

Tax Flash

Czech Republic

Tax Flash is an electronic newsletter prepared by PricewaterhouseCoopers Česká republika, s.r.o. to keep you up to date on the latest tax and legal news. A more complex look at key tax changes and their impact on your business is provided in our monthly newsletter, Tax & Business News.

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Intangibles - new provisions in OECD Guidelines

On 6 June 2012, the OECD released the Discussion Draft of Chapter VI of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines") on intangibles.

It is proposed that the current provisions of Chapter VI of the OECD Guidelines be replaced by the new provisions as provided in the Discussion Draft.

The document is available on the OECD website under the following link:

<http://www.oecd.org/dataoecd/39/61/50526258.pdf>

The Czech tax authorities (especially the new specialised tax office operating since 1 January 2012 and focusing on transfer pricing) may seek to apply new provisions of Chapter VI in the tax disputes to the extent this is to their advantage.

Key changes

The key changes in the new Chapter VI are made in the following areas:

- How to define intangibles?
- Who is entitled to intangibles-related return?
- When are intangibles used or transferred?
- What is the price of intangibles?

Defining intangibles from the transfer pricing perspective

The intangibles are defined as "**something which is capable of being owned or controlled for use in commercial activities**".

Everything that is "not capable of being owned, controlled or transferred by a single enterprise" is not treated as intangibles (e.g. group synergies, low labor costs, proximity to markets, and, in most cases, assembled workforce).

Moreover, goodwill and going concern (with certain exceptions) are not considered separately as intangibles but rather taken into account as part of other business assets.

The Discussion Draft focuses on how independent third parties would behave in comparable situations, rather than on certain accounting, legal or general tax definitions. For transfer pricing purposes, the definition of intangibles is broader than that in the Czech GAAP, the commentaries of the Czech Ministry of Finance, the Czech Industrial Property Office and the definition of royalty under the OECD Model Tax Treaty.

Allocating entitlement to intangibles-related returns

The key test in allocating entitlement to intangibles-related returns is the **actual conduct of the parties and substance of the transaction**.

The owner of intangibles should have the requisite **capability and capacity to bear costs** related to intangibles and risks thereof, as well as **to control the important function(s)** related to the "development, enhancement, maintenance and protection" of intangibles.

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Intangibles - new provisions in OECD Guidelines (continued)

If the party to the transaction passively bears a cost but does not control the risks or critical functions, the ownership and the related returns should not be attributable to such party.

Importantly, contractual agreements and legal registration are seen as valid starting points for assessing ownership. However, the legal ownership and bearing of the costs do not entitle the entity to intangibles-related returns – rather this should be determined on the basis of relevant functions, assets and risks.

Differentiating between the use of intangibles and their transfer

The Discussion Draft provides guidance on factors that should be considered in the characterisation of intra-group transactions with intangibles and distinguishes between two broad classes of transactions:

- 1) Transactions in which intangibles are used in connections with sales of goods or services; and
- 2) Transactions in which the rights to intangibles are transferred as part of the controlled transaction.

The Discussion Draft considers the possibility of combinations of intangibles and their segmentation. These peculiarities are highlighted through examples in the consumer, pharmaceutical and IT industries.

Pricing the intangible transaction

The Discussion Draft confirms that associated enterprises do not necessarily operate in a manner similar to independent third parties and stresses the importance of comparability analysis and two-sided approach.

Draft Chapter VI raises the bar for comparability analysis and emphasises comparability adjustments – different factors (e.g. exclusivity, useful life, stage of development, rights to enhancements etc.) should be considered. In addition, the analysis should consider the “options realistically available” (including making no transfer at all) to each party.

The key guidance relevant to the intra-group pricing of intangibles is summarized below:

- A thorough understanding of the group's value chain, business process and its interaction with intangibles is necessary in setting up the price – transfer pricing methodology should not too readily assume that all residual profit is attributable to the owner of intangibles.

- Valuations done for accounting purposes may not be relevant for transfer pricing,
- Rules of thumb and valuations based on cost of intangible development are discouraged,
- If some intangibles have indeterminate lives, it does not mean that they are expected to produce non-routine returns indefinitely.

As a result of key changes in the draft Chapter VI, taxpayers may expect the following from the tax authorities:

- Separate valuation needed for transfer pricing purposes with strict guidelines,
- Increased challenge on the comparability of data used in the application of one-sided methods, and
- Overall closer examination of the processes followed to establish or document transfer prices in transactions with intangibles.

Should you be interested to discuss details of these changes, please do not hesitate to contact **David Borkovec** or **Natalia Pryhoda**.