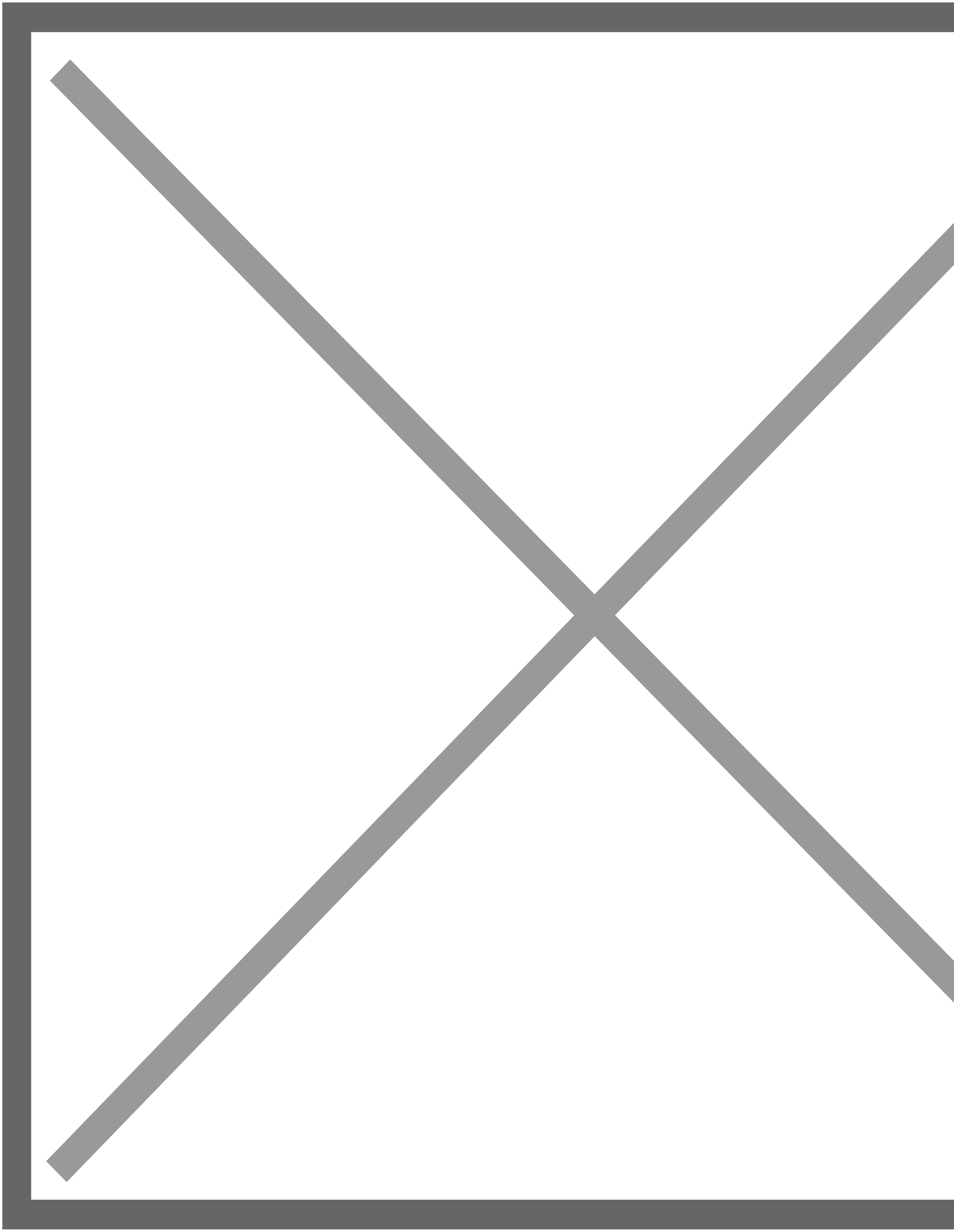
The IP evolution

Large Corporate



01 October 2017

Ronald van den Brekel and *Alex Postma* on how BEPS is changing businesses' tax focus on value creation

Key Points

What is the issue?

The OECD's BEPS recommendations have changed the rules around how businesses define IP and the related tax consequences.

What does it mean to me?

A description of businesses' IP strategy is now necessary as part of the BEPS documentation disclosure requirements.

What can I take away?

The changing rules will require businesses to review their entire business models to avoid material risks of added tax.

The Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting (BEPS) project has changed the rules around the recognition of intellectual property (IP) and related remuneration. Rather than being defined in the traditional sense by legal ownership and funding, the value of IP is now considered to be created by people functions that carry the responsibility for making key management decisions. It is important, therefore, that companies review their IP business strategy – not only because the tax consequences around IP may have changed, but also because a description of the IP business strategy is now necessary as part of the BEPS documentation disclosure requirements.

Organisations that view the impact of the OECD's BEPS project as only a tax compliance issue could be at a competitive disadvantage to those who see it as an opportunity to rethink their business and what is really driving value. Each organisation will have to make its own evaluation of the many potential impacts of the BEPS initiative on its global business. Different sectors will be affected to varying degrees by different BEPS measures, and industries that typically have significant investment in research and development (R&D) and IP will have very different concerns compared with sectors for which IP investment is less material.

The status of all kinds of IP is becoming increasingly important to business. Intangibles typically contain a company's value drivers and frequently the majority of total value. Further, intangible taxation is at the very heart of the BEPS project, which is very much focused on aligning taxation with value creation as conceptualized by the OECD. That being considered, there are three key changes to consider in the area of IP as a result of BEPS:

- The adjustment in the definition of IP and what that amounts to
- The rule changes on who is entitled to the income deriving from IP
- The information companies will now need to provide relating to IP

Let’s take a look at how each of these will impact businesses.

A new definition of IP is emerging under BEPS

The OECD has introduced a much broader definition of IP. Regarding transfer pricing, an intangible is much broader than legally protected rights. Using the language of BEPS, intangibles can be classified as ‘easy to identify’ (i.e. classic registered rights, patents, trademarks and domain names) and ‘hard to identify’ (non-registered intangibles such as know-how, marketing intangibles, distribution networks and goodwill). BEPS will therefore require business leaders to look at their organisations through a new lens and to learn new skills to respond to these changes.

It is likely that in many companies – even in sectors such as real estate or investment banking – some of the drivers of value will be intangible. Indeed, many companies’ competitive edge may be provided by intangibles, such as algorithms and knowledge processes. As the world increasingly connects socially, it may be argued that new value drivers will not so much be those that are easy to identify, but rather those more likely to be hard to identify – such as corporate purpose, culture and diversity, key relationships, sustainable supply chains, and user communities.

Notably, organisations need to take steps to ensure that their IP strategy takes into account the changing tax focus on value creation that the OECD requires in the area of intangibles. And R&D, marketing and other core processes could now lead to the creation of intangibles that will be recognized for transfer pricing purposes where they were not regarded before.

Rule changes on income entitlement

Once a business has defined intangibles under this new model, it is important to ask who should receive the income from the intangible.

It is clear that legal ownership is the starting point of any analysis, but mere ownership of the intangible is not enough to be eligible to receive the all profits. To determine entitlement, organisations need to establish who is controlling the ‘important’ functions related to the asset, by taking stock of the so-called DEMPE functions: development, enhancement, maintenance, protection and exploitation. Such analysis has to be based on the actual conduct of the parties.

The DEMPE construct is the means by which the OECD proposes to evaluate ownership for transfer pricing purposes. The view is that if a legal owner is to be considered to earn all of the returns associated with exploitation of an intangible, then it must perform all of the functions, assume all risks and contribute all assets related to the development, enhancement, maintenance, protection and exploitation of the intangible. If the legal owner does not meet these criteria, then other entities controlling and performing ‘important’ DEMPE functions should be compensated and consequently should earn a return related to the intangible. This does not mean that physically performing these roles is always necessary, but oversight and control of these functions will determine the entitlement to the intangible related return.

In practice, however, it may be a challenge to determine what an ‘important’ function actually is. The OECD’s guidance is explicit in the questions and criteria to be applied in this regard, but the fact finding will likely throw up a series of grey areas. Ultimately, organisations need to understand what relative contribution each function makes to the value chain. It is clear, therefore, that analysis and monitoring of the value chain will be critical.

The ‘master file’: disclosure of IP across the entire business

The OECD has proposed that companies should prepare documentation to be disclosed upon request, or with each subsidiary’s tax return, using a unique document referred to as the master file, thereby providing an overview of the entire business group. The required information will include a list of the group’s intangibles and details relating to which of these are driving value. Also required will be a section that describes the group’s intangible strategy, outlining how intangibles are managed.

Often, organisations do not have a clearly articulated strategy to cover intangibles, and certainly not those intangibles that are hard to identify. It will be interesting, therefore, to see how companies will approach compliance with this requirement.

Tax authorities around the world will not just look at the IP and IP strategy of a company, but they will also compare an organisation’s IP information with that of its competitors. Organisations may have to explain why their competitors list certain IP information that perhaps they don’t. In addition, a business’ list of IP, together with its IP strategy, needs to be consistent with global transfer pricing policies and outcomes around the world.

Creating an IP strategy is not only relevant for compliance purposes; it also offers benefits. For example, it will give management a higher level of awareness on specific areas of value. And in some cases, it may actually lead to different investment choices and allocations of capital, perhaps away from one business area or product with low value contribution towards others with a higher value.

The changing rules under BEPS will require organisations to review their entire business models to avoid material risks of added tax and to reconsider what is driving value. This requires input from all business functions, not only tax teams. Organisations exhibiting best practices are managing intangibles – and IP – from the executive management team and seeking early input in the decision-making process from an essential range of functions.

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