OECD Draft on Intangibles and Planning Implications

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With developments on 'GAAR' and 'Vodafone' taking centre stage, structural or transactional issues have remained at forefront and the not so perceptible or the so to speak 'intangible' related tax issues have taken backseat. However, now more than ever before and for reasons more than one, Transfer pricing of intangibles has come to forefront calling for immediate attention of taxpayers and practitioners alike.

Recently, on June 6, 2012 the OECD released a Discussion Draft on intangibles ('discussion draft') providing policy direction on several aspects pertaining to Transfer Pricing of intangibles. Published well ahead of schedule, the discussion draft provides valuable guidance on definition, identification and allocation aspects of intangible related returns.

From an India perspective, the timing of the Draft could not have been better for a number of reasons. Under Finance Act, 2012 India has recently adopted (retrospectively from AY 2002) an expanded definition of 'intangible property' covering ten different kinds of intangibles - marketing, technology, artistic, engineering, customer, location, human capital and a few others - and as if that was not enough, a residual clause covering *'any other item deriving its value from intellectual content'* is also provided. Further, for those acquainted with Indian Transfer Pricing, it is trite that 'marketing intangibles' has attracted significant attention culminating into high value adjustments for multinational taxpayers. With the above as background, this article examines OECD recommendations (as yet in draft form) on Transfer Pricing of intangibles and their relevance in Indian context – particularly in light of the amended definition of 'intangible' provided under Indian tax code.

<u>Overview of Discussion Draft</u>

The discussion draft is divided into five parts:

Part A deals with the *identification of intangibles* supported with multiple illustrations on what would constitute an intangible.

Part B focuses on *identification of members entitled to intangible related returns* under controlled conditions.

Part C deals with *use or transfer (partial or absolute) of intangibles* in controlled transactions.

Part D focuses on comparability and valuation aspects of intangibles. The discussion draft concludes with 22 illustrations on Transfer Pricing aspects of intangibles – the same have been classified below based on area of focus.

<u>Examples in OECD Discussion Draft</u>

Example No.	Topic
Example 1	Economic versus legal ownership
Example 2	Limited risk distributor
Examples 3 to 8	Marketing intangibles
Examples 9 to 11	Contract and entrepreneurial R&D centres
Example 12	Geographical scope of license agreement
Example 13	Sale of intangibles as part of going concern
Example 14	Economic ownership (emphasis on ‘control’ functions)
Example 15	Internal business re-structuring
Example 16	Transfer of intangibles
Example 17	Human capital related intangible
Example 18	Transfer of intangibles
Example 19	Discounted cash flow analysis
Examples 20 to 22	Price adjustment clause

The above examples provide useful guidance in understanding inter-play of different factors such as legal title, functions and costs in determining return attribution for intangibles. However, for sake of brevity, this article focuses on certain key concepts that knit together different parts and examples of the entire discussion draft.

Triumph of ‘Economic Ownership’

Ownership of an intangible can be of two kinds - ‘de-jure’ ie ‘legal’ ownership based on legal registration and like formalities or ‘economic’ or ‘de-facto’ ie ownership based on contribution towards or critical decision making in respect of an intangible’s development. The decision making can relate to the quantum of expenditure, its direction, scope, nature and other such modalities pertaining to development of intangible. The locus of ‘legal’ and ‘economic’ ownership may often coincide or it can even remain separate - a finding that needs to be made separately in each factual setting.

Without referring to the concept of ‘economic ownership’ as such, the discussion draft repeatedly drives at it holding performance of functions and the bearing of risks and costs relating to intangible development as conclusive for ‘intangible return’ entitlement. In the event of a conflict between legal and ‘economic’ ownership, intangible related returns will be allocated to the entity which *“as a matter of substance, performs the functions, bears the risk and costs relating to the development, enhancement, maintenance and protection of intangibles*.” In other words, the discussion draft accords clear precedence to ‘economic’ over ‘legal’ ownership for attributing intangible related return.

‘Who does what’ – focus on functions, risk and cost

While an entity may legally own an asset, the ‘functions’/ ‘risk’ associated with its use or development may lie elsewhere. For determining ‘economic’ ownership what is material is not the locus of ‘title’ (by law or contract) but the locus of functions pertaining to *creation, control* and *funding* of intangible. To illustrate in the context of a marketing intangible, the performance of functions pertaining to budgeting, direction of marketing programme, choice of marketing media and other strategic decisions is crucial (as opposed to legal registration of trademark/ product name) in determining which entity is entitled to intangible related return.

An interesting question is what happens if there is a conflict between the ‘funding’ and ‘control’ functions. In this regard, the discussion draft states that *“bearing costs related to the development, enhancement, maintenance and protection of intangibles does not, in and of itself, create an entitlement to intangible related returns”*. In other words, as per the discussion draft, the entity in charge of developing, enhancing or maintaining the intangible should be entitled to the supernormal return and not the entity that merely funds its development. Hence, the dominance of 'control' vis-a-vis the 'funding' function is clearly evident.

Guidance on Marketing Intangibles

At this juncture, it may be appropriate to consider Indian Revenue's position on determination and application of the 'bright line' test[1] in the context of marketing intangibles. In simple terms, 'bright line' is a watermark defining the limit of 'routine' or 'permissible' marketing expenditure for a given industry. To determine the 'bright line', comparable product or service providers are identified and their average marketing spend is computed. Thereafter, the 'excess' of taxpayer's marketing expenditure over and above such 'average' is disallowed on the ground that it fails the industry standard. Revenue's argument for disallowance is that the 'excessive' expenditure benefits only the parent (whose brand is promoted) and not the subsidiary.

Though the discussion draft does not expressly refer to 'bright line' concept, it discusses examples wherein tax authorities would (or would not) be justified in making adjustments on account of excessive marketing spend. In its analysis of return attributable to marketing intangible, the discussion draft attaches particular importance to the rights and obligations of entities inter-se, the functions performed, risks assumed and the costs borne in the creation and development of the marketing intangible. In summary, the question of marketing intangible ownership is a highly fact specific question governed by the detailed functional analysis in each case.

Human Capital Related Intangibles

While the discussion draft does not regard an isolated employee as an intangible, it recognizes that the transfer of an assembled workforce can entail a number of intangible related questions. Hence, the transfer of an assembled workforce may as a factual matter result in the transfer of valuable know-how or trade secrets for which compensation may be required in an arm's length dealing. Similarly, the long term contractual right to use services of a uniquely qualified workforce may constitute an intangible under particular circumstances.

The amended definition of 'intangibles' under Indian Tax Code (post Finance Act, 2012) also includes human capital related intangibles such as trained and organized workforce, employment agreements and union contracts. A similar position exists in some other jurisdictions notably Japan, China, and Australia that recognise human capital (under specific factual settings) as an intangible for transfer pricing purposes.

Planning Implications

Though, the OECD work is in draft stage, a number of valuable insights can be gleaned. The Draft acknowledges that not all intangibles important for transfer pricing purposes are recognised as intangibles for accounting or legal purposes. Hence, for Transfer Pricing purposes taxpayers need to be vigilant and exercise high degree of care while identifying intangibles involved in inter-company dealings.

In the Indian context, the amended definition of 'intangible property' matches the intent of discussion draft as it provides a broader definition transcending the conventional understanding of intangible property. The amended definition includes newer kinds of intangibles such as human capital, customer, contract and location related intangibles. In-fact, the expanded definition castes an onerous burden on taxpayer to identify, report and value all intangibles involved in related party dealings.

The OECD work may also be viewed as an unequivocal votary of 'substance over form' as it gives overriding importance to 'economic' as against 'legal' ownership. This concept is extended still further to give greater importance to decision making functions where there is a conflict between 'funding' and 'control' functions.

In the Indian context, the existing regulations do not provide any express guidance on the ownership question. However, one can say that in absence of specific guidance, OECD commentary and internationally accepted principles may be referred as has been the trend in past (in line with numerous Tribunal and Court Rulings). Moreover, inasmuch as the regulations emphasize on functions performed, assets employed and risks assumed, the argument of 'people functions' determining intangible return entitlement assumes importance even in Indian context. Interestingly, in Foster's Ruling[2] relying on foreign judicial decisions, the Authority for Advance Rulings held that the place of 'use and development' determined the locus of marketing intangibles and not the situs of legal registration.

All in all, the OECD view with its focus on economic ownership may well be a shot in the arm for Revenue Authorities in the crusade against tax evasion. Housing intangibles in a low tax jurisdiction would no longer serve the purpose unless ‘people functions’ corresponding to intangibles are performed in the same jurisdiction. Not even funding (alone) is sufficient for staking a claim on intangible return. While surprising at first, the argument does have reasoning. Should intangible ownership be based on title or funding (alone), re-structuring of risks/ reward would be tad easy enabling rampant tax avoidance and abuse by a mere re-location of title or funding sources. Surely the time has come to re-look at intangibles in earnest and in ‘substance’ ensuring alignment of contractual entitlements with *‘who does what’.*

This article has been authored by Mr. Ashutosh Mohan Rastogi, assisted in research by Mr. Philip Mathew. Views expressed are personal.

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[1] The concept was used for the first time in a celebrated US Court of Appeals decision in the case of DHL in 2002.

[2] AAR No. 736 of 2006