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IP TRANSFERS AND TRANSFER PRICING OF INTANGIBLES

PRESENTATION BY
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Agenda

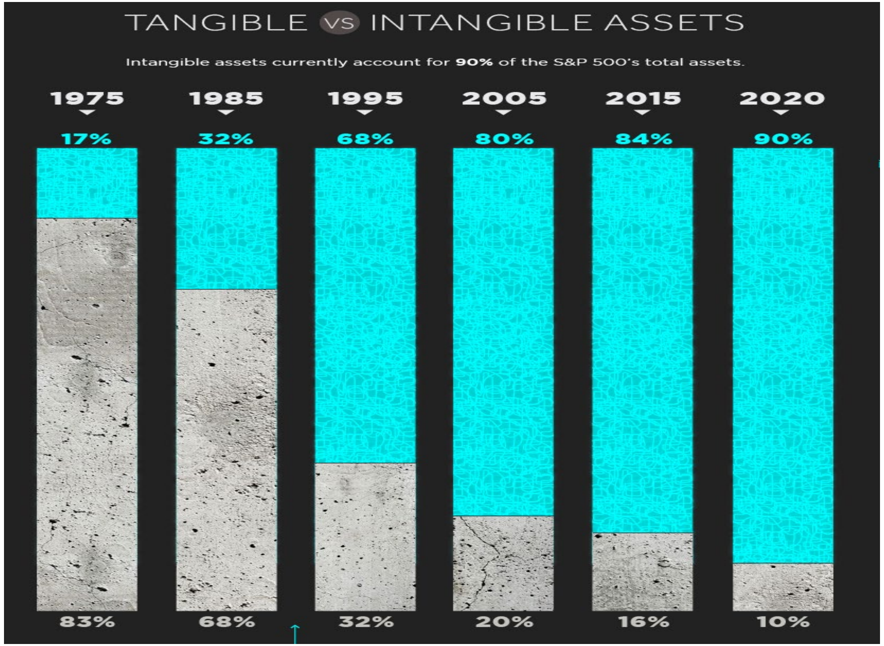
1. Transfer Pricing and Intangibles: Introduction
2. Assessment of the Arm’s Length Nature of Intangibles
3. Case Law Example
4. References

Transfer Pricing and Intangibles: Introduction

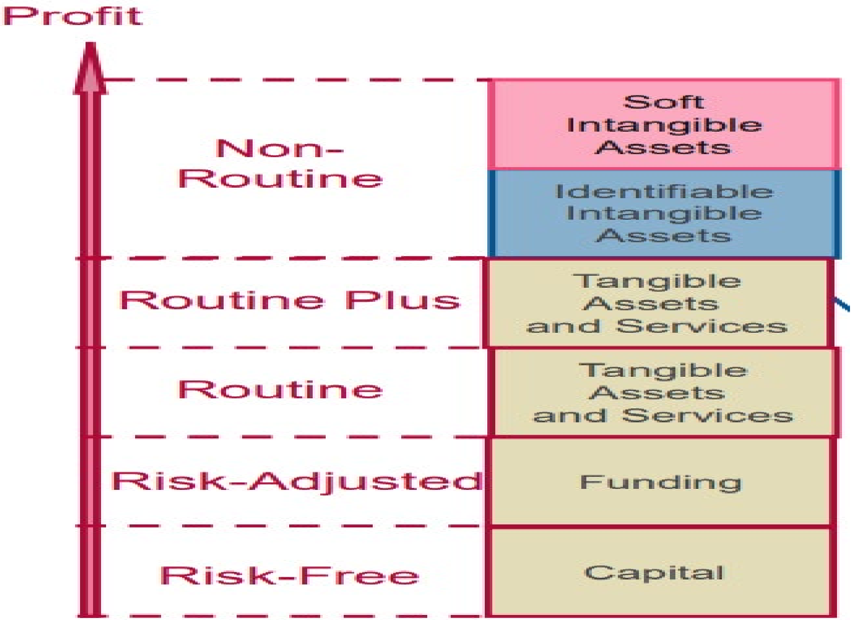
Christos Theophilou

Why Intangibles are Important

Intangible assets in 2020 account for 90% of the S&P 500's total assets.



Post-BEPS Remuneration Spectrum*



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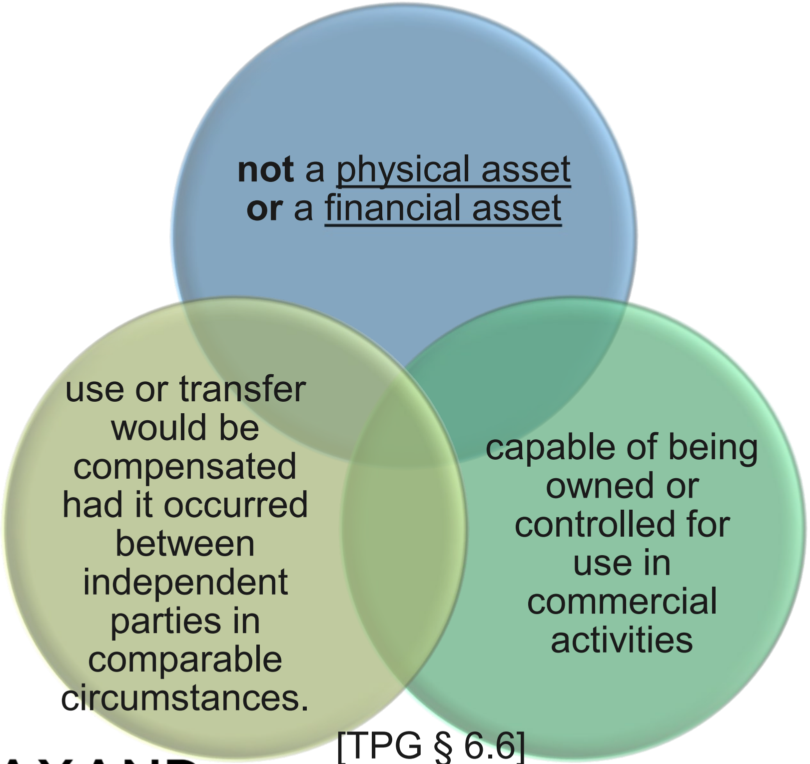
* Source IBFD

Definition of Intangibles



[TPG § 6.6]

Definitions and characterisations for accounting, legal and tax purposes are not relevant [TPG § 6.7]

The existence of legal protection and separate transferability is not a necessary condition [TPG § 6.8]

Not every Intangible requires compensation

Transfer Pricing Challenges for Intangibles: Definitions: 2022 OECD TPG vs IAS 38

Transfer pricing

- Something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances
- Patents; Know-how and trade secret; Trademark, trade names and brand; Rights under contracts and government licences; Licences and similar limited rights in intangibles; and Goodwill and ongoing concern value.
- Specific local market advantages, group synergies and assembled workforce are not classified as intangibles.

IAS 38

- An identifiable non-monetary asset without physical substance, controlled by the entity and held for use in the production or supply of goods or services, for rental to others, or for administration purposes.
- *<u>IAS 38 may require that intangible development be recorded as an expense and not capitalized and shown as an asset on the balance sheet. Yet, for TP purposes, there may be a valuable IP asset.</u>*

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Transfer Pricing Challenges for Intangibles: Definitions: 2022 OECD TPG Vs. Tax Treaties

Transfer pricing

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Tax Treaties

- The term "royalties" as used in this Article means **[1]** payments of any kind received as a consideration **[2]** **<u>for the use of, or the right to use</u>**, any **[3]** copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or concerning industrial, commercial or scientific experience.

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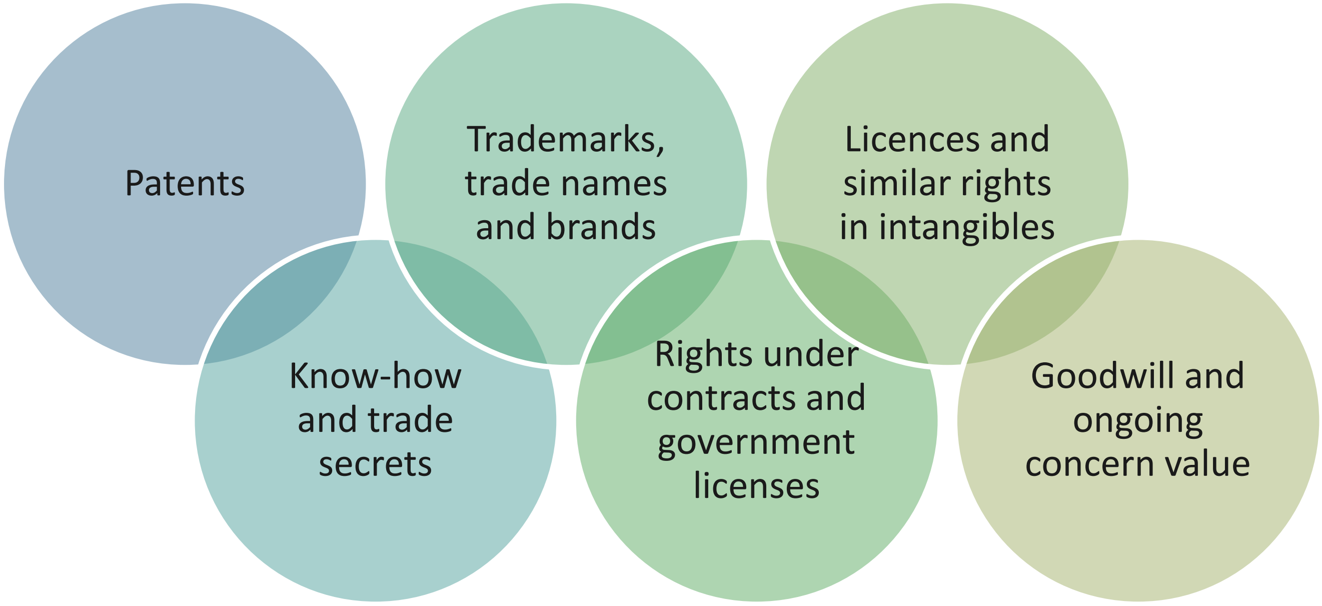
Types of Intangibles: Illustrations



- The following were **rejected** as intangibles because they are considered **comparability factors**:
  - Group synergies
  - Market specific characteristics

[TPG § 6.18-6.31]

Categories of Intangibles

- OECD provides for two commonly used terms, "**marketing intangibles**" and "**trade intangibles**".
- Yet distinctions are sometimes made between "**soft**" intangibles and "**hard**" intangibles, between **routine** and **non-routine** intangibles, and between other <u>classes and categories</u> of intangibles. [TPG § 6.15]

- IFA 2007 General Report, Intangibles can be classified into:
  - **marketing intangibles** (trademarks, trade names, brand names, copyright, franchises, licences, contracts, methods, systems, studies, forecasts, customer lists or technical data relating to marketing);
  - **manufacturing intangibles** (patents, inventions, formulae, processes, designs, patterns or knowhow); and
  - a third category that **does not fall neatly into either of the above two**.

Types of IP Tax Structuring

- Businesses often face **two crucial** considerations when organizing their intellectual property:

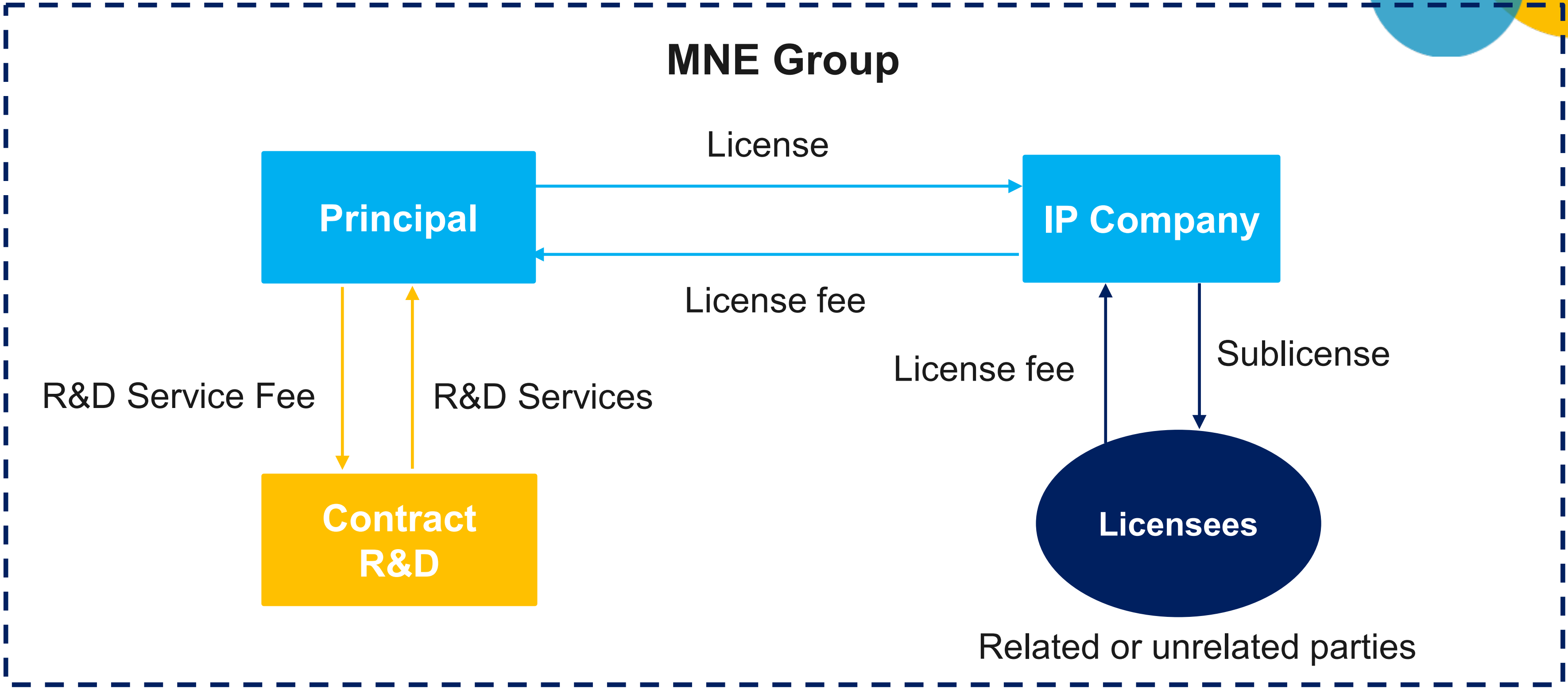
  1) Determining the location for IP development; and

  2) Deciding where to own the IP for exploitation.

IP Development
- Conventional Model
- Contract R&D Model
- Cost Contribution Model

IP Exploitation
- Conventional Royalty Model
- Principal Model
- Cost Contribution Model

Intangibles: Contract R&D Example



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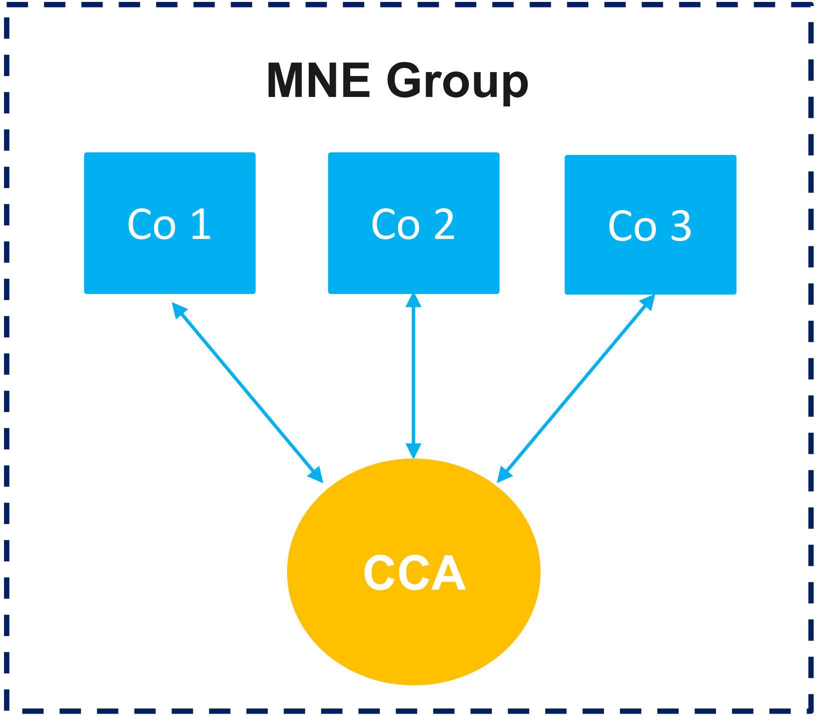
Intangibles: Cost Contribution Arrangements "CCAs" Example



- Separate legal entity not set up
- Developments costs shared by participants
- Cost sharing based on benefits to be received by each
- May require "buy-in" and "buy-out" payments if participants change

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Assessment of the Arm's Length Nature of Intangibles

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Practical Application of the ALP: 4 Step Approach

Step 1: Identification of the commercial or financial relations

Step 2: Recognition of the accurately delineated controlled transactions

Step 3: Selection of the most appropriate transfer pricing method

Step 4: Application of the selected transfer pricing method: Economic analysis (Benchmarking)

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Framework for analysing transactions involving intangibles: Six-step process

The allocation of returns from the exploitation of intangibles should especially be based on which parties perform the DEMPE functions, assume the risks and provide funds or other assets [OECD TPG 6.34]

1. **Identify** the **intangibles used** or transferred in the transaction with specificity, and the **economically significant risks** associated with the **Development, Enhancement, Maintenance, Protection and Exploitation** (**DEMPE**) of intangibles
2. **Identify** the full contractual arrangements, with special emphasis on determining **legal ownership** of intangibles
3. **Identify** the **parties** performing functions, using assets and managing **risks** related to the **DEMPE** of intangibles
4. **Confirm consistency** between the terms of the contractual arrangements and the conduct of the parties (allocation of risks)
5. **Delineate** the **actual** controlled transactions related to the DEMPE of intangibles
6. **Determine** arm's length prices for transactions consistent with each party's contribution of functions, assets and risks

[TPG § 6.35-6.72]

Going forward <u>Legal Ownership</u> becomes less important

Ownership of Intangibles

- IFA 2007 General Report, the Ownership of an intangible can be classified under any of three tests:
  - Legal Ownership;
  - Economic ownership; and
  - Ownership by agreement (may cover the partial transfer of rights, e.g. through a license agreement).

- Under the OECD:
  - Legal Owner?
  - Economic owner?
  - Functional owner?

Important Functions: Practical Examples

Intangibles: Self-developed or Acquired for Further Development	Other Functions of Intangibles Beyond Development
• Design and control of research and marketing programmes • Direction of and establishing priorities for creative undertakings including determining the course of "blue-sky" research, • Control over strategic decisions regarding intangible development programmes, management and control of budgets	• Important decisions regarding defence and protection of intangibles • Ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible

[TPG § 6.56]

Important Risks: Practical Examples

Development Risk	Including the risk that costly research and development or marketing activities will prove to be unsuccessful, and taking into account the timing of the investment (for example, whether the investment is made at an early stage, mid-way through the development process, or at a late stage will impact the level of the underlying investment risk);
Risk of product obsolescence	Including the possibility that technological advances of competitors will adversely affect the value of the intangibles
Infringement risk	Including the risk that defence of intangible rights or defence against other persons' claims of infringement may prove to be time consuming, costly and/or unavailing
Product Liability Risk	Product liability and similar risks related to products and services based on the intangibles
Exploitation Risk	Exploitation risks, uncertainties in relation to the returns to be generated by the intangible

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[TPG § 6.56]

How is income allocated between related parties from exploiting the intangible?

The legal owner of intangibles does not, in and of itself, necessarily imply that the legal owner is entitled to any income generated by the business after compensating other members of the MNE group for their contributions in the form of functions performed, assets used, and risks assumed [TPG 6.47].

All members of the group receive appropriate compensation for any functions they perform, assets they use, and risks they assume in connection with the development, enhancement, maintenance, protection, and exploitation of intangibles [TPG 6.48].

— Which member(s) perform and exercise **control** over **DEMPE**;

— Which member(s) provide **funding** and other assets; <u>and</u>

— Which member(s) **assume the various risks** associated with the intangible.

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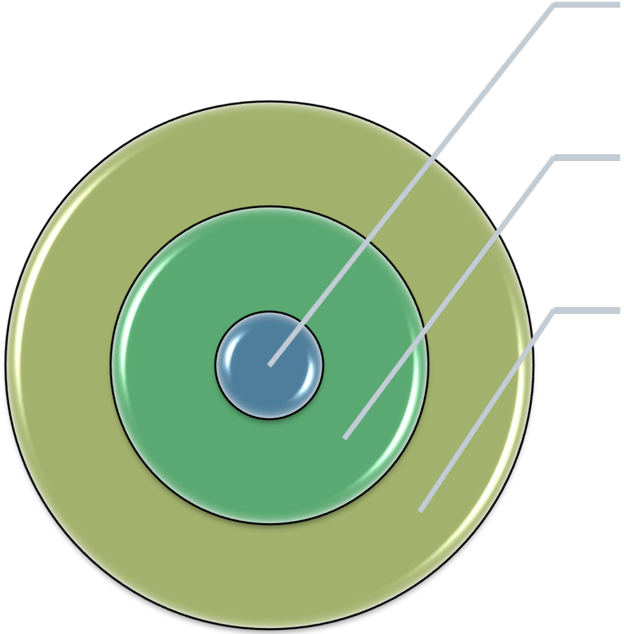
DEMPE and Income Attribution



Risk-free return → Entity with limited functions (i.e. Cash Box)

Risk-adjusted return → Entity with funding and financial risk)

Full intangible related return → Entity with full DEMPE* functions

*DAEMPE (UN), DEMPEP (China)

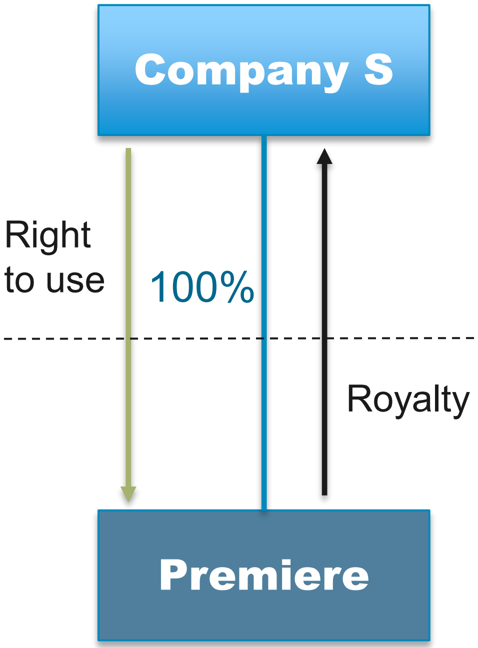
Non-Recognition

- An exception to the general principle of the recognition of the actual transactions, the tax authorities may depart from accepting a transaction when:
  - The **economic substance** of a transaction differs from its form; **or**

  - while the form and substance of the transaction are consistent, the arrangements made in relation to the transaction **viewed in their totality** nevertheless differ from those that would have been adopted by independent enterprises behaving in a **commercially rational manner** and the actual structure practically impedes the tax authorities from determining an appropriate transfer price

[TPG § 1.142]

Practical Example: Holding intangible and simply performing a patent administration function is not entitled to intangible related returns



- Company S employs **three lawyers** to perform its **patent administration** work and has no other employees
- Company S **does not conduct or control** any of the R&D activities of the Premiere group

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- Premiere **funds R&D** and performs ongoing R&D functions in support of its business operations.
- Premiere **performs all DEMPE functions** <u>except</u> for <u>patent administration</u> services.
- Premiere contributes and uses **all assets** associated with the development and exploitation of the intangible, and
- Premiere **assumes** all or substantially all of the **risks** associated with the intangibles.

<u>OECD Conclusion</u>

S is entitled to an arm's length price for the patent administration services and is **not entitled to any intangible related returns**

[OECD TPG Annex I Chapter VI]

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Poland vs "K.P.", October 2023, Provincial Administrative Court, Case No I SA/Po 475/23

Case Law Example

Facts of the Case (1)

- In December 2013, K.P., a Polish company (the **Parent** or **Licensee** or **Taxpayer**) engaged in retail sales of computers, peripheral equipment, and software, transferred valuable trademarks (the **IP Asset**) to its subsidiary (the **Subsidiary** or **Licensor**) in exchange for shares (i.e. contribution in kind). Parent incurred license fees for using these trademarks.

- In valuing the license fee to the Subsidiary for the use of the trademarks by the Parent, relied on formal legal ownership in granting a share of the revenue generated by the Parent despite the fact that the Subsidiary did not take any part in the creation of these revenues. As a result, almost all of Parent's profits were transferred as royalties to the Subsidiary

Polish tax authorities arguments (1)

- Parent reported a lower income than what would have been expected in the absence of such a relationship and therefore considered that the Parent had overstated its cost (i.e. by incurring excessive license fees).

- Deemed this arrangement commercially irrational and recharacterised it because, from the facts viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances.

- Relied on the 2017 OECD Guidelines example 1 of the Annex to Chapter VI

Polish tax authorities arguments (2)

- The business case lacks economic rationality because an independent entity wouldn't dispose of essential assets, finance their acquisition by another company, exchange shares for significantly lower value assets without compensation, and incur extra costs for licensing trademarks previously owned.

- The license agreement was, in substance, a contract for the provision of trademark administration services and therefore priced the controlled transaction using a mark-up on the total operating costs of the Licensee (median value of 6.91%).

- The Polish tax authorities rejected the taxpayer approach from using the comparable uncontrolled price method in pricing the license agreement in calculating the arm's length intra-group royalties.

Taxpayer arguments (1)

- Taxpayer won the case by arguing against the Polish tax authorities use of recharacterisation, introduced in 2019, for a tax year that started in April 2016 and ended in March 2017
- OECD Guidelines are not a binding law and should be treated as a “set of good practices”
- At the time of the license agreement, the 2010 OECD Guidelines was in force. The DEMPE concept, introduced in July 2017, couldn't be considered by the Taxpayer for the tax year spanning April 1, 2016, to March 31, 2017

Conclusion and Planning Points

- Had the transactions occurred post-2019 anti-avoidance provision and significant OECD Guidelines amendments, the outcome might have differed, with the tax authorities having stronger grounds to challenge the economic substance of the transaction

- If the European Commission's transfer pricing Council Directives proposal, announced on September 12, 2023, were enforced, tax authorities could use it to challenge transactions.

Conclusion and Planning Points

- The proposal aims to harmonise transfer pricing rules, incorporate the arm's length principle into Union law, clarify the role of OECD Guidelines, and create the possibility of establishing common binding rules within the Union.

- 2022 similar cases that tax authorities are more inclined to challenge the economic substance of the transaction:
  - Poland vs “Fertilizer Licence SA”, April 2022, Provincial Administrative Court, Case No I SA/Po 788/21
  - Poland vs “X-TM” sp. z o.o., March 2022, Administrative Court, SA/PO 1058/21

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- OECD/G20 BEPS Project, the 15 actions, click here.
- OECD Model Tax Convention on Income and on Capital: Condensed Version 2017, click here
- ATAD Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, click here.
- OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, click here.
- Proposal for harmonised transfer pricing rules in the EU click here
- Poland vs "K.P.", October 2023, Provincial Administrative Court, Case No I SA/Po 475/23click here
- Poland vs "Fertilizer Licence SA", April 2022, Provincial Administrative Court, Case No I SA/Po 788/21 click here
- Poland vs "X-TM" sp. z o.o., March 2022, Administrative Court, SA/PO 1058/21 click here
- Toshio Miyatake 'Transfer Pricing and Intangibles' (2007) 92A Cahiers de droit fiscal international, General Report to the IFA Congress

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Thank You!

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Christos is a tax expert who advises private and corporate clients on complex international tax and transfer pricing matters, such as cross-border investments, private equity structuring, structured finance, IP structuring and international trade.

Christos holds an MSc in Tax Law from Oxford University, a Bachelor's degree in Economics, and an LLB from Frederick University Cyprus. He is a Chartered Accountant in England & Wales and a Certified Public Accountant in Cyprus. He also has the Advanced Diploma in International Taxation (ADIT) from the UK Chartered Institute of Taxation.

Christos contributes to various international tax publications, such as IBFD, Tax Notes International, Bloomberg BNA, International Tax Review, Edward Elgar and IFA. He is a member of the Tax Policy and Strategy committee of the Institute of Certified Public Accountants of Cyprus.

Christos is a freelance lecturer for Tolley's (LexisNexis) and IBFD, where he teaches ADIT Paper 1 Principles of International Tax and Transfer Pricing. He is a frequent speaker at international tax conferences.

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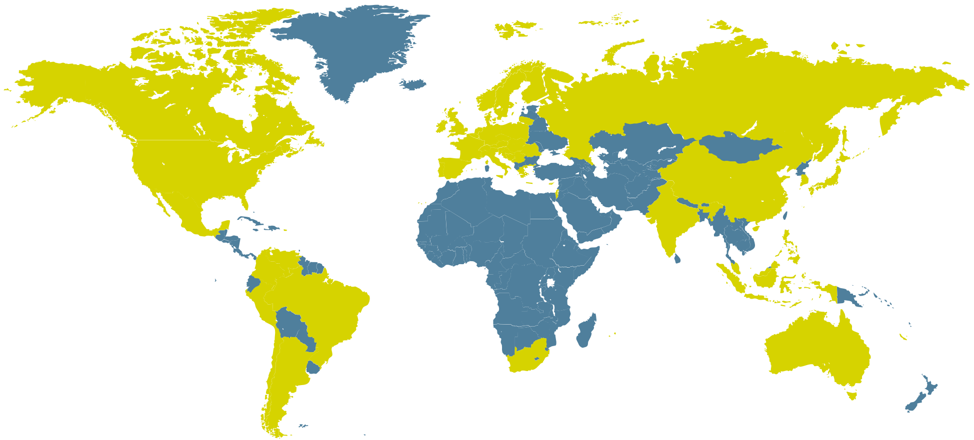

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Australia	Czech Republic	Israel	Peru	Slovenia
Austria	Denmark	Italy	Philippines	South Africa
Belgium	Finland	Japan	Poland	South Korea
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