Intangibles in a BEPS World and How the Netherlands Is Complying with OECD Rules

Many countries have already adopted or are poised to adopt changes to their international tax and transfer pricing systems based on the OECD recommendations under the BEPS project, specifically following the issuance of the package of final reports on 5 October 2015. In addition to discussing the changes to come, the authors address ways in which the Netherlands has implemented the OECD’s recommendations with respect to intangibles.

1. Introduction
On 5 October 2015, the OECD issued a final package of reports in connection with its Action Plan to address base erosion and profit shifting (BEPS), as well as a plan for follow-up work and a timetable for implementation. The OECD’s BEPS Action Plan, which was launched in July 2013 and endorsed by the G20, includes 15 key areas for identifying and curbing aggressive tax planning and practices, and modernizing the international tax system. The OECD delivered interim reports with regard to seven of the 15 action items in September of 2014. Those 2014 reports have been consolidated with the remaining 2015 deliverables to produce a final set of recommendations for addressing BEPS.

Many countries have already adopted or are poised to adopt changes to their international tax systems based on the OECD recommendations. While implementation and timing will vary across borders, this “final” OECD release on 5 October 2015 marked a crucial shift from the recommendation and consultation phase of the BEPS project to legislation and implementation. To help multinational organizations assess the potential impacts, this article analyzes the latest OECD recommendations and, in particular, focuses on intangibles and, finally, on substance-related items in a Dutch context, see section 7.3 below.

2. Background
Actions 8, 9, and 10 of the BEPS Action Plan relate to a number of closely related topics. These include the development of:
- rules to prevent BEPS by moving intangibles among group members;
- rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members, which will involve adopting transfer pricing rules or special measures (i) to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital and (ii) to require alignment of returns with value creation; and
- rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties.

Under these Actions, the OECD released more discussion drafts than any of the other Actions. Specifically, the OECD released the following deliverables under Actions 8, 9, and 10:
- initial report on intangibles: September 2014 (subsequent to the issuance of two discussion drafts);1
- discussion draft on low-value-adding intra-group services: November 2014;2
- discussion draft on risk, recharacterization and special measures: December 2014;3
- discussion draft on intra-group commodity transactions: December 2014;4
- discussion draft on profit splits in global value chains: December 2014;5
- discussion draft on cost contribution arrangements (CCAs): April 2015;6 and
- discussion draft on hard-to-value intangibles: June 2015.7

On 5 October 2015, the OECD released final guidance under Actions 8, 9, and 10 in a single document (the Final Report).8 The guidance takes the form of amendments to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). The Report covers risk and rechar-

6. OECD, Discussion Draft, BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs) (OECD 29 Apr. 2015), International Organizations’ Documentation IBFD.
7. OECD, Discussion Draft, BEPS Action 8: Hard-To-Value Intangibles (OECD 14 June 2015), International Organizations’ Documentation IBFD.

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characterization (chapter I of the OECD Guidelines), intra-group commodity transactions (chapter II of the OECD Guidelines), intangibles including hard-to-value intangibles (chapter VI of the OECD Guidelines), services including low-value-adding intra-group services (chapter VII of the OECD Guidelines) and cost contribution arrangements (chapter VIII of the OECD Guidelines). Key points relevant in the Final Report on Actions 8, 9 and 10 include the following:

– chapter I: addresses the capacity to assume and control risk; the relationship between contractual arrangements and conduct; as well as the return for low-functioning or “cash box” companies. It also sets out the circumstances in which transactions that lack commercial rationality may be disregarded. Given these changes and the outputs from other actions, no special measures were ultimately deemed to be needed. It also contains guidance on the treatment of location savings and other market features, assembled workforce and group synergies;
– chapter II: provides additions to address intra-group commodity transactions. This involves addressing applicable methods (generally the comparable uncontrolled price (CUP) method) and the application of the methods (e.g. economically relevant characteristics) to commodity transactions;
– chapter VI: clarifies the definition of intangibles and hard-to-value intangibles, and discusses ownership of intangibles and transactions involving development, enhancement, maintenance, protection and exploitation of intangibles. The Report provides supplemental guidance for determining arm’s length conditions in intangible transactions;
– chapter VII: provides guidance regarding intra-group services transactions and an elective simplified method or safe harbour for low-value-adding services; and
– chapter VIII: defines CCAs, addresses the value of contributions to CCAs and addresses the substance of CCA participants. As expected, this guidance accords with the principles in chapters I and VI to ensure that CCAs cannot be used to circumvent the new guidance relating to intangibles and risk.

3. Authors’ Observations

As expected from the OECD comments at the July 2015 Public Consultation, the guidance (i.e. chapter I of the OECD Guidelines) has changed significantly from the discussion draft. In the Final Report, the OECD recommends beginning with the contractual arrangement and reviewing it against the conduct of the parties. The Final Report (i) provides guidance on risk, the control over risk, the financial capacity to assume risk and (ii) removes content from the discussion draft regarding moral hazard. The guidance also makes it clear that non-routine profits are attributable to entities with substantive decision-making functions (in contrast, ‘cash boxes’ may receive only a risk-free rate of return for funding).

The Final Report contains a substantially new section on the identification of risk in commercial or financial relations. Control over risk should be understood as the capability and authority to decide to take on the risk, and to decide whether and how to respond to the risk. A party requires both capability and functional performance as described above in order to exercise control over a risk. The Final Report provides that risks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over the risks, or does not have the financial capacity to assume the risks, will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks. Capital-rich entities without any other relevant economic activities (so-called cash boxes), which are therefore unable to exercise control over investment and other risks, will not be entitled to any premium returns. The profit that the cash box is entitled to retain will be equivalent to no more than a risk-free financial return.

The new guidance provides a theoretical framework or roadmap which taxpayers can follow to ensure that their ex ante allocations of risk are respected by the tax authorities. In order to increase the chances of success, taxpayers should (i) give careful consideration to their ex ante allocation of risk on a risk-by-risk basis, and (ii) ensure that this allocation is reflected in the written contracts and that the conduct of the parties is consistent with the new OECD guidance (especially in relation to control of risks) and that the conduct remains aligned with the contractual term over its life.

Attention also needs to be given to ensuring that transfer pricing documentation as described under Action 13 is also entirely consistent with the approach taken on risk. The revised chapter I makes specific reference to information likely to be included in the master file and local files as relevant to analysis of risks and their attribution. Consideration should be given to the discussion of important risk allocations in the master file where the overall context of the business is presented, in order to support the position taken; furthermore, risk allocations impacting local entities will need to be consistently documented in the local file.

10. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports, supra n. 8, at 51-54.
11. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports, supra n. 8, at 63-139.
12. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports, supra n. 8, at 141-160.
15. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports, supra n. 8, at 17, para 1.42.
17. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports, supra n. 8, at 15-38.
18. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports, supra n. 8, at 11.
4. Hard-to-Value Intangibles

The Final Report asserts that it is difficult for a tax authority to evaluate the reliability of information used by a taxpayer to price a hard-to-value intangible, given the information asymmetry between tax authorities and taxpayers. Thus, a tax authority may consider ex post evidence about actual financial outcomes to gauge the reasonableness of the ex ante price determined by the taxpayer. Ex post evidence is to be used only in situations when the difference between ex ante projections and ex post outcomes is “significant”, and when such a difference is due to events that were foreseeable at the time of the transaction. In addition, ex post evidence may not be used when the hard-to-value intangible is covered by an advance pricing agreement, when the difference in compensation for the hard-to-value intangible is not material (not more than 20%) and, under certain circumstances, when a commercialization period of five years has passed. The OECD has mentioned that implementation guidance on hard-to-value intangibles will follow in the near future.

Guidance on the implementation of this approach will be provided during 2016, and the practical application of the exemptions, including the measurement of materiality and time periods contained in the current exemptions, will be reviewed by 2020 in the light of further experience.

5. Revised Chapter VI

The intangibles guidance in the revised chapter VI remains largely unchanged from the September 2014 report, other than finalizing the previously provisional Section B. However, guidance on hard-to-value intangibles – previously issued only as a discussion draft – is now incorporated. More significantly, this guidance on hard-to-value intangibles covers situations when tax authorities may use ex post evidence when evaluating ex ante pricing arrangements (corresponding to the US commensurate-with-income approach). The final section on hard-to-value intangibles includes expanded limitations on the use of ex post evidence relative to the discussion draft.

As a general theme, contractual arrangements will come under greater scrutiny and pressure as the location of key functional substance (i.e. key personnel) will take increasing precedence over contractual entitlement (as well as financial capital and other assets) when allocating rewards as part of a transfer pricing analysis. Legal ownership alone does not determine entitlement to returns from the exploitation of intangibles. Associated enterprises performing significant value-driving functions related to development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangibles can expect appropriate remuneration. A group company assuming risks with regard to the DEMPE of the intangibles must exercise control over the risks and have the financial capacity to assume these risks. If a group company is only providing funding and does not exercise control over the financial risks, it is entitled to only a risk-free return. In the case of artificial structures, non-recognition of the transaction applies. The Final Report provides guidance on the situations in which valuation techniques can appropriately be used.

In exceptional circumstances, the transaction as accurately delineated may be disregarded, according to the OECD, when the exceptional circumstances of commercial irrationality apply. The key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, and not whether the same transaction can be observed between independent parties. More notably, the mere fact that the transaction might not be seen between independent parties does not mean that it does not have characteristics of an arm’s length arrangement. It is the fundamental underlying basis of the arrangements that matters, not whether the same transaction is observable between independent parties.

6. Revised Chapter VIII

The CCA guidance in chapter VIII has been modified to reflect the new chapter I, chapter V (i.e. transfer pricing documentation as described under Action 13) and chapter VI guidance, including hard-to-value intangibles. The Final Report still requires the contributions to be based on their arm’s length value rather than on their cost (except for low-value-adding services), and it now makes a distinction between contributions of pre-existing value and current contributions.

The Final Report makes an explicit distinction between (i) CCA for joint development of tangible and intangible assets and (ii) CCAs for the provision of services; the definition of a CCA remains broadly the same. However, it does make clear that the former may involve not just development, but also enhancement, maintenance, protection or exploitation of such assets. The key difference between the two types is that the former typically generate future benefits, whereas the latter typically generate only current benefits. In addressing the valuation of contributions, the Final Report advocates using “value” by way of general rule, with cost being used only exceptionally, such as for low-value-added services. In determining whether a party is a participant in a CCA, the Final Report has regard not only to whether there is a reasonable expectation that it will benefit (as in the existing OECD Guide—

19. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Report, supra n. 8, at 64.
20. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Report, supra n. 8, at 64.
23. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Report, supra n. 8, at 117-139.
lines), but also to whether the party exercises control over the specific risks it assumes under the CCA and has the financial capacity to bear those risks.29

In summary, the guidance ensures that CCAs are appropriately analysed and produce outcomes that are consistent with how and where value is created. The new guidance of the Final Report is included in the new chapter VIII of the OECD Guidelines on the application of the arm’s length principle to CCAs.

The final (BEPS Action 9) guidance on intra-group commodity transactions is an improvement on the earlier draft, as it states more clearly that the CUP is generally an appropriate method for commodity transactions30 (in contrast to the “sixth method” favoured by some developing countries) and provides practical guidance on which economically relevant characteristics might need to be adjusted in order to ensure comparability.31 It also makes clearer that tax authorities may impute the pricing date for a commodity transaction (usually the shipment date) only when the taxpayer has not provided reliable evidence of the actual pricing date. These changes should significantly reduce the risk of tax authorities’ recharacterizing the terms and conditions of commodity transactions, provided that such transactions are comprehensively documented.

As expected, the (BEPS Action 10) guidance on low-value-adding intra-group services did not change significantly from the discussion draft. The main changes to the low-value-adding intra-group services guidance include OECD recommendations that (i) tax authorities may adopt a threshold for which, if exceeded, the simplified method would not be allowed (the OECD does not set a specific threshold and it is up to local countries in the legislation to do so)32 and (ii) the markup under the simplified approach is 5% (as opposed to 2% to 5% in the discussion draft), with the exception of pass-through costs.33

The OECD has stated that, as part of the follow-up work after October 2015, it will complete guidance on profits splits and financial transactions; provide implementation guidance on low-value-adding services and hard-to-value intangibles; and develop a transfer pricing toolkit for low-income countries.34

7. Impact of BEPS Action 8 for the Netherlands

The 2013 Dutch Transfer Pricing Decree35 (the 2013 Decree) already seems very much in line with the Final Report36 with regard to BEPS Action 8. As such, it remains to be seen what changes and/or additions to the existing Dutch guidance as outlined above for the 2013 Decree will be required in order to fully comply with the new OECD Guidelines. The following specific items are currently already covered in the 2013 Decree.

7.1. Hard-to-value intangibles

The 2013 Decree already includes some guidance on hard-to-value intangibles. Under certain circumstances, the Dutch tax authorities take the position that it is not consistent with the arm’s length principle to agree on a fixed price when the valuation is highly uncertain at the time of the transaction, as the Ministry of Finance assumes that independent parties in a similar situation would not have agreed on a fixed price. This view of hard-to-value intangibles is also reflected in section 5 of the 2013 Decree, which gives the example of a situation where a new intangible asset has been developed and is transferred to an associated enterprise at a moment when its success remains insufficiently visible. In this situation, the valuation at the time of the transaction is highly uncertain, and the Ministry of Finance argues that stipulating a price adjustment clause would be reasonable.

In addition, the following example is included. In the situation whereby an intangible asset is transferred to a (foreign) group company and this intangible asset is subsequently largely (e.g. for more than 50%) licensed to the transferring Dutch company and/or to associated entities of this company established in the Netherlands, a price adjustment clause will be deemed to have been agreed unless the taxpayer makes it plausible that (i) there are business motives for the transaction and (ii) the valuation at the time of entering into the agreement can be determined to such an extent that independent enterprises would not have demanded a price adjustment clause.

So, the Dutch tax authorities take the position that it is not consistent with the arm’s length principle to agree on a fixed price when the valuation is highly uncertain at the time of the transaction, as the Ministry of Finance assumes that independent parties in a similar situation would not have agreed on a fixed price either.37

7.2. Cost contribution arrangements

The 2013 Decree also covers guidance on CCAs in accordance with the OECD Guidelines, under which the amount of the compensation of the participants in a CCA should not differ (materially) from the compensation which the respective enterprises would receive if they were to cooperate outside a CCA.38 In the current chapter VIII, the OECD Guidelines prescribe that the relative share of each participant in the contributions to the CCA correspond with the relative share of that participant in the

29. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10. 2015 Final Reports, supra n. 8, at 167.
30. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10. 2015 Final Reports, supra n. 8, at 53.
31. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10. 2015 Final Reports, supra n. 8, at 53.
32. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10. 2015 Final Reports, supra n. 8, at 159.
33. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10. 2015 Final Reports, supra n. 8, at 158.
34. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10. 2015 Final Reports, supra n. 8, at 185-186.
36. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10. 2015 Final Reports, supra n. 8.
37. See e.g. NL: SC, 17 Aug. 2008, Case 32.997.
38. Decree IFZ2013/184M.
total benefits expected. Whether this is the case must be assessed, in practice, on a case-by-case basis. According to the Netherlands, the arm’s length principle means that the relative share of each participant in the contributions to the CCA, as well as the relative share of that participant in the total benefits expected, is determined on the basis of the value on the open market. The 2013 Decree states that if it is plausible that the average relative added value of the individual performances contributed by the various participants to the CCA is approximately equal, it will be in accordance with the arm’s length principle to take the cost price of the contributions as a starting point when determining whether every party’s share in the total benefits expected corresponds with every party’s share in the contributions.

The 2013 Decree already covers a number of matters related to aligning value creation with transfer pricing outcomes, which is closely linked to Action 9.

7.3. (In)tangible fixed assets

In this example, the 2013 Decree describes where an (in)tangible fixed asset is transferred to a group company that does not have the required functionality to manage the risks associated with the (in)tangible fixed asset. Under the 2013 Decree, the transfer of assets to an acquiring group company that has no added value is regarded as not being at arm’s length. Because the joint profit will not increase, the price offered by a potential purchaser will be less than the asking price of the potential vendor. The transfer of the asset will then not materialize, as the transfer will also involve transaction costs.

The assumption in the 2013 Decree that third parties would not agree on an IP transaction if the total value of the IP does not increase as a result of the transaction, is not reflected in the OECD approach discussed above. This measure in the 2013 Decree is aimed at situations where such assets are contractually relocated to low-tax jurisdictions, but the purchaser lacks the required functionality (applying the concept of substance over form).

However, the 2013 Decree also requires that a relocation of the intangible fixed asset within the multinational group be substantiated in order to explain the logic behind the transaction from a Dutch financial and commercial perspective. Those provisions are reflected in section 8 of the 2013 Decree.

8. Conclusion

The 2013 Decree was ahead of OECD developments in its view that appropriate functionality is key to the management and control of intangible assets that generate entitlement to intangible-related returns. The 2013 Decree also includes a provision on hard-to-value intangibles, albeit not in as much detail as is the case in the above OECD approach. The OECD has provided more guidance on which Dutch and other taxpayers may rely once the OECD Guidelines have been amended.