X and Y  
• For sound economic reasons, the business in country Y is transferred to a new subsidiary C  
• B transfers tangible assets to C  
• A terminates the agreement with B regarding rights to manufacture and distribute, use the patents, customer relationships, goodwill and other items in country Y  
• A enters into long-term licensing agreement with C  
• B has developed substantial business value in country Y that would be treated as goodwill in a purchase price allocation with a third party | • There are three different transactions:  
1. Transfer of tangible business assets in country Y from B to C  
2. Surrendering by B of rights under licence to A  
3. Subsequent granting of rights via new licence by A to C  
• The prices paid in connection with these transactions should reflect the value of the business including amounts that may be treated as goodwill for accounting purposes | Para. 6.92¹⁰ | Simplification of example; identification of separate transactions added |

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²⁾ Please refer to Section C. Transactions involving the use or transfer of intangibles.
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<tr>
<td>Artificial separation of intangibles</td>
<td>22</td>
<td>Consumer goods company A in country X is legal owner and developer of the trademark; products are sold through affiliated distributors • In year 2, A sets up company S as a super distributor and invoicing centre in country Y; shipment goes from A to distributors, legal title flows via S • In year 2, S starts to reimburse the distributors for their advertising costs, but increases I/C prices simultaneously such that OM of distributors stay constant (these OM are arm’s length); S does not perform functions or control any risk related to advertising • In year 3, I/C prices from A to S are reduced stating that S is entitled to income related to intangibles</td>
<td>In substance, S has no claim to income derived from the exploitation of intangibles, given that it performs no functions, bears and controls no risk and in substance bears no costs related to the development, enhancement, maintenance or protection of intangibles. • TP adjustments to increase income of A in year 3 are appropriate</td>
<td>Para. 6.93 (^{11})</td>
<td>No changes</td>
</tr>
<tr>
<td>PPA as arm’s length price</td>
<td>23</td>
<td>Company A owns government licences for both mining (market value of 20) and exploitation of a railway (market value of 10) • Independent company B acquires A for 100; the purchase price allocation (PPA) attributes 20 to the mining licence, 10 to the railway licence and 70 to the goodwill resulting from synergies • Immediately after acquisition, B causes A to transfer both licences to S, a subsidiary of B</td>
<td>When determining the arm’s length price to be paid by S, the specificity of the transferred intangibles has to be identified • The goodwill associated with the licences should be considered, given that this value neither disappears nor is destroyed • The 100 paid by B for the shares of A represent an arm’s length price and provide useful information regarding the combined value of the intangibles</td>
<td>None</td>
<td>New example</td>
</tr>
<tr>
<td>Transfers of (rights in) intangibles in combination with other business transactions</td>
<td>24</td>
<td>Company A acquires 100% of R&amp;D company T; the purchase price is primarily justified by T’s promising but only partially developed technologies and the potential of its personnel • Right after acquisition, T transfers all rights in (partially developed) technologies to subsidiary S of A and enters into a contract R&amp;D agreement (cost-plus remuneration) with S • Company S will fund all R&amp;D and assume financial risk; it also has large research and management staff to assume full management and control of the contract R&amp;D work done by T • All existing research personnel of T is exclusively devoted to the contract R&amp;D provided to S</td>
<td>The definitions and valuations of intangibles in the PPA are not determinative in this case • Depending on the facts, a substantial portion of the value described in the PPA may have been transferred from T to S, but some portion of the value described as goodwill might have been retained by T • Company T should be compensated for such value, either via the transfer price or via compensation for the R&amp;D services of its workforce in the following years • If the transfer of intangibles is separated from acquisition in a timely manner, this requires a separate inquiry of changes in the value of these intangibles</td>
<td>Para. 1.97(^{12}); 6.24(^{13}); 6.14(^{14})</td>
<td>Minor comment added regarding timely separation</td>
</tr>
</tbody>
</table>

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\(^{11}\) Please refer to Section C. Transactions involving the use or transfer of intangibles.

\(^{12}\) Please refer to amendments to Chapters I-II of the Transfer Pricing Guidelines – Assembled workforce.

\(^{13}\) Please refer to Section A. Identifying Intangibles.

\(^{14}\) Please refer to Section D. Supplemental guidance for determining arm’s length conditions in cases involving intangibles.
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| Application of the CUP method | 25 | - Software development consulting company A has developed proprietary copyrighted software for client X  
  - A agrees to support related company B on a similar project with client Y by providing employees which have access to the above software and know-how  
  - The software system provided to client Y uses the initial software to an extent that would justify a claim of copyright infringement by a third party | - The TP analysis should recognise that B received two benefits which both require compensation:  
  - Services from A's employees  
  - Right to use A's proprietary software as foundation for the new software system | Para. 6.24 | No changes |
| | 26 | - The legal department of group parent P has experience with large litigation matters and has developed a unique and proprietary document management software  
  - Subsidiary S is involved in a complex litigation and receives support from P by means of two employees  
  - These employees use the document management software for this litigation, but S is not allowed to use the software in other litigations or make it available to its own customers | - It is not appropriate to treat P as having transferred rights in intangibles in this case as part of the services provided by its employees  
  - The fact that the employees had experience in similar litigations and the available software tools allowed to provide services more effectively and efficiently should be considered in the comparability analysis when determining the service fee to be charged | Para. 6.24 | No changes |
| | 27 | - Parent company P acquires 100% of independent, publicly traded company S at 160; the shares of S at that time had a trading value of 100, competitive bids offered 120–130  
  - S only had a nominal amount of fixed assets at acquisition, the PPA allocated 10 to tangible assets, 80 to intangibles and 90 to goodwill, justified by reference to the complementary nature of P’s and S’s products  
  - T is a subsidiary of P and has exclusive, arm’s length licences for all of P group’s intangibles related to European and Asian markets  
  - Immediately after the acquisition, P liquidates S and grants an exclusive and perpetual licence to T for the intangibles related to S’s products in Europe and Asia | - The arm’s length price for the intangibles of S licensed to T should take into account the premium over the trading value of S’s shares  
  - To the extent that the premium reflects the complementary nature of P group’s products with the acquired products in Europe and Asia, T should pay an amount for the (rights in) intangibles transferred from S that reflects an appropriate share of the purchase price premium  
  - To the extent that the premium relates to product complementarities outside of Europe and Asia, this premium should not be taken into account  
  - The value attributed to intangibles in the PPA is not determinative for TP purposes | Para. 6.144 | No changes |
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| Use of valuation techniques      | 28          | • Subsidiary B in country Y owns patents, trademarks and know-how for product M  
  • For sound business reasons, ownership of patents will be centralised at parent company A in country X; B sells its patents to A for a lump-sum price  
  • No comparable uncontrolled price (CUP) is available; A and B use valuation techniques as most appropriate TP method  
  • A direct valuation of property and patents yields a value of 80 based on industry-typical royalty rates, discount rates and useful lives; given the material differences between product M (and related intangibles) and typical products in the industry, an adjustment is made to the valuation  
  • Company A also conducts a discounted cash flow (DCF) valuation for the entire Product M business which results in a value of 100 | • The difference between the 100 valuation of the entire product M business and the 80 valuation of the patent on its own appears to be inadequate to reflect the value of routine functional returns for the activity of B and to recognise any value for trademarks and know-how retained by B  
  • Further review of the reliability of the 80 value ascribed to the patent is needed | Para. 6.15415 | No changes |
|                                 | 29          | • Parent company A in country S decides to centralise all of the groups intangibles outside S in one location  
  • All intangibles (including patents, trademarks, know-how and customer relationships) owned by subsidiary B in country T will be sold to subsidiary C in country U  
  • C retains B as a contract manufacturer and manages further development of intangibles for B  
  • No CUP is available; valuation techniques are used as most appropriate TP method  
  • In the valuation, no reliable segregation of cash flows associated with the specific intangibles is possible | • To determine an arm’s length compensation in this case, it may be appropriate to value the transferred intangibles in the aggregate rather than asset by asset  
  • This is particularly true if there is a significant difference between the sum of the best estimates of the separate valuations of the individual intangibles and other assets and the value of the business as a whole | Para. 6.154 | No changes |

15 Please refer to Section D. Supplemental guidance for determining arm’s length conditions in cases involving intangibles.
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<tr>
<td>Parent company P has developed patents and trademarks related to product F; it produces F in country X and supplies affiliated distributors at arm’s length prices</td>
<td>30 •</td>
<td>In determining the arm’s length price it is important to take into account 1. the perspectives of both parties, 2. the options realistically available and 3. the particular facts of the case.</td>
<td>Para. 6.154</td>
<td>Facts of the case substantially simplified; detailed tables showing DCF example were deleted</td>
<td></td>
</tr>
<tr>
<td>To save costs, P wants to transfer all production of product F to subsidiary S in country Y</td>
<td>30 •</td>
<td>P would not sell below 600 but would also not sell below 875, given the realistically available option</td>
<td>6.170–6.180</td>
<td></td>
<td></td>
</tr>
<tr>
<td>P sells all patents and trademarks for product F to S and uses a DCF valuation technique to determine an arm’s length price</td>
<td>30 •</td>
<td>S would not accept a price above 1000, given it should earn a positive return on its investment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>According to the DCF, P could have generated a net present value (NPV) after tax of 600 by continuing the business, while S could generate a NPV of 1000</td>
<td>30 •</td>
<td>The arm’s length price should fall into the above range, taking into account that third parties would also consider cost savings and projected tax effects when setting the price for intangibles</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>If P were to retain ownership of intangibles and retains S (or another supplier) to manufacture on its behalf, this generates a NPV of 875</td>
<td>30 •</td>
<td>P would not sell below 600 but would also not sell below 875, given the realistically available option</td>
<td></td>
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Arm’s length pricing of hard-to-value intangibles

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<td>Two associated companies enter into an arm’s length licensing agreement for manufacturing and distribution rights for an established drug; there is a fixed royalty rate for the three-year term of agreement</td>
<td>31 •</td>
<td>If the lack of price adjustment clauses or other protection against the risk of uncertainty of valuation is consistent with comparable uncontrolled transactions, there is no reason to believe the development was so fundamental to have led to a renegotiation between third parties.</td>
<td>Para. 6.178 ff</td>
<td>No changes</td>
</tr>
<tr>
<td>In the third year, it is discovered that the drug has another therapeutic capability, which increases sales and profits for the licensee</td>
<td>31 •</td>
<td>An adjustment of the royalty rate in year 3 would be an inappropriate use of hindsight</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Had the agreement been negotiated with this knowledge in year 3, a higher royalty would have been agreed between third parties</td>
<td>31 •</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>There is evidence that the new capabilities were unanticipated when the initial agreement was fixed</td>
<td>31 •</td>
<td></td>
<td></td>
<td></td>
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</table>

Facts are as in example 31, but the agreement is renegotiated at the end of year 3

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<tr>
<td>The sales development for the drug cannot be predicted reliably re-evaluation of the intangible rights is highly uncertain</td>
<td>32 •</td>
<td>Given that it is not industry practice to enter into long-term agreements with fixed royalty rates when no established sales track record exists and there is evidence that third parties would have insisted on prospective price clauses, the royalty rate fixed at the outset of the ten-year agreement cannot be seen as arm’s length beyond year 5</td>
<td>Para. 6.178 ff</td>
<td>No changes</td>
</tr>
<tr>
<td>Nevertheless, the associated companies enter into a 10-year licence contract that significantly increases the fixed royalty rate based on speculative expectations of increasing demand</td>
<td>32 •</td>
<td>TP adjustments from beginning of year 5 are appropriate, given that third parties would have included price adjustment clauses based on annual reviews</td>
<td></td>
<td></td>
</tr>
<tr>
<td>In year 5, a competitor introduces a drug with greater benefits and the sales of the first drug decline rapidly</td>
<td>32 •</td>
<td></td>
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Please refer to Section D. Supplemental guidance for determining arm’s length conditions in cases involving intangibles.
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|           | 33         | • Company X licenses rights to produce and market a microchip to subsidiary Y for five years at a fixed royalty based on sales projections of 50–100 million per year  
• Contracts between third parties dealing with comparable intangibles would not consider the projections reliable enough to fix the royalty rate, but agree on a price adjustment clause (as in the contract of X with an independent manufacturer)  
• After year 1, sales are three times higher than expected | • The tax administration would be justified in determining the royalty rate on the basis of the adjustment clause that would be provided in a comparable uncontrolled transaction as the one between X and the independent manufacturer | Para. 6.180; 6.182–6.183<sup>17</sup> | No changes |

<sup>17</sup> Please refer to Section D. Supplemental guidance for determining arm’s length conditions in cases involving intangibles.
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