Transfer pricing consideration for intangible property and intragroup services

by: The International Tax Office, KRA

1. Evans Sang
2. Mercy Mbithi

9th March 2023

Introduction

- The guidance given by the OECD transfer pricing guidelines on comparability analysis and selection of the most appropriate method in a given case cut across all manner of transactions (Chapters II & III).
- However the OECD saw it fit to provide further specific guidance on these with regards to intangible property (Chapter VI) and intragroup services (Chapter VII)
- This is due to the unique challenges presented by these two elements of intragroup dealings.

Introduction

- Current developments in the international business arena driven by globalization and digitalization have made the need for revenue authorities to focus on transfer pricing on transactions involving intangible property and intragroup services even more acute.
- The digitalization of the economy has for instance accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations.
- The most important value drivers of the business of the largest multinational enterprises are no longer physical assets such as land and buildings but intangible assets such as patents, brands, knowhow, customer relationships etc.

Transfer pricing consideration for intangible property

Definition

- **Definition -** Intangible asset is 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 had it occurred in a transaction between independent parties in comparable circumstances.”
- The term “intangible” addresses something which is:-

✓not a physical asset or a financial asset;

✓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.

- Intangibles that are important for transfer pricing are not necessarily recognized for accounting purposes. E.g. the expensing of marketing & advertising and R&D expenditure in books of accounts rather than capitalizing them.

Why consider intangibles?

The law – Rule 6(c) TP rules, 2006 sale or licensing of intangibles be subjected to TP analysis

Easy to move across borders- not physical

Different tax regimes for intangibles across different jurisdictions e.g. amortization, not charging WHT on royalty income

Existence of low tax jurisdictions and tax havens

Actions of MNEs

business restructuring; Centralization of R&D, moving of intangibles, charging royalties and technical fees

Effect of the actions of MNEs; stripping of income earning IPs from local entities, increased royalty expenses, increased charges for R&D expenses, increased expenses for technical support

Identification of specific intangibles

- Identification of an intangible is different from determination of the price for its use or transfer.
- Not all intangibles deserve a compensation for their use or transfer. E.g. if a manufacturer uses non-unique know-how which is available to comparable manufacturers, no return should be paid.
- Care should be taken in determining whether or when an intangible exists and whether an intangible has been used or transferred. E.g. not all research and development or marketing activities lead to the creation of an intangible
- Has a valuable asset been developed which can be commercially exploited?

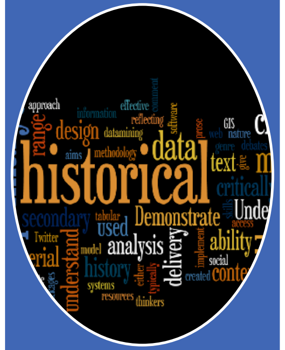
Identification of specific intangibles

The following are some of the intangibles recognized for transfer pricing:-

- Patents;
- Know-how and trade secrets;
- Trademarks;
- Trade names;
- Brands;
- Rights under contract and Government licenses;
- License and limited rights in intangibles;
- Goodwill (Reputational value)

Approaches to identification of IP

Interviews



Historical background of the company

Financial information released for investors (e.g. IPOs)

- extraordinary rates of return
- inter-company agreements

Annual reports

Marketing programs and associated material

Business and media publications

Customers and competitors

Company websites

Approaches to identification of IP

- research and development activities
- equipment source
- equipment modifications
- engineering change orders
- capital requisition
- design and layout of machinery

Categories of intangibles

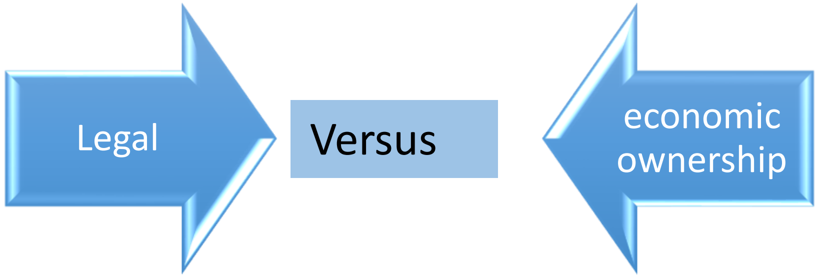
Intangibles are largely categorized into trade (e.g. patents, Production processes and Know-how) and marketing intangibles (e.g. customer lists, unique names and symbols).

Intangibles can further be categorized as either "unique and valuable" or "non-unique".

"Unique and valuable" intangibles are those:-

(i) that are not comparable to intangibles used by or available to parties to potentially comparable transactions, and

(ii) whose use in business operations is expected to yield greater future economic benefits than would be expected in the absence of the intangible.



- One of the critical consideration under intangibles is identification of the legal and economic owner of the intangible.

Legal Ownership

- This can be noted from:-

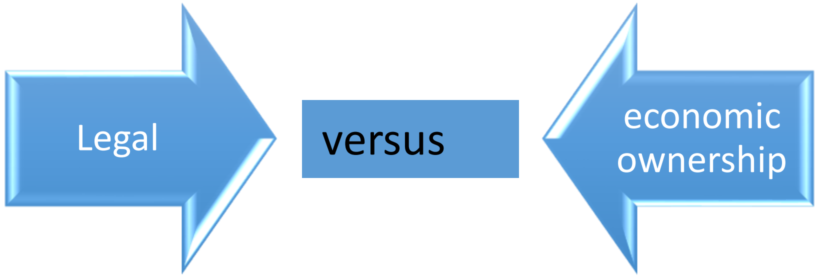
✓ Written contracts;

✓ Registration documents of the intangibles;

✓ Correspondence between the parties; and

✓ Where no contract, it may be inferred from conduct of the parties.

- Legal owner has exclusive legal and commercial right on use and protection of the intangible.
- When the relevant registrations and contractual arrangements are consistent with the conduct of the parties, the legal owner will generally be considered the sole owner of the intangible for transfer pricing purposes.



- The legal owner is simply a reference point for identifying and analyzing controlled transactions. Hence, what is ultimately retained by the legal owner depends upon his contribution to the anticipated value of intangible through functions performed, assets used and risks assumed.
- Hence, the other MNE members may have a claim over the intangible depending on their contribution to its development, enhancement, maintenance and protection.
- **Exploitation of intangibles should as such be shared based on the contribution made by MNE members towards its value.**

Functional analysis

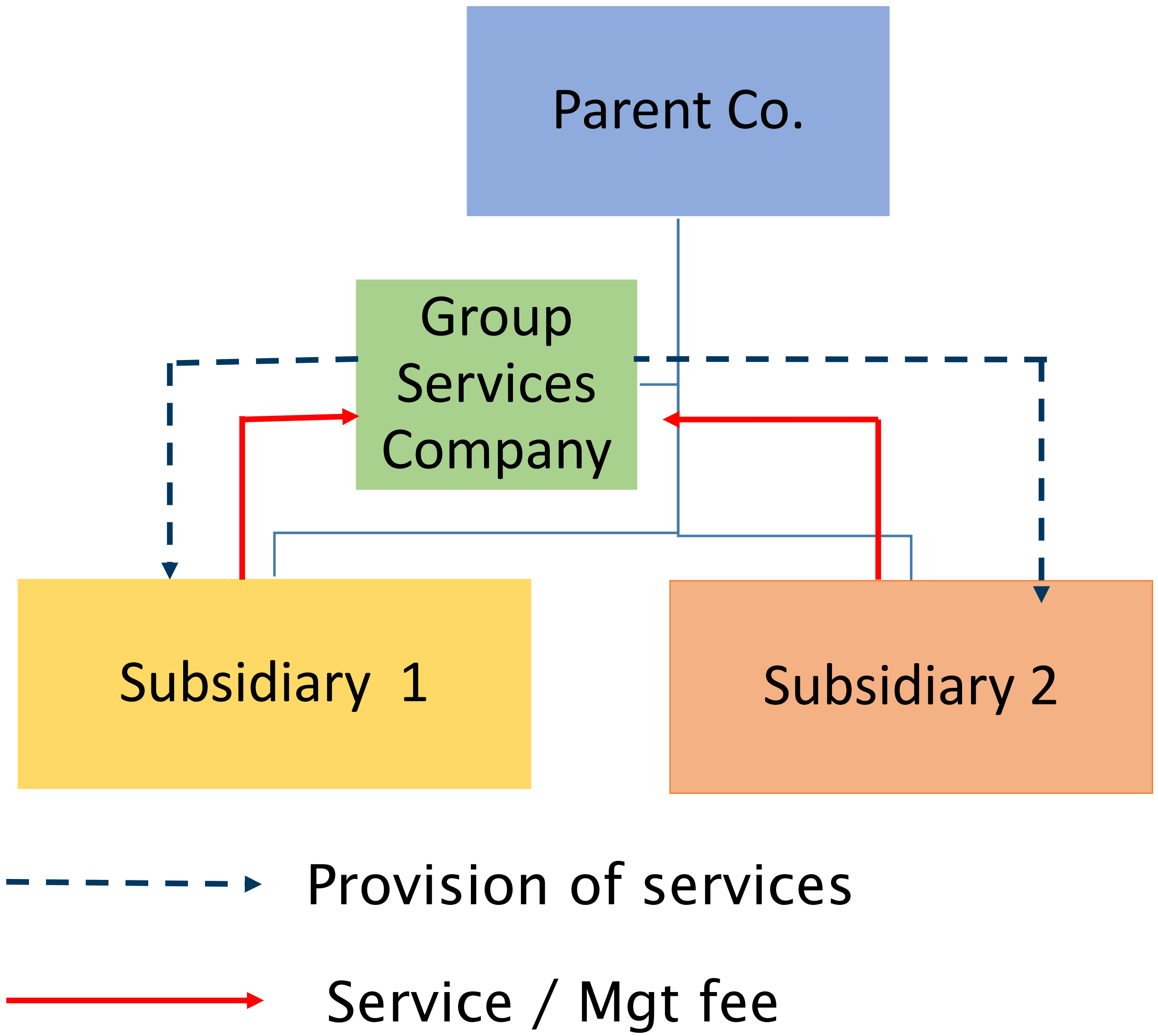
- We consider the functions performed, assets used and risks assumed towards the **D**evelopment, **E**nhancement, **M**aintenance, **P**rotection and **E**xploitation of intangibles
- This helps in the determination of the division of profits emanating from the use or transfer of the intangible property.

Determination of arm’s length condition

- The use or transfer of intangibles may raise challenging issues regarding comparability, selection of transfer pricing methods, and determination of arm’s length conditions for transactions.
- For comparability analysis consider – exclusivity, extent and duration of legal protection, geographic scope, stage of development, rights of enhancements
- Conduct comparability adjustments – unique features of transaction vis-à-vis comparables
- Scope of using commercial databases e.g. KtMine, RoyaltyRange
- Select Most Suitable TP method based on proper functional analysis
- One-sided and cost based method may not be suitable
- Can use CUP but be careful, if suitable CUPs not available use TPSM
- There is scope of using Discounted Cash Flow (DCF) to value IP

Intra-Group Service Contracts

Introduction:



- Generally refer to activities that are performed for one or more related parties within a group of companies.
- **Rationale of intra-group services:** Operational synergies, economies of scale, Development of centers of excellence, Centralized business strategies, among others.
- **Are there any tax motivations?**
- These services include:
  - Administrative services: Planning, Accounting, Auditing, legal, IT
  - Financial services: e.g supervision of cash flows, loans,
  - Assistance in production, buying, distribution & marketing
  - Staff services: Recruitment, training
  - Technical services-Back office business support

Key Considerations: Intra-Group Services

Main Issues:

- Determining whether an IGS has been rendered.
- Calculating the ALC

Determining an IGS has been rendered

- Benefits Test
- Chargeable vs Non chargeable Services
- Special considerations

Calculating ALC

- Charging : Direct Vs Indirect Methods
- Calculation : CUP , Cost Plus , TNMM

ALP

Key Issues: Intra-Group Services

Benefits test:

- ✓Seeks to determine that an IGS provides a group member with economic or commercial value to enhance or maintain its business position.
- ✓Considerations here are whether an independent enterprise in similar circumstances would be willing to pay for the activity; if performed by an independent enterprise or would have performed the activity for itself in-house.

Chargeable Vs Non chargeable services:

- ✓Shareholder activities
- ✓Duplication of services
- ✓Incidental benefits / Passive Association
- ✓On call services

Calculating ALC:

Charging:

Direct cost allocation:

- ✓ Group members are charged for specific services
- ✓ Identifies costs incurred for a particular service to a specific affiliate.

Indirect Cost Allocation:

- ✓ Used where proportion of the value of services rendered to each entity cannot exactly be quantified.
- ✓ Identifies all relevant costs and allocates them among all recipients using a sensible cost allocation key/keys.
- ✓ E.g. Manufacturing Support – No. of Trips produced
- ✓ HR Services- No. of Personnel
- ✓ IT?

Applied Transfer Pricing methods used:

1. Comparable Uncontrolled Price (CUP)

- ✓ Suitable when: There is a comparable service provided between independent enterprises.
- ✓ The related entity providing the service also renders it to independent enterprises in comparable circumstances.

2. Cost Plus

- ✓ Applicable in the absence of a CUP where functions, assets and risks are comparable
- ✓ Cost base is very important
- ✓ Mark-up

3. TNMM (Net Cost Plus)

*** **Low value adding services**

COST BASE (Verification mechanisms)

Service Provider

- How much does the service cost?

Service receiver

- How much is the service worth?
- How much would a comparable independent enterprise be willing to pay?
- How much do external independent providers charge for similar services
- How much would it cost to provide the service in-house?

Documentation (Burden of proof)

Key documentary evidence will primarily emanate from the taxpayer's documents:

- ✓Transfer Pricing Policy documentation
- ✓**Intercompany service agreements**
- ✓Correspondences and copy of emails between related parties of subject matter deliberations
- ✓Copy of invoices issued and/or raised
- ✓Detailed breakdown of costs incurred in provision of service with verifiable supporting documentation
- ✓Evidence of actual provision of the service-Demonstrate how the service is actually offered by producing any reports or outputs from the service.
- ✓For CUP – Invoices and documentation (third party agreements) demonstrating charge to third parties and other group entities
- ✓What would we need in case of cost allocation?
- ✓Demonstrate with verifiable evidence the ability of the service provider to provide the services.
- ✓*Any other relevant document all facts considered.*

Thank you