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EY TAX Flash

Aspects to consider in relation to intangibles BEPS action 8 Chapter VI of the OECD guidelines

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The last update of the Transfer Pricing Rules issued by the Organization for Economic Cooperation and Development (OECD) incorporates the revisions made in 2016, which reflect the clarifications and revisions agreed in the 2015 report on Actions 8 and 10, guaranteeing that the transfer pricing outcomes are in line with value creation.

The report includes revisions to chapters I, II, VI, VII and VIII. It also provides examples on the matter of intangibles and how to analyze aspects related to the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE Analysis) of these assets. These examples are useful in practice and help us know how to apply these concepts in real situations that occur in the day-to-day.

Identifying intangible assets

In accordance with the Rules, the term intangible refers to 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.

In accordance with section A.1 of Chapter VI of the Rules, the following assets are considered intangibles: patents, know-how and trade secrets; trademarks, trade names and brands; rights under contracts and government licenses; licenses and similar limited rights in intangibles; goodwill and ongoing concern value; group synergies; and market specific characteristics.

Construyendo un mejor entorno de negocios

Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles

Intangible assets involve certain elements that are different from other transfer pricing transactions, primarily due to the difficulty of evaluating and identifying which company should receive the compensation for exploitation of the intangibles. The OECD guidelines state that legal ownership and contractual arrangements could be one way to identify the functions, assets and risks assumed by each company, but in practice, there may be no contractual arrangement and legal ownership by itself does not mean that that company has the right to receive the benefits generated by the use of the intangible asset, in accordance with the arm's-length principle.

The 2015 report on Actions 8-10, *Aligning Transfer Pricing Outcomes with Value Creation*, describes approximately 30 situations that involve different functions, assets and risks related to the DEMPE analysis for intangibles.

All of the people involved in performing transfer pricing analyses will find these examples useful in understanding the appropriate treatment and analysis of intangibles.

One of the examples illustrates a company that owns an intangible asset and also performs all of the functions related to the development, enhancement and exploitation of said intangible. This company evidently has the right to receive all the benefits generated by the intangible. In this case, the compensation is only received by the company that owns the intangible.

On the other hand, the situation could be as follows: if Company A owns the intangible, Company B provides the financial assets to develop the intangible and Company C has control over the R&D team, all three companies should receive compensation based on their functions, assets and the risks assumed. In this case, Companies A and B should receive a lower compensation amount than Company C, since Company C is responsible for the profitability of the intangible.

Transactions involving the use or transfer of intangibles

Identifying the intangibles involved in a particular transaction and identifying the owner of such intangibles is not enough for transfer pricing purposes. The type of transaction must also be identified. There are three main types of transactions:

1. Transfers of intangibles or rights in intangibles
2. Transfers of combinations of intangibles
3. Transfers of intangibles or rights in intangibles in combination with other business transactions

It is important to consider the type of transaction in the search for comparables, as there are cases where the comparable companies may transfer a single intangible or right or several intangibles, or intangibles in combination of another business transaction. In some of these cases it is very difficult to separate the intangibles, and in other cases the combination of several intangibles or a combination of the intangible and another business transaction enables the creation of value of both intangibles, which, if analyzed separately, would not show the same value. Therefore, it would not be appropriate to analyze the three types of transactions with the same search for comparables.

Supplemental Guidance for Determining Arm's Length Conditions in Cases Involving Intangibles

Transactions involving intangibles may be difficult to evaluate and compare due to the many variables that could change when licenses are granted or intangibles are sold. These variables 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.

The variables mentioned above may affect the compensation for the intangible; therefore, it is essential to perform a more thorough analysis to be able to compare compensations agreed based on variables that are similar to the analyzed intangible. For example, having exclusive rights in an intangible in one country is not the same as having global exclusivity.

Intangibles in Master Information Return

The Master Information Return required by the tax authorities in Mexico requests specific information on intangibles and the examples shown in the Exhibit to Chapter VI of the 2015 report on Actions 8-10, *Aligning Transfer Pricing Outcomes with Value Creation*, are very useful in seeing how companies address their intangibles and they set the standard on how to structure the allocation of returns based on value creation.

The Miscellaneous Tax Resolutions issued on December 22, 2017 explain the points stipulated in the Mexican Income Tax Law, which was last updated on November 30, 2016 and which establishes the obligation for taxpayers who meet certain conditions to present the Local File and Master File. Taxpayers are required to present information on the intangibles used by the Multinational Company, specifically, a description of the strategy used for the DEMPE analysis, as well as a list of the intangibles and legal owners, and a list of the contractual arrangements related to the intangibles. The main reason for requesting this information is to verify that the transfer pricing results are in line with the value creation and that the benefits are allocated correctly and in accordance with the risks assumed by the companies involved in the use of the intangible, so it is very important to have clarity as to whether the intangible generates value and which company of the group should receive the corresponding benefits. At this point it is important to comment that the creation of value can be generated by the intangibles involved or by the value chain or production, therefore, it is necessary to distinguish where the value is being generated, if the intangible is involved, or if there is any industrial or intangible secret that is not registered with the authorities.

Conclusions

For several years, the media has been discussing and publishing news stories about certain companies that have decided to use intangibles to create tax strategies to reduce the tax base of a jurisdiction without benefitting another. In response to these aggressive strategies, the authorities have begun to regulate the way intangibles are evaluated. This has led to considerations for intangibles being reviewed more thoroughly due to how easy it is to arbitrarily decide on an amount to transfer the earnings of one company to another, even from country to country.

What the tax authorities are looking for and what all companies should keep in mind with the implementation of the DEMPE analysis is the measurement of intangibles at fair value based on the value creation of the intangible, considering the development, enhancement, maintenance, exploitation and protection factors involved.

For further information about this bulletin, please contact any of the following professionals:

Enrique González
enrique.cruz@ey.com

Alma Gutiérrez
alma.gutierrez@mx.ey.com

Alberto Peña
alberto.penacostales@ey.com

Andrés Olvera
andres.olvera@mx.ey.com

Gabriel Lambarri
gabriel.lambarri@mx.ey.com

Marco Molina
marco.molina@mx.ey.com

Mauricio Fuentes
mauricio.fuentes@mx.ey.com

Mónica Cerda
monica.cerda@mx.ey.com

Olga Ponomareva
Olga.S.Ponomareva@mx.ey.com

Ricardo Barbieri
ricardo.barbieri@mx.ey.com

Ricardo Cruz
ricardo-manuel.cruz@mx.ey.com

Ricardo González
ricardo.gonzalezmtz@mx.ey.com

Violeta Valerio
violeta.valerio@mx.ey.com