

Transfer pricing trends, common risks and case law on intangible assets (1) 3/28/21



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As the tax system evolves, the regulatory authorities have been rearranging their priorities around transfer pricing risks and focusing on increasingly complex cases in recent years. The transfer pricing aspects of intangible assets are climbing up the agenda, so we will be posting a few articles to explain the significance of related-party transactions involving the use of intangibles, as well as looking at transfer pricing trends, common risks, and relevant case law.

The substance and accounting for intangible assets

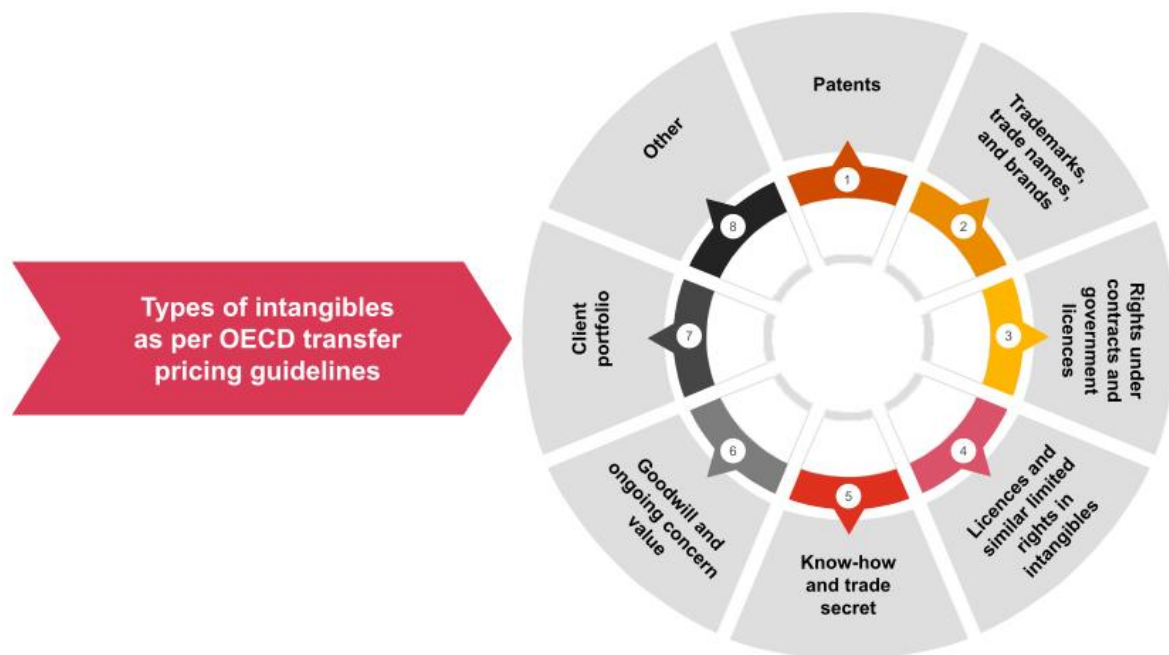
An intangible is an asset the company owns or controls that has these characteristics:

- This is not a tangible or financial asset;
- The company uses it in its business;
- Its use or transfer involves a consideration similar to one that is paid in a transaction between independent parties under comparable conditions.

It is important to note that intangibles for transfer pricing purposes are not always recorded as such in the company's books. Costs associated with in-house development of intangibles (e.g. R&D and advertising) are sometimes posted as expenses, rather than being capitalised in the books. So intangibles arising from such expenses do not always appear on the balance sheet. Yet those assets can be used for creating a considerable economic value and should be taken into account for transfer pricing purposes.

Types of intangibles

The OECD's transfer pricing guidelines specify the types of intangibles that are subject to transfer pricing. The picture below shows the main types:



Types of transactions involving intangibles

There may be two types of transactions with intangibles once they are split off:

- Transfer of intangibles – transfer of all rights in intangibles the company in fact sells, leading to a change of legal or economic owner;
- Grant of rights to use the intangibles.

Transfer pricing risks associated with intangibles

The transfer pricing risks associated with intangibles can be grouped into three main categories:

1. *The entitlement to a fee.* The main question relates to the legal/economic owner – we need to determine whether the payee is entitled to a fee by analysing the functions performed, risks assumed and assets used under the DEMPE (development, enhancement, maintenance, protection, and exploitation) concept.
2. *Incorrect pricing.* The risk that a price agreed between related parties is not arm's length and helps shift the profit to a certain jurisdiction. An incorrect price can appear in valuing the intangible, or because the transaction has been inaccurately defined, the functional analysis is misleading, the choice of method is wrong, or the application of the method is inappropriate. Incorrect pricing risk is crucial for unique and hard-to-value intangibles and for ones that are transferred at the stage of development.
3. *Substance.* The risk is associated with an artificial structure being used for intangibles. This risk is similar to the first one and involves aggressive tax planning, which was very common before the development of BEPS action plans, with multinational enterprises trying to register the holders of intangibles in jurisdictions with lower tax rates to minimise their tax burden.

Examples include shell companies that have no capacity (they do not carry on an active business and have no employees) but generate huge profits from payments they receive, for instance, for the right to use intangibles.

The main corollary of tax risks associated with intangibles is that licences or other types of payments are used for shifting profits to a jurisdiction with a more generous tax regime or lower rates.

Tax advantages are achieved by having the tax base reduced at the payer's end by deducting licences or other payments associated with intangibles. The payee, in turn, achieves a tax saving from lower tax rates or a special regime.

In our upcoming articles we will be exploring the concept of "hard-to-value intangibles" and the case law relating to intangibles in general.