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TRANSFER PRICING: WHAT HAS CHANGED IN OECD'S 2017 GUIDELINES? [PART 2]

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This article summarises the key additions/ modifications made in the 2017 Guidelines as compared to the earlier Guidelines. The first part of the article, published in the December issue of the Journal, discussed about the general guidance contained in Chapters I to V of the new Transfer Pricing Guidelines issued in 2017 (2017 Guidelines). This part of the article deals with guidance relating to specific transactions:

- Chapter VI – Special Consideration for Intangibles
- Chapter VII – Special Considerations for Intra-Group Services,
- Chapter VIII – Cost Contribution Agreements, and
- Chapter IX – Business Restructurings

1. Chapter VI - Special Considerations for Intangibles

The 2017 Guidelines have broadened the concept of 'intangibles' for transfer pricing purposes, and also provide detailed guidance on intangibles including several aspects of intangibles not addressed in the earlier guidelines. The key differences are discussed in this section.

1.1. Definition of intangibles

The 2017 Guidelines provide that the word 'intangible' is intended to address 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.**[1] The 2017 Guidelines provide that intangibles that are important to consider for transfer pricing are not always recognised as intangible assets for accounting purposes and the accounting or legal definitions solely may not be relevant for transfer pricing.

The 2017 Guidelines discuss that distinctions are sometimes sought to be made between (a) trade and marketing intangibles[2] (b) soft and hard intangibles (c) routine and non-routine intangibles and between other classes and categories of intangibles, but the approach to determine arm's length price does not depend on such categorisations.[3] An illustrative list of intangibles is also provided in the 2017 Guidelines. The Guidelines also provide that factors such as group synergies and market specific characteristics are not intangibles, since they cannot be owned or controlled by any one entity in the group.

1.2. Framework for transfer pricing analysis of transactions involving intangibles

Like any other transfer pricing matter, analysis of cases involving intangibles should be in accordance with principles outlined under Chapter I to III of the 2017 Guidelines. The Guidelines provide for a similar six-step framework for analysing transactions involving intangibles.[4]

1. Identification of specific intangibles and the risk relating to development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles
2. Determination of contractual arrangements including legal ownership of intangibles and contractual assumption of risk
3. Functional, Asset and Risk analysis in relation to the DEMPE of the intangibles
4. Confirmation of consistency between contractual assumption of risk with actual conduct of parties
5. Delineation of actual controlled transaction related to intangible considering legal ownership, contractual terms and conduct of parties
6. Determination of arm's length price taking into account the functional profile of the parties to the transaction

1 *Refer para 6.6 of 2017 Guidelines*

2 *Marketing Intangible and Trade Intangible have also been defined in the 2017 Guidelines.*

3 *Refer para 6.15 of 2017 Guidelines*

4 *Refer para 6.34 of 2017 Guidelines*

1.3. Intangible ownership and contractual terms relating to intangibles

The 2017 Guidelines specifically provide that legal ownership does not necessarily confer the right to returns generated from the intangible. The Guidelines give an example of an IP Holding Company which does not perform any relevant functions, does not employ any relevant assets and does not assume any relevant risks. The Guidelines provide that such party will be entitled to compensation, if any, only for holding the title to the IP, and not in the returns otherwise generated from the IP. The returns from the intangible, even though they accrue initially to the legal owner of the intangible, will need to correspond to the functions performed, assets employed and risks assumed by the different entities in the group.

1.4. Functions, Assets and Risks relating to Intangibles

1.4.1. Functions

The 2017 Guidelines provide that determining the party controlling and performing functions relating to DEMPE of intangibles is one of the key considerations in determining arm's length conditions for the controlled transactions.

In case some functions are outsourced, if the legal owner neither performs nor controls the outsourced functions relating to the DEMPE of intangible, it would not be entitled to any ongoing benefit attributable to the outsourced functions. Depending on the facts, the return for entities performing and controlling such functions may comprise a share of the total return derived from exploitation of the intangible.

1.4.2. Assets

The 2017 Guidelines provide for considering important assets and specifically identify intangibles used in research, development or marketing, physical assets and funding.

Unlike the earlier guidelines, there is a detailed discussion in the 2017 Guidelines on funding, and returns corresponding to funding. The Guidelines provide that funding returns from intangibles would depend on the precise functions performed and risks undertaken by the funder. An entity providing funding but not controlling risks or performing functions relating to the funded activity would be entitled to lesser returns than an entity which also performs and controls important functions and controls important risks associated with the funded activity.

In the context of funding, the Guidelines distinguish between financial risks (risks relating to funding/ investments) and operational risks (risks relating to operational activities for which the funding is used). If the investor controls the financial risk associated with the provision of funding, without the assumption of operational risks, it could generally expect only a risk-adjusted return on its investments.

1.4.3. Risks

The 2017 Guidelines specifically identify risks relating to transactions involving intangibles, such as risks related to development of intangibles, risk of product obsolescence, infringement risk, product liability risk, and exploitation risk.[5] A detailed analysis of the assumption of these risks with respect to functions relating to the DEMPE of intangibles is crucial.

The Guidelines also provide that generally, the responsibility for the consequences of risks materialising will have a direct correlation to the assumption of risks by the parties to the transaction.

1.5. Actual (*ex post*) Returns

The 2017 Guidelines also discusses regarding sharing of profit/losses among group entities in case of variation between actual (*ex post*) and anticipated (*ex ante*) returns.

The 2017 Guidelines provide that the entitlement of the group entity to the variation depends on which party assumes the risks identified while delineating the actual transaction. The entitlement also depends on performance of important functions or contributing to control of economically significant risks, and for which an arm's length remuneration would include a profit-sharing element.

1.6. Illustration on application of arm's length principle in certain specific fact patterns

The 2017 Guidelines identify specific commonly found fact patterns and provide useful guidance on those and provide detailed guidance on these situations. These are briefly discussed in this section.

1.6.1. Marketing intangibles

The 2017 Guidelines discuss a common situation where a related entity performs marketing or sales functions

5 *Refer para 6.65 of 2017 Guidelines*

that benefit the legal owner of the trademark – through marketing arrangements or distribution/marketing arrangements.[6]

The Guidelines provide that such cases require assessment of:

- Obligations and rights implied by the legal registrations and agreements between the parties;
- Functions performed, assets employed and risks assumed by the parties;
- Intangible value anticipated through the marketer/distributor's activities; and
- Compensation provided to the marketer/distributor.

The Guidelines then provide that any additional compensation for the marketer/distributor will arise if it is not already adequately compensated for its functions through the contractual arrangement.

1.6.2. Research, development and process improvement arrangements

The 2017 Guidelines provide that in cases involving contract research and development activities, compensation on a cost plus modest mark-up basis may not reflect arm's length price in all cases. While determining the compensation, the Guidelines give much weightage to the research team, i.e., including their skills and experience, risks assumed by them, intangibles used by them, etc. Similarly, analysis would be required in case of product or process improvements resulting from the work of a manufacturing service provider.

1.6.3. Payment for use of company name

The 2017 Guidelines provide that generally, no compensation should be paid to the owner of the group name for simple recognition of group name, or to reflect the fact of group membership. A payment would be due only if the use of the group name provides a financial benefit to the entity using the group name. Similarly, where an existing successful business is acquired by another business, and the acquired business begins to use the group name, brand name, trademark, etc., of the acquirer, there should be no automatic assumption that the acquired business should start paying for such use of the group name and other intangibles. In fact, in a case where the acquirer leverages the existing positioning of the acquired business to expand to new markets, one should evaluate whether the acquirer should pay a compensation to the acquired business.

1.6.4. Other specific cases

The 2017 Guidelines also provides guidance on various other specific fact patterns involving intangibles such as transfer of all or limited rights, combination of intangibles, transfer of intangibles with other business transactions, use of intangibles in connection with sales of goods/services.

1.7. Comparability factors

The 2017 Guidelines provide detailed guidance on comparability factors relating to intangibles. These factors should be considered in a comparability analysis especially under the CUP Method (say, benchmarking analysis to find comparable royalty rates for use of intangibles). The comparability factors specifically mentioned, although not exhaustive, include exclusivity; extent and duration of legal protection; geographic scope; useful life; stage of development; rights to enhancements, revisions and updates; and expectation of future benefit.

Similarly, some key risks that need to be analysed for a comparability analysis include risks related to future development of the intangible, product obsolescence and depreciation, infringement risks, product liability risks, etc.

1.8. Valuation of intangibles

The 2017 Guidelines tend to favour the CUP Method and the transactional profit split method for valuing intangibles. The Guidelines also recognise valuation techniques as useful tools. One-sided methods including RPM and TNMM are generally not considered reliable for directly valuing intangibles.

Use of cost-based methods for valuing intangibles have also been largely discouraged, other than in limited circumstances involving, say, development of intangibles for internal business operations, especially when such intangibles are not unique or valuable.

The Guidelines have provided detailed guidance on the use of Discounted Cash Flow (DCF) Method or other similar valuation methods for valuing intangibles. Having said that, the Guidelines also caution that because of the heavy reliance on assumptions and valuation parameters, all such assumptions and parameters must be appropriately documented, along with the rationale for

6 *Refer para 6.76 of 2017 Guidelines*

using the said assumptions or parameters. The Guidelines also recommend taxpayers to present a sensitivity analysis, with alternative assumptions and parameters, as part of their transfer pricing documentation.

1.8.1. Intangibles having uncertain valuations

In cases involving intangibles the valuation of which is highly uncertain at the time of the transaction, the 2017 Guidelines provide guidance on a much broader concept of arm's length behaviour. The Guidelines *inter alia* provide that in case the valuation of the intangible is highly uncertain at the time of the transaction, the parties to the transaction would potentially adopt short-term agreements, include price-adjustment clauses, adopt a contingent pricing arrangement, or even renegotiate the terms of the transaction in some cases.

1.8.2. Hard-to-Value Intangibles (HTVI)

HTVIs include intangibles for which, at the time of their transfer, (i) no reliable comparables exist, and (ii) it is difficult to predict their level of success.

The 2017 Guidelines make an exception regarding the use of *ex post* results, and provide that in certain cases involving HTVIs, and subject to certain safeguards and exemptions, *ex post* results can be considered as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements. The Guidelines also provide a safe harbour of 20%, within which valuation based on *ex ante* circumstances should not be questioned and replaced by valuation based on *ex post* results.

2. Chapter VII – Special Considerations for Intra-Group Services

In the analysis of transfer pricing for intra-group services, one key issue is whether intra-group services have in fact been provided, and the other issue is, what is the intra-group charge for such services under the arm's length principle. Detailed guidance has been provided in the 2017 Guidelines on various aspects in the context of intra-group services such as shareholders' activities, on call services, form of remuneration, determination of cost pools, documentation and reporting, levy on withholding tax on provision of low value-added intra-group services.

2.1. Low Value Adding Intra-Group Services

The 2017 Guidelines recommend an elective, simplified transfer pricing approach relating to particular category of intra-group services referred to as **low value adding intra-group services.** Under this approach, subject to fulfilment of certain criteria, the arm's length price of the services would be considered to be justified without specific benchmarking and detailed documentation of the benefit test by the recipient.

The guidance provided in the 2017 Guidelines are summarised below.

Characteristics	Supportive; not core business; no use/creation of unique/valuable intangibles; no assumption, control, creation of significant risk
Exclusions	Core business; R&D; manufacturing and production; purchasing; sales, marketing, distribution; financial transactions; senior management etc.
Inclusions	Accounting, auditing; accounts receivable, payable; HR; IT; communications and PR; legal, tax; administrative/clerical services etc.
Documentation	Simplified benefits test and other documentation; at the level of the MNE headquarters
Cost Pools & Allocations	Accurate determination of allocable costs; scientific allocation keys
Mark-up on costs	5%
Thresholds	Availability subject to thresholds based on costs/profits

3. Chapter VIII – Cost Contribution Arrangements

The 2017 Guidelines provide that a Cost Contribution Arrangement (CCA) is a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services, with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants.

Two types of CCAs are commonly encountered: (1) Joint development, production or the procurement of intangibles or tangible assets ("Development CCAs"); and (2) Procurement of services ("services CCAs").

With regard to application of arm's length principle, the general guidance provided in the 2017 Guidelines, including the risk analysis framework, also apply to CCAs. To apply the arm's length principle to a CCA, it is therefore a necessary precondition that all the parties to the arrangement have a reasonable expectation of benefit. The next step is to calculate the value of each participant's contribution to the joint activity, and finally to determine whether the allocation of CCA contributions (as adjusted for any balancing payments made among participants) accords with their respective share of expected benefits.

The Guidelines also provide that the guidance provided in Chapter VI relating to intangibles and Chapter VII relating to intra-group services also apply to CCAs, to the extent relevant.

Further, the Guidelines provide specific additional guidance in the following areas:

3.1. Participants

A participant must be assigned an interest or rights in the intangibles, tangible assets or services that are the subject of the CCA and should have a reasonable expectation of being able to benefit from that interest or those rights. The Guidelines discuss in detail regarding determination of participants in CCAs.

3.2. Expected benefits

In determining the participants' share of expected benefits, the 2017 Guidelines encourage the use of relevant allocation keys. The Guidelines also provide that the CCA should provide for a periodic reassessment of allocation keys. Consequently, the relevant allocation keys may change over a period of time, and this may lead to prospective adjustments in the share of expected benefits of the participants.

3.3. Value of Contributions

The 2017 Guidelines recommend distinguishing between pre-existing contributions and current contributions for the purpose of valuing them. Any pre-existing contributions (say, any existing patented technology) should generally be valued at arm's length based on the general guidance provided in the 2017 Guidelines, including the use of valuation techniques. However, any current contributions (say, ongoing R&D activities) should be valued based on the value of the functions themselves, rather than the potential value of the future application of such functions.

3.4. Documentation

The 2017 Guidelines emphasise that taxpayers should provide detailed documentation relating to CCAs as a part of the master file. Additionally, the local file should also contain transactional information including a description of the transactions, amounts of payments and receipts, identification of the associated enterprises involved, copies of inter-company agreements, pricing information and satisfaction of the arm's length principle. The Guidelines also provide for an additional disclosure of management and control of CCA activities and the manner in which any future benefits from the CCA activities are expected to be exploited.

4. Chapter IX - Business Restructurings

The 2017 Guidelines contain an elaborate discussion on transfer pricing aspects of business restructurings. Business restructuring refers to the cross-border reorganisation of the commercial or financial relations between associated enterprises, including the termination or substantial renegotiation of existing arrangements.

Business restructurings may often involve the centralisation of intangibles, risks or functions with profit potential attached to them.

As compared to the earlier guidelines which included conversion of full-fledged distributors or manufacturers to low risk ones and also included transfers of intangibles, the 2017 Guidelines also include concentration of functions in a regional or central entity with corresponding reduction in scope or scale of functions carried out locally, as a business restructuring transaction.

The Guidelines address two aspects of a business restructuring – i) arm's length compensation for the restructuring itself, and ii) arm's length pricing of post-restructuring transactions.

Some key additional guidance provided in these Guidelines is discussed in this section.

4.1. Arm's length compensation for the restructuring itself

4.1.1. Accurate delineation of the restructuring transaction

The general guidance relating to arm's length principle is applicable also for business restructuring. The 2017 Guidelines recommend performing accurate delineation of transactions including detailed functional analysis in pre and post-restructuring scenarios. In doing so, the Guidelines place special emphasis on the risks transferred as a part of the restructuring, and importantly, whether such risks are economically significant (i.e., whether they carry significant profit potential and hence, may explain a significant reallocation of profit potential).

Like earlier guidelines, one needs to also analyse the business reasons for and expected benefits from restructuring, and other options realistically available to the parties.

4.1.2. Transfer of something of value

The 2017 Guidelines provide that in case **physical assets** such as inventories are transferred between foreign associated enterprises as a part of the restructuring, the valuation of such assets is likely to be resolved as a part of the overall terms of the restructuring. In practice, there may also be an inventory rundown period before the restructuring becomes effective, to mitigate complications relating to cross-border inventory transfers.

Similarly, in case **intangibles** are transferred as a part of the restructuring, the Guidelines provide that the valuation of such intangibles should be done in line with the guidelines provided for valuation of intangibles, including guidance provided for valuing HTVIs (Chapter VI).

In case of transfer of an **activity**, the 2017 Guidelines are aligned with the earlier guidelines and provide that the valuation of such an activity should be done as a going concern of the entire activity, rather than individual assets.

4.1.3. Indemnification for termination or substantial renegotiation of existing arrangements

Indemnification means any type of compensation that may be paid for detriments suffered by the restructured entity, whether in the form of an up-front payment, of a sharing in restructuring costs, of lower (or higher) purchase (or sale) prices in the context of the post-restructuring operations, or in any other form.

The 2017 Guidelines provide for consideration of the following aspects in this regard:[7]

- Whether, based on facts, the commercial law supports the right to indemnification for the restructured entity
- Whether the indemnification clause, or its absence, is at arm's length
- Which party should bear the indemnification costs

Each of the above aspects has been discussed in detail in the OECD guidelines.

4.1.4. Documentation

The 2017 Guidelines provide for documenting important business restructuring transactions in the master file. Further, in the local file, taxpayers are required to indicate whether the local entity has been involved in, or affected by, business restructurings occurring in the past year, along with related details.

4.2. Arm's Length compensation for post-restructuring transactions

The 2017 Guidelines, like the earlier guidelines, provide that the arm's length principle should apply in the same manner to restructured transactions, as they apply to transactions which were originally structured as such.

Further, there could be inter-linkages between the restructuring and the business arrangement post-restructuring. In these situations, the compensation for the restructuring and for the subsequent controlled transactions could be potentially dependent on each other, and may need to be evaluated together from an arm's length perspective.

7 *Refer para 9.79 of 2017 Guidelines*

5. Concluding Remarks

The 2017 Guidelines have addressed some key challenges faced by taxpayers with respect to the specific transactions/situations covered in this part of the article. In several situations, the Guidelines provide for arm's length behaviour in principle, considering the overall scheme of things, and not merely evaluating the price of isolated transactions.

In the Indian context, transfer pricing for transactions involving intangibles appears to be a significant focus area for Indian tax authorities. Analysis of control of functions and assumption of risks vis-à-vis provision of funding in transactions relating to intangibles is extremely pertinent in the Indian context given India's leading position as a preferred destination for several MNCs for intangible creation/upgradation in verticals such as technology, engineering, pharma, etc.; and also given the huge marketing and promotional spend incurred by many Indian distributors. The guidance also aligns, in principle, with the approach of valuing intangible transfers using a DCF approach, *albeit* with several safeguards relating to the assumptions and other parameters used for valuations. Overall, the guidance provided in the 2017 Guidelines is largely being implemented by tax authorities, as evidenced by the nature of queries and depth of discussions during APAs as well as transfer pricing audits.

Guidance on low value adding intra-group services has already been largely implemented in the Indian safe harbour rules.

The 2017 Guidelines also provide several examples relating to intangibles and CCAs in Annexes to Chapters VI and VIII, respectively. Readers are encouraged to study the examples for a better understanding of these concepts. ■

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