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Subject: New Project on the Transfer Pricing Aspects of Intangibles

Dear Mr. Owens,

WTS is pleased to provide you with comments regarding scoping of the OECD project on intangibles.

WTS provides below an overview of points of which it believes should be covered in the final output of the OECD Working Party 6. The overview covers the most significant issues encountered in practice by WTS:

- lack of a unified definition of intangibles;
- lack of a unified classification of intangibles, and;
- lack of unified valuation methods and procedures for intangibles.

In general, we expect this project to become a very fascinating endeavor. The current discussion about intangibles has already intensified, and not only in transfer pricing matters. We are currently lacking a common ground on the definition and understanding of intangibles, which - among other problems - results in diverging tax laws and balance sheet treatments. And the work on business restructurings has led to even more issues which need to be solved.

For tax and reporting needs, it was usually enough to consider the position of the owner or buyer of an intangible. Already in that case, the treatment of goodwill has caused many discussions. In a business restructuring, it will also be necessary to consider the view of the seller. Seller and buyer of an intangible will in most cases have different benefits from the intangible, leading to different values for both of them. Since they are also related parties, it will be difficult to arrive at an exact sales price by applying economic theory.

For a single intangible, it might in certain cases be possible to arrive at one single value, for example by analyzing comparable transactions. In a business restructuring, we will usually have to look at several intangibles at the same time. This might or might not include goodwill or synergies. A business restructuring will often have to be treated as an acquisition of a company (or part of a company), due to the strong similarity with market transactions of legal entities.

In such an acquisition case, certain evaluation methods can be used. However, these methods do practically never arrive at one single price, but at a range of prices. Different from regular comparables in transfer pricing benchmarkings, such a range is not a range of real prices, but of possible prices (bid or offer prices). In other words, this range is a range for negotiation. This becomes even more obvious when both seller and buyer perform separate evaluations and/or use different methods to support their case and strengthen their negotiating position.

In the market, real negotiations take place and form the market price (or fail). In related party transactions, these negotiations do not happen, or at least have a different format. It will be a challenge to overcome this deficiency, either by applying negotiation theory or by allowing for a huge range to be used by taxpayers. Reference should be made to the solution currently in place in Germany, where the mean value between seller and buyer price is the final transactional value as long as no other value within the range can be economically justified. This outcome is somewhat backed by economic theory, which has shown that in certain situations a mean value can be the theoretical outcome. However, in most cases this will not be applicable. Other factors like time, negotiating persons, bargaining power, outside options, information, and tactics will play a role.

In the following, we will lay down our proposed structure for the OECD project on intangibles. We hope for a great discussion and a successful project.

Yours sincerely,

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Proposed Structure for the Project on the Transfer Pricing Aspects of Intangibles

Proposed Structure for the Project on the Transfer Pricing Aspects of Intangibles:

1. Definition / Identification of Intangibles

    a. Introduction

        i. What is an intangible? Can a general definition for tax purposes be identified? What is the difference between an intangible and "benefits" which are connected to the going concern of a business itself? When does a benefit become an intangible asset? Are hidden reserves / future profits an intangible? How about goodwill?
        ii. Can the OECD harmonize a definition for tax purposes with the definition of existing accounting standards.
        iii. Should we refer to single legislation (IFRS, US GAAP etc.) or propose a separate OECD approach to intangibles?
        iv. Can intangibles be split into legal ownership and economic ownership? If yes, what are the requirements to economically own intangibles?

    b. General Criteria to identify and define an intangible

        i. Is identifiability required to recognize an intangible? Under which circumstances? Could goodwill be qualified as a separate intangible or only as a part of a business/function that could not be utilized independently from the business/function itself?
        ii. To recognize intangibles, should it provide (long term) benefits? Is a benefit test required and in which circumstances?
        iii. Are costs connected to the intangibles relevant to be able to recognize intangibles? Under which circumstances?
        iv. Is transferability possible and/or required? Under which circumstances?
        v. Is legal protection required? Under which circumstances?
        vi. Is there a difference between self developed and acquired intangibles? Under which circumstances?
        vii. What is the distinction between intangibles and know-how? How do we treat know-how in case of secondments?

2. <u>Classification / Identification of IP under the criteria of Chapter</u>

   Do we recognize the single items mentioned below as intangibles and what would be an example definition of each item? Should the OECD list on intangibles be exhaustive?

   a. Patent
   b. Know-how (Production related)
   c. Marketing intangibles
   d. Trade intangibles / trademarks
   e. Hybrid intangibles (trade or marketing intangibles)
   f. Software (self developed software solutions)
   g. Customer or client list
   h. Brands
   i. Goodwill
   j. (Other) Rights
   k. R & D activities
   l. Functions in general
   m. Profit/ Loss Potentials
   n. Risks
   o. Services and service intangibles
   p. Synergy effects/Network effects
   q. Beneficial (long term) contracts
   r. People (Sport-Stars, Artists ...)
   s. People-related know-how
   t. Process-know-how
   u. Unique intangibles (which possibly create extremely high value)

3. <u>Possible Valuation approaches of intangibles</u>

   a. Will the OECD follow a general valuation approach or a specific approach per single intangible as classified above?
   b. Will the OECD refer to a (single approach on) valuation that already exists (IAS etc.)? Or will the OECD propose to have a separate OECD approach?
   c. Should the value of the intangible be based on costs, market value of other intangibles, the net present value ("NPV") of future cash flows / profits or on a combination of these valuation methods? Is there a preferred (other) valuation method?
   d. Does the OECD require different valuation methods under licence and purchase structures?

e. Cost valuation method

   i. How are the relevant costs identified?
   ii. Is a valuation possible based on production costs, replacement costs or a combination of both?
   iii. Is it relevant when the production costs were accrued? Should the production costs get compounded? What compound rate should be used?
   iv. How to handle depreciation / Financing costs / risks?
   v. To which extent is the cost valuation method considered appropriate when the R&D costs have been limited and the operating profit achieved with the intangible is high.

f. Market valuation method

   i. How can market data, e.g. prices for certain comparable intangibles, deemed royalty (relief-from-royalty-method) or license fee CUPS, be used for intangibles?
   ii. Reference to uniqueness of intangibles vs. comparables
   iii. Are Benchmarking studies possible, considering the uniqueness of intangibles?
   iv. To which extent are existing databases, including royalty agreements, considered appropriate to perform a benchmarking study on?

g. Net Present Value method

   i. Identification of cash flows / profits
   ii. Identification of Interest/Discount Rate
   iii. Valuation Period (Time of usage vs. perpetuity)
   iv. Cash flow effects of depreciations
   v. Tax effects
   vi. Can the incremental cash flow method be used to determine the value of the intangible?

h. How do we treat the negotiation process between seller and buyer?